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Chapter 10: Property Valuation

Overview

The franchise tax is .25% of the greater of a taxpayer's net worth or the book value of real and tangible property owned or used within the state.[1] The franchise tax property base, reported on Schedule G of the franchise and excise tax return, is often referred to as the "minimum tax base" or "minimum measure" because taxpayers without taxable net worth, or whose net worth is less than the book value of real and tangible property owned or used within the state, are subject to franchise tax based on the book value of their owned or used property within the state.[2] The franchise tax base will never 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.[3]

The franchise tax base includes the book value of tangible property owned or used in Tennessee, as determined in accordance with generally accepted accounting principles ("GAAP"). If books and records are not maintained in accordance with GAAP, the value of the property may be computed in accordance with the accounting method used by the taxpayer for federal tax purposes as long as the method fairly reflects the property's value. To the extent that GAAP records are not maintained by the taxpayer, the book value of property computed for federal tax purposes may be used in completing Schedule G.[4]

Schedule G must be completed regardless of whether the amount on Schedule F1 or F2 is greater than the Schedule G amount, and regardless of whether the federal Schedule L balance sheet is completed by the taxpayer.

1. Property Included

Tangible property owned or used in Tennessee is reported on Schedule G. All tangible property that is not exempt from franchise tax and that is owned by the taxpayer in this state should be included on Schedule G regardless of whether the property is held for sale, held for investment purposes, or in service during the tax year. Property reported on Schedule G, which is discussed in detail in later sections, includes:

- Land
- Buildings
- Leasehold improvements
- Rented and leased tangible personal property

- Machinery and equipment
- Furniture and fixtures
- Automobiles and trucks
- Inventories
- Prepaid supplies
- Other tangible personal property

> ⚠ **Reporting Tip: When reporting the book values of tangible property, taxpayers should separate land, buildings, equipment, and auto values. If taxpayers enter the total book value of all tangible property on one line, auditors may require the taxpayer's detailed books and records to verify the reported amount.**

2. Property Excluded

Computer Software

Computer software is not considered tangible personal property for franchise tax purposes, and it should not be included on Schedule G. Although capitalized software may be reported as a long-lived asset and amortized, it is nonetheless considered an intangible for franchise tax purposes and should be omitted from Schedule G.

According to GAAP, costs incurred for duplicating computer software, documentation, and training materials from the product masters and costs associated with the physical packaging of the product for distribution are considered inventory costs and are properly includable in the minimum measure as inventory.

Software that is depreciated because it is part of a tangible asset should be treated as tangible property for franchise and excise tax purposes.

- When dealing with these assets, the book value of depreciable property should be reported on Schedule G, and no value should be assigned to the software.

- For example, a bundled computer system may include preloaded software that is not separately invoiced.

- The removal of software from Schedule G may result in a decrease in franchise tax if the tax was originally computed based on Schedule G, as opposed to Schedule F.

Intangibles

Intangible property such as cash, stocks, bonds, and goodwill should not be included on Schedule G.

3. Property Exempted

Property exempt from inclusion on Schedule G is discussed in detail in later sections and includes:

- Exempt inventory
- Exempt capital investment
- Construction in progress
- Exempt certified green energy production facility equipment
- Certified pollution control equipment

Property Owned

For taxpayers whose tangible assets are owned and used entirely within the state, the amounts reported on Schedule G should agree with the related balance sheet prepared under GAAP accounting and to the related book basis depreciation schedule. Taxpayers that own or use assets both within and outside of the state will only report the assets owned or used in Tennessee on Schedule G.

If GAAP books and records exist, they must be used to compute the franchise tax base. However, if books and records are not maintained in accordance with GAAP, then federal tax basis records may be used.[5]

Railroad companies may choose to compute their franchise tax base by using either GAAP basis accounting or the accounting method used for federal tax purposes.[6] They may value their real and tangible personal property in accordance with the method used for federal tax purposes as long as the chosen method fairly reflects the property's value for franchise tax purposes.

1. Land and Buildings

The book basis cost of land is reported on the first line of Schedule G and the book value of real estate is reported on the second line. Auditors may reconcile these entries with information that is available to the public on the county property assessor's website.[7] This audit procedure may help the auditor identify possible real estate omissions from the franchise tax base.

- For example, if an auditor wished to confirm the ownership of a motel located in Mount Juliet, the auditor may:
  - Navigate to the county property assessor's website
  - Click on Wilson County on the map of Tennessee
  - Enter the property address
  - Then view the property's ownership information and sales records

Replacement Property from a Like-Kind Exchange

The basis of replacement property received in a like-kind exchange that should be reported on Schedule G in the year of the exchange is the purchase price (fair value) of the replacement property plus any other expenses that are properly capitalized to the replacement property under GAAP.[8] The replacement property will subsequently be depreciated in accordance with GAAP and the net book value of the property reported on Schedule G. See Chapter 11 for additional information on like-kind exchanges, including the basis of replacement property includable on Schedule G when GAAP records are not maintained by the taxpayer.

2. Leasehold Improvements

Leasehold improvements located in Tennessee are also included on Schedule G, Line 2. Note that lease expenses are not reported on this line.

Leasehold improvements are long lived amortizable assets. Improvements to a leasehold may provide a lessee with many of the benefits of property ownership. A lessee may invest in improvements on leased assets to enhance the assets' usefulness. These investments are referred to as leasehold improvements and are often made to property leased for relatively long periods of time.[9]

- Improvements may range from relatively inexpensive fixes to extensive remodeling to prepare the asset for the intended use of the lessee.
- Leasehold improvements (net of accumulated amortization) are reported on Schedule G, Line 2.
- Leasehold improvements are established in a separate account at cost and amortized over the shorter of the life of the improvement or the length of the lease.
- For franchise and excise tax purposes, leasehold improvement expenses are treated differently than the lease agreements themselves.
    - If a lease agreement expense is entered on Schedule G, Line 2 instead of on Lines 11-13, the franchise tax base will be understated because the expense will escape the franchise tax code's rental multiples.[10]

3. Depreciable Property

Depreciable property is reported on Schedule G at book value (cost less accumulated depreciation).

Only the property located in the state is reported on Schedule G.

- Amounts reported on Schedule G, Lines 1-4 should be the book value of the property as of the last day of the tax period, unless the taxpayer is in final return status, in which case the taxpayer must use either pre-liquidation values or monthly averaging.[11]

Schedule G - Determination of Real and Tangible Property		
Book Value of Property Owned - Cost less accumulated depreciation		In Tennessee
1. Land	(1)	
2. Buildings, leaseholds, and improvements	(2)	
3. Machinery, equipment, furniture, and fixtures	(3)	
4. Automobiles and trucks	(4)	

For additional information on final returns, see Chapter 5 – Filing Requirements.

Mobile and Movable Property

Construction companies, common carriers, and air carriers commonly have mobile/movable property. The value of mobile or movable property located both inside and outside the state, whether it is owned or leased, is based on the total percentage of time it is in the state during the tax period.

GPS tracking systems tied to industry specific software owned by many taxpayers may provide a means to accurately track assets by location and time. Common carriers and air carriers maintain mileage records by state because of state and federal reporting requirements. Mileage is considered a reasonable approximation of time and may be used for the Schedule G calculation.

However, the value of a vehicle assigned to a traveling employee is considered 100% in Tennessee if the employee's compensation is assigned to Tennessee for purposes of the taxpayer's apportionment formula payroll factor or if the vehicle is licensed in Tennessee.[12]

Mobile or movable property includes:

- Vehicles
- Construction equipment
- Trailers
- Containers
- Barges
- Airplanes
- Other Property

Audit – Mobile and Movable Property

When conducting an audit, auditors first gain an understanding of the taxpayer's business and consider what mobile or movable property may have been located inside and outside of the state.

Mileage Verification

For movable property apportioned on Schedule G, auditors may request and review the records that serve as the basis for the apportionment (time or miles) and test the calculation.

If mileage numbers came from the Schedule O, P, or R apportionment schedules, auditors may check to make certain that only the mileage portion of the ratio was used and that it was not reduced by the intrastate receipts or originating revenue. Because the Schedule O, P and R apportionment ratios are computed based on the miles of *all revenue-generating equipment* (even equipment that did not enter the state), the Schedule G amount should be computed as *all revenue-generating equipment* times the miles/mileage ratio.

If necessary, auditors may verify that the miles reported on Schedule O and the miles used in apportioning mobile equipment on Schedule G agree with the International Fuel Tax Agreement (IFTA) reports.

Traveling Employees

Auditors may verify that vehicles assigned to traveling employees are fully included on Schedule G if the employee's compensation is assigned to Tennessee or if the vehicle is registered in Tennessee and not apportioned based on mileage.

Auditors may also verify that any apportionment based on time or miles is applied only to mobile or movable property and not to all the Schedule G assets.

Property in Transit

Property in transit between a buyer and seller and shown on the books and records of the taxpayer in accordance with the taxpayer's regular accounting practices will be included in the minimum measure of the franchise tax if it is destined to a Tennessee location.[13] In some situations, property in transit between the U.S. and a foreign country is specifically exempted from all federal and state taxation under a U.S. treaty agreement.

4. Prepaid Supplies

Prepaid supplies are generally categorized as current assets or other assets on the balance sheet. Only prepaid supplies located in Tennessee are entered on Schedule G, not all prepaid expenses.

5. Inventory

Inventory reported on Schedule G, Line 7 includes all inventory included in the taxpayer's book/GAAP balance sheet and located in Tennessee, including raw materials inventory, work in progress inventory, and finished goods inventory. Any exempt finished goods inventory is deducted on Line 7b.[14]

Exempt Finished Goods Inventory

Finished goods inventory in excess of $30 million is exempt inventory. Exempt finished goods inventory that is eligible for deduction from Schedule G must meet the following requirements:

- Owned by the taxpayer;
- Stored in a facility used primarily for manufacturing, warehousing, or distribution of such inventory;

- Held for wholesale or retail sale by the taxpayer but not sold over-the-counter to consumers at the location where stored, (inventory not held at a retail location);
- Shown as inventory on the taxpayer's books and records kept in accordance with generally accepted accounting principles; and
- In need of no further fabrication or processing by or for the taxpayer; except in the case of configuring, testing, or packaging of computer products.[15]

Examples

- A taxpayer in the business of processing bourbon whiskey considered barreled whiskey as finished goods inventory after it was stored for two years.
  - The whiskey, if it meets the other requirements of the finished goods definition, would properly be classified as finished goods inventory, because after two years it met the federal definition of bourbon whiskey and was sellable without need of further fabrication or processing.
- An auto parts company with a division that rebuilds automotive parts (e.g., starters, generators and engines) cannot deduct the parts on hand that have not yet been rebuilt as finished goods inventory because they need further processing.
  - This inventory should be categorized as work in progress inventory in the taxpayer's records and fully reported on Schedule G.
- A taxpayer has a distribution center warehouse in Tennessee as well as several supermarket type grocery stores throughout the state. The taxpayer's inventory records revealed that it had in excess of $30 million of inventory, but less than $30 million at its warehouse facility. The taxpayer claimed a portion of this amount as exempt inventory, but it should have reported $0 in exempt inventory. Below is a schedule detailing the computations to arrive at this conclusion.

	2014	2015	2016
As Reported by Taxpayer			
Finished Goods Inventory –Total	$51,138,453	$52,380,714	$49,501,102
Finished Goods Inventory – Reported	30,000,000	30,000,000	30,000,000
Exempt Inventory	$21,138,453	$22,380,714	$19,501,102
As Reported by Auditor			
Finished Goods Inventory – Warehouse	$ 21,138,453	$22,380,714	$19,501,102
Other Inventories – Warehouse	1,036,047	1,406,747	2,694,595
Finished Goods Inventory***** - Grocery Stores	28,963,953	28,593,253	27,305,405
Total Inventories	$51,138,453	$52,380,714	$49,501,102
Exempt Inventory	$ 0	$ 0	$ 0

***** This inventory does not meet the definition of finished goods inventory because it is held at a retail location.

6. Construction in Progress

Qualifying Property

Property that is considered construction in process ("CIP") is not included in the franchise tax base, as computed on Schedule G, nor is it shown as a deduction on Schedule G.[16] Property must meet four requirements to be considered CIP.

CIP property must be:

- Owned by the taxpayer;
- Clearly under construction;
- Not used by the taxpayer (either in whole or in part); and
- Shown on the books and records as property under construction, where no depreciation expense has been recorded.

Tangible Personal Property

Tangible personal property ("TPP") may also qualify as CIP if the property meets the criteria and supporting documentation is provided. When tangible personal property is placed in service, it can never revert to a CIP classification regardless of any repairs, periods of inactivity, obsolescence, maintenance, etc. Depreciation expense taken on an asset indicates that it has been placed in service and therefore no longer qualifies as CIP.

For TPP to qualify as CIP, the property must:

- Be owned by the taxpayer;
- Be recognized on the balance sheet in a construction in process, or similar type of, account (except for inventory), where the asset is not being depreciated or expensed for book and/or tax purposes or is part of an inventory classification;
- Never be utilized or benefited from at any time, either in whole or in part, (as well as not being considered an inventory item); and
- Need additional work or completion, such as installation, configuration, or improvement, etc., before any operation or utilization can begin.

Example

- A diversified manufacturer has plants in several states, including one in Tennessee. During the period under audit, its plant in Tennessee was undergoing a production line expansion where specialized machinery and equipment as well as leasehold improvements were booked to a CIP account and reported as such in the year-end financial statements.
- Both the tangible property and leasehold improvements are allowed as excludable CIP from the minimum measure of the franchise tax base, as computed on Schedule G.

CIP on Balance Sheet

Generally, the balance sheet will show a CIP account that accumulates the costs incurred as the construction project is being completed. When the project is complete, the CIP account balance is transferred to a fixed asset account and depreciation begins. When the asset is placed in service and depreciation begins or any part of the project is utilized, the asset is no longer exempt from inclusion in the minimum measure. For example:

- If a company is incurring costs to build a retail facility, and the facility is not yet complete at year end, then the costs associated with the project are considered CIP since the property is not yet in use.

  - For accounting purposes, this means the property is not yet capitalized as a depreciable asset, and the company cannot take depreciation expense on the asset. As such, costs incurred go into some type of CIP account in the asset portion of the balance sheet.

  - When the project is finished, the costs roll over from a CIP account and are set up as a depreciable asset like any other facility, building, warehouse, etc. At this point, the asset is in use, and depreciation expense is allowed on the capitalized value of the property.

  - These classifications are consistent with GAAP rules as to the recognition of the value of an asset that is either CIP or a depreciable asset.

Utilization of Property Evidenced by Depreciation

The CIP exemption is intended to exclude only property that has not yet become a part of the capital employed in the business of the taxpayer. If property is in the process of being constructed and there is no actual utilization by the taxpayer, then it is not included in the franchise tax base, as computed on Schedule G. For example:

- If a manufacturer is building a new plant or is expanding an existing plant, then the amount will not be included in the franchise tax base until the construction is utilized in the business.

- If a big box retailer is expanding its space in a shopping mall, then the costs incurred for the new build-out would not be included in the minimum measure until the space is opened to consumers.

- If the taxpayer puts a fixed asset into use on the last day of its business year, then the entire amount would be included in the minimum measure.

For CIP to be excluded from Schedule G, the property under construction must have never been utilized or depreciated. CIP is reclassified as a depreciable asset when construction has been completed and the asset is being used. Once depreciation begins, an asset can never revert to CIP status.

Construction Businesses

The determination of the utilization issue depends, in large part, upon the nature of the business of the taxpayer. The nature of the taxpayer's business may indicate that the property in question is not CIP.

When construction is the very essence of a taxpayer's business, the property under construction must be included on Schedule G. Contractors in the business of constructing buildings should treat their unfinished projects as work-in-progress inventory and *not* exempt CIP. For example:

- A taxpayer in the business of building commercial office space for lease is using the buildings it has under construction in conducting its business.

- The buildings under construction are part of the capital employed in doing the taxpayer's business and are includable in the franchise tax base.[17]

CONTRACTUAL BUILDING

When construction companies perform construction on other persons' properties, pursuant to a contract, the property is not included as property on the construction company's Schedule G. Many builders use the "percentage of completion" accounting method, and their balance sheets will show a receivable for the amount of unreimbursed building costs or a liability if payment was received before the work was completed.

- The receivable/payable accounts may be referred to as "Costs in Excess of Billings," "Billings in Excess of Costs," or simply "Accounts Receivable."

- The use of these accounts would not trigger Schedule G recognition because the builder is not the owner of the property.

- In this case, the structure being built is not CIP for the builder, but the structure may be CIP for its owner. A review of the underlying construction contract will provide the name of the true owner.

If a taxpayer does not own the property, the CIP exclusion is not available to the taxpayer. The taxpayer would complete Schedule G like any non-construction taxpayer and the receivable accounts would be ignored. For example:

- A construction company agrees to build a structure for another entity. The construction company incurs material and labor costs as the structure is being built but will invoice the owner to recoup those costs plus a portion of the expected profit. The builder is paid periodically as the work progresses.

    - We can conclude that the builder is not the property owner because the construction costs are being reimbursed by the true owner that is named in the underlying construction contract.

Speculative Builders

If the taxpayer is a speculative builder, construction costs would be considered inventory and reported as inventory on Schedule G. Like manufacturers, speculative builders should report all types of inventory (raw materials, work in progress, and finished goods).

Audit of CIP

In evaluating a CIP exclusion, auditors will consider the given property's ownership, utilization, and depreciation.

- *Ownership of the property* – Because CIP is not included in the amounts reported on Schedule G, auditors may consider whether Schedule G omissions represent excludable CIP. A key component that auditors evaluate when auditing construction activity is whether the taxpayer owns the property at the completion of the project.

    - If the construction company *does* own the property at the completion of the project, and construction is the very essence of the company's business, the property would be considered work in progress inventory.

        - The property would be included in the construction company's franchise tax base, and the company would be liable for franchise tax on the property.

    - If the construction company *does not* own the property at the completion of the project, the property would not be considered inventory.

- The property would not be included in the construction company's franchise tax base, and the construction company would not be liable for franchise tax on the property.

- *Utilization of property* – Auditors may inquire as to how a partially-built facility or piece of tangible personal property is being used. They may inquire about:

  - The accounting treatment of the property
  - The property's history of activity
  - The taxpayer's history with the property

- *Depreciation* – Generally, CIP claimed in an audit period will have likely been placed into service by the time audit work begins. As such, auditors may review depreciation schedules subsequent to the audit period to note when depreciation was first taken.

Potential Audit Adjustments – The following types of taxpayer errors could result in an audit adjustment that *increases* the franchise tax base:

- CIP was deducted from the Schedule G franchise tax base without first being included in the tax base. The net effect of the CIP entries was not zero.

- Depreciation was taken on the CIP before the end of the audit period. When depreciation begins, the property is no longer CIP and should be included in the franchise tax base like any other tangible property.

- The CIP exemption was claimed but the property should have been treated like inventory and included in the tax base.

The following taxpayer error could result in an audit adjustment that *decreases* the franchise tax base:

- An amount included in the Schedule G franchise tax base was under construction and had not been placed in service as of the end of the audit period. As such, it should have been excluded from Schedule G.

7. Exempt Certified Pollution Control Equipment

Certified pollution control equipment is property used primarily for air or water pollution control or treatment of hazardous waste that has been certified by the appropriate government authority as necessary to meet the requirements of state, federal, or local law.

- The book value of this equipment should be reported with other equipment on Schedule G, Line 3, and then deducted on Schedule G, Line 8.
- The deduction amount should be the book value of the equipment and not its original cost.
- The book value of certified pollution control equipment may be deducted on Schedule G to the extent it was previously included on that same schedule and only if the Certificate of Exemption for Pollution Control is provided. [18]

8. Exempt Certified Green Energy Production Facility

A certified green energy production facility is a facility certified by the Department of Environment and Conservation to produce electricity for use and consumption off the premises using clean energy technology.

Clean energy technology is technology used to generate energy from geothermal, hydrogen, solar, and wind sources.

The book value of equipment used to produce electricity at a certified green energy production facility may be deducted on Schedule G to the extent it was previously included on that same schedule and only if the Certificate of Exemption for Green Energy is attached to the return.[19]

See the Supplement Application for Certified Green Energy Production Facility and the related instructions for additional information.

9. Exempt Required Capital Investment

Taxpayers may take a deduction for two-thirds of the book value of capital investments that constitute the taxpayer's required capital investment made to qualify for the *additional annual job tax credit for higher level investments and job creation* ("HLIJC job tax credit").[20] Exempt required capital investments are deducted on Schedule G, Line 9.[21] If this exemption is claimed on Schedule G, Line 9, auditors may verify that the taxpayer claimed the HLIJC job tax credit on Schedules X and D of the tax return.

- The investments will qualify as "exempt required capital investments" only in those tax years in which the HLIJC job tax credit is allowed.

- The investment can include real or tangible property, purchased or leased.

- The Schedule G exemption may only be claimed for tax years in which the taxpayer claimed the HLIJC job tax credit.

Calculation

- The calculation of required capital investments ("RCI") is made for each tax year of the investment period to determine the book value of the assets as of that tax year.

  - The value of assets in the first tax year is based on the RCI purchases in the first year of the investment period.

  - In subsequent years, any additional purchases within the investment period are included and any assets that were sold or removed from the state in that tax year are excluded.

- The value of assets in the minimum measure is always based on the net book value, so that each subsequent year a depreciable asset would have a decreased net book value.

  - Therefore, the exclusion of RCI is based on the same net book value as the assets when included in the minimum measure.
  - If the assets purchased as part of the RCI are financed through an Industrial Development Board, Tenn. Code Ann. § 67-4-2108(b) provides for treatment of those assets in the minimum measure.

10. Federal Repair Regulations

Federal repair regulations or tangible property regulations require that amounts paid to improve a unit of property are capitalized and that amounts paid for repairs and maintenance are expensed as a current deduction.[22]

In 2014, federal repair regulations changed depreciation rules and introduced a new system for maintaining accounts for tax depreciation, the multiple asset account method. This method permits taxpayers to group multiple assets into a single depreciation account.

To the extent that the taxpayer's books are <u>not</u> maintained under generally accepted accounting principles, Schedule G of the franchise tax return conforms to these federal rules.

Accounting Method Changes – Federal Form 3115

Changes that taxpayers must make to conform to the repair regulations are considered changes in accounting method. Although these changes are mandatory, taxpayers must receive IRS consent to make the accounting change on federal Form 3115 – Application for Change in Accounting Method. Form 3115 requires that taxpayers make a calculation known as a 481(a) adjustment to prevent items of income or deduction from being omitted or duplicated. For example:

- If a taxpayer in 2012 capitalized and began to depreciate an improvement cost that is determined, under the repair regulations, to be an expense deductible as a repair, the taxpayer would have to stop claiming depreciation deductions beginning with the 2014 tax year.
    - To prevent the taxpayer from getting neither the benefit of a 2012 deduction of the cost, nor the benefit of depreciation deductions in 2014 and later years, the taxpayer makes a 481(a) adjustment that decreases the taxpayer's gross income for 2014 by the amount of the repair cost less the depreciation claimed before 2014.
- Alternatively, if a taxpayer deducted repair costs in 2012 that would be capitalized under the repair regulations, the taxpayer would have to begin taking depreciation deductions in 2014 (calculated as if the taxpayer had, in 2012, capitalized the cost and begun taking depreciation deductions for the cost).
    - To prevent the taxpayer from getting both the benefit of the 2012 deduction of the cost and of the depreciation deductions to be taken in 2014 and later years, the taxpayer must make a 481(a) adjustment that is an increase, usually spread over a four-year period, of the taxpayer's gross income by the amount of the post-2013 depreciation deductions.

481(a) Adjustment Implications for Schedule G

Auditors often verify the values reported on Schedule G by agreeing the reported amounts with the taxpayer's GAAP financial statements and supporting depreciation schedules.

- When GAAP records are not maintained, tax basis records are allowed.
- Federal depreciation records may reflect changes because of the repair regulations and these changes will in turn be reflected on any Schedule G prepared using tax basis accounting.
  - In these cases, auditors may see newly capitalized amounts for items expensed in prior periods.
  - Auditors may also see previously capitalized amounts being removed from the current depreciation schedule even though the items acquired were not sold or moved out of state.

> ⚠ **Federal repair regulations may cause the franchise tax base to increase or decrease if a taxpayer's treatment to expense or capitalize a previously acquired repair or improvement item has changed under the repair regulations.**

- For example, a 2012 improvement might be reported on Schedule G for the first time in 2014 because of a 481(a) adjustment.
  - In this case, the auditor should not question why it was *not* reported on Schedule G in 2012 and 2013.
  - Similarly, a 481(a) adjustment might cause an asset reported in 2012 and 2013 to no longer be reported in 2014, even though the asset has not been disposed of or moved outside of the state.
  - Again, if the change was the result of a repair regulation 481(a) adjustment, it should be accepted without further investigation.

Property Rented or Leased

The franchise tax base is the value of real and tangible property owned or used within the state, including property rented by a taxpayer.[23] As with owned property, the source of rent expense amounts must come from GAAP records, if they are maintained by the taxpayer. To properly complete the rental section of Schedule G, the following topics, which are discussed in this section, should be considered:

- Property multiples
- Sub-rentals
- In lieu of rent
- Rent versus service
- License versus lease
- Operating versus finance leases
- Annualization requirements
- Property used, but not owed or rented

1. Property Multiples

The Schedule G value for rented property used in Tennessee is determined by multiplying the net annual rental by a statutory multiple.[24] The net annual rental amount is the gross annual rent paid less the gross rent received for sub-rental.[25] If the return is for a short period, the rents are annualized before applying the statutory multiple.

Most leased property clearly falls within one of the four "multiple" categories:

- Real property;
- Manufacturing equipment;
- Office furniture and equipment; and
- Mobile equipment.

Traditionally, the Department has treated construction equipment and items that do not seem to fit into other categories such as furniture, office machinery, and equipment. Planes, barges, and automobiles are categorized as delivery or mobile equipment.

Real Property

The Schedule G value of rented real property used in Tennessee is determined by multiplying the net annual rental[26] by 8.

- This amount is reported on Schedule G, Line 11.

Manufacturing Equipment

The Schedule G value of rented manufacturing equipment used in Tennessee is determined by multiplying the net annual rental by 3.

- This amount is reported on Schedule G, Line 12.

Furniture, Office Machinery, and Equipment

The Schedule G value of rented furniture, office machinery, and equipment used in Tennessee is determined by multiplying the net annual rental by 2.

- This amount is reported on Schedule G, Line 13.

Delivery or Mobile Equipment

The Schedule G value of rented delivery or mobile equipment used in Tennessee is determined by multiplying the net annual rental by 1.

- This amount is reported on Schedule G, Line 14.

2. Sub-Rents

To qualify as a sub-rental:

- Rents received and rental expenses must be for the same property, and
- The sub-lessee must have the same rights as the original lessee with respect to the use of the property.[27]

Sub-rental income is only considered to the extent that it offsets the rental expense for that particular property. Rentals included in the minimum measure of franchise tax may be offset by sub-rentals only to the amount of rentals paid. If sub-rental income exceeds the corresponding rental expenses, the correct inclusion on Schedule G would be zero and not a negative value.[28]

Sub-rental income is not treated in the same manner on Schedule G and Schedule N. Sub-rents in relation to the property factor of the apportionment ratio are discussed later in Chapter 14 – Apportionment.

Examples

- A real estate developer is the lessee of a motel, and it leases rooms to guests daily.
  - The amounts received from guests are not sub-rents, and there is no Schedule G offset.

- The guests did not have the same rights as the lessee with respect to the use of the property.[29]

- A real estate developer is the lessee of a motel, and the developer leases the entire building to a motel operator.

  - The amount received from the motel operator is sub-rental income because the operator was treated as owner of the property and was given exclusive possession.

  - There was more than just a license or authority to do an act or series of acts on another's property.[30]

- A leased public warehouse contracts with customers to manage and store their inventory. The contracts detail the charges for facility rent, labor, and other expenses.

  - In this case, it was found that no portion of the receipts was considered offsetting sub-leases.
  - The contracts failed to show any transfer of property (an optional/alternative warehouse could be used), and they never indicated that the customers were granted any interest in the leased premises.

  - Contrarily, the contracts gave the taxpayer/lessor exclusive possession and control of the warehouse facilities. The fact that the contract named an amount for rent is not sufficient to treat that amount as an offsetting sub-lease.

  - The important question is whether the taxpayer/lessor granted the right to exclusive possession of the leased premises.

- A taxpayer rents a ten-story building and occupies two floors and subleases the remaining floors.

  - If the sub-lessee has the same rights as the taxpayer with respect to the use of the property, the rental receipt would be deductible as sub-rents on Schedule G.

  - In no case should the sub-rent deduction bring the related rent expense below zero.

- For example, if the annual lease for the entire ten-story building was $1,000,000 and two floors of the building are sub-leased for the same amount, then the Schedule G amount before the multiple should be zero [$1,000,000 - $1,000,000 = $0].

Audit - Sublease

When auditors encounter subleases, they may request copies of all lease documents and verify that:

- The taxpayer's lease is a true lease and not a license or service;
- The sublease is for the same property;
- The lease and sublease agreements have the same terms with respect to the use of the property; and
- The deduction amount agrees with the taxpayer's books and records and is computed as discussed in the prior paragraph.

3. "In Lieu" of Rents

A lessee's payments made to others on behalf of the lessor of real estate are considered rent for franchise and excise tax purposes.[31] Before "in lieu of rent" payments can be included as rents in the franchise tax base, it must be established that the payments tie to the property leased by the taxpayer.

Interest, Taxes, Insurance, and Repairs

The lessor of real estate is generally the owner of the property and, as such, is the party responsible for paying expenses related to the property. The following payments made by a lessee to a lessor, or to someone else on behalf of the lessor, are considered rent if there is an agreement that the lessee pay them:

- Interest
- Taxes
- Insurance
- Repairs

- Other expense items involving leased real property.

Interest, taxes, insurance, and repairs are *not* in lieu of rent payments if:

- It is shown that the taxpayer's lease was only for land and that the expenses were related to a building owned by the taxpayer and not the leased land.
  - Long-term ground leases are common in areas where land is very valuable but is rarely for sale. Businesses wishing to operate in these areas will enter long-term ground leases and then build structures on the land. Therefore, the taxes, interest, insurance, and repairs on a taxpayer's books may be in relation to a building they own and not the land they lease.
- The lease is for tangible personal property. The recharacterization of in lieu of rent expenses only applies to real property.
  - A copier with monthly rents of $100 plus a maintenance agreement of $20 per month to cover service, toner, etc. would be reported on Schedule G in the amount of $1,200 under "furniture, office machinery, and equipment" (multiple 2). The reported amount is the $100 base rent times 12 months. The maintenance charges are not part of the calculation.

4. Rents that Include a Service

A taxpayer may pay for a service that includes equipment. When a taxpayer pays for a service that includes the use or rental of equipment, the entire payment should be categorized as being for a service if the taxpayer does not have the expertise to use the equipment on its own. For example:

- A taxpayer needs trees cleared from a lot and he hires an excavation company to do the work. In clearing the lot, the excavation company utilizes both equipment and an operator.
  - In this case, the primary element of the transaction is a service, and therefore, no rental amount would be included in the minimum measure.
  - The taxpayer did not have any control, use, or possession of the equipment.

- However, if the taxpayer leased the bulldozer and used its own labor or contracted separately with an operator, then the bulldozer rents would be included in the minimum measure.

Form and Substance of Agreements

Lease/rental agreements may take on multiple forms, such as:

- One invoice that shows a single amount for the equipment and labor used;
- One invoice with breakdowns for rents and the operator's labor charges; or
- Two invoices from separate providers.

No matter the form, if the substance is that a service was provided to a business that had no capacity of using the equipment on its own, the entire amount is considered a service and not rents. For example:

- A builder enters into an agreement with a crane company to place a steel beam on top of a structure under construction.
  - Even though the crane company's invoice shows charges for both equipment rental and labor, the entire amount should be considered a service and thus excluded from Schedule G.
  - Because the builder could not operate the crane on its own, it is evident that a service was purchased.
  - If the equipment rental (crane) and operator are contracted for separately and the builder receives two invoices from different providers, the equipment rental will still be considered a service. The crux of the transaction is the same in that the equipment is of no value to the builder without the contracted operator.

Ability to Operate Equipment

If a taxpayer has the skill and ability to operate certain equipment but chooses to contract with a third party to provide both labor and equipment, the amount paid still would be considered a service, because the taxpayer does not have specific rights to use the equipment and would most likely be in conflict with the owner if it tried to do so.

However, the outcome would be different if the taxpayer entered into separate agreements with the equipment lessor and the operator. In this case, the taxpayer would have the right to use the equipment on its own in addition to providing it to the operator for use, and the equipment rents would be includable on Schedule G.

Common Carriers and Trucking Companies

Common carriers and trucking companies often contract with "owner operators" to pick up and deliver goods for them. The owner operators perform a service using their own equipment and labor. The owners may operate under the trucking company's motor carrier (MC) authority, and their equipment may be included in the trucking company's annual Tennessee Ad Valorem Tax Report. Here, there is a service provided by the operator that entails both equipment and labor, which is not reportable on Schedule G of the trucking company. However, if the owner operator is a Tennessee taxpayer, its equipment used in the state would be reported on its Schedule G.

Third-Party Warehouse and Distribution Centers

Often the "service or lease" question arises when a taxpayer contracts with a third-party warehouse and distribution center to store and distribute its inventory. In addition to warehousing, these centers may offer a variety of services including inventory management, logistics, transportation, and packaging.

Even though the use of real property is integral to the services provided, no amount should be considered Schedule G rent unless the underlying agreement grants a specific, designated space for the taxpayer's exclusive use and full access and provides for a fee based on area (square footage) and time. Even though the agreement may indicate a monthly charge for rents based on square footage, no amount is includable on Schedule G unless the space is a specific/defined area with exclusive use and full access granted to the taxpayer.

Warehouse and distribution agreements often have elements of both real estate rents and services. When reviewing the actual agreement for possible Schedule G inclusions, auditors will consider the following:

- Does the taxpayer have use, full access, and rights to a designated space or area? Does the taxpayer have the type of rights to use the property that lessees normally have (such as lessees of office space)?

- Is the charge, whether labeled rent in the contract, based on an actual, specific space, or is it based on a service provided by the vendor in which the vendor uses the space?

- Who bears the risks and rights of the warehouse space, the vendor or the taxpayer?
- Who runs and operates the facility, the vendor's employees or the taxpayer's employees?

5. Distinguishing Between Leases and Licenses

Licenses can have aspects that are very similar to leases, but licenses are not includable in the franchise tax base. The proper categorization of a transaction as a license or a lease is paramount in determining whether it should be included on Schedule G.

- The account name used in the taxpayer's books and records may not accurately describe the transaction. Sometimes bookkeepers use the words "rent" and "license" interchangeably, and transactions may have elements of both a license and a lease.
- Classification could turn on facts specific to a given contractual agreement.
  - For example, a contractual agreement for use of a conference room may be more like that of a motel room as opposed to a business office, and as such, would be classified as a license instead of a lease.

Auditors may inquire and review the underlying contract before reaching their conclusion as to whether an agreement is a lease or a license.

Leases

Generally, during the existence of a lease, the owner transfers the right to possess the leased property to the lessee, who is treated as the owner of the property and is entitled to exclusive possession. When the lessee is treated as the owner of the leased property, the lessee may control and use the property as if it were the true owner. However, the lessee is not required to pay the true owner's property tax and insurance on the leased property.

A lease must be for a defined area of real estate or specific, identifiable tangible property. The ability to assign the lease to others is not a requirement to be includable on Schedule G as a lease, but if this feature is present, it is likely that the agreement is a lease and not a license.

Examples of Leases

- Storage Spaces

  - The tenant has exclusive control and use of a defined space, and the relationship is like that of a landlord/tenant.

- Car Rentals
  - Lessee has exclusive control and use of car, and the lessee is treated as the owner during the lease term.
- Business Offices
  - Landlord/tenant relationship where tenant has exclusive control and use of a designated space and is treated as the owner during the lease term.
- Conference Rooms
  - Lessee has exclusive control and use of a designated space and the agreement is similar to an office lease that treats the lessee as the owner in relation to the specific property.
  - This could easily be a license if the underlying facts were different.
- Forklift Rentals
  - Lessee has control and use of the equipment, even though the lessor may put some normal, reasonable restrictions on its use.
- Mall Kiosks
  - Lessee has exclusive possession of a defined area and control over the kiosk.
  - This could easily be a license if the underlying facts were different.

Licenses

A license, with respect to real estate, is an authority to do a particular act or series of acts on another's property without possessing any estate therein. Leases are includable as rents on Schedule G, but licenses are not.

- Licenses provide a limited privilege. Generally, a license is not assignable and is revocable at the will of the licensor. Licenses may exist for real estate and other types of tangible and intangible property.

Examples of Licenses

- Motel rooms
  - A guest only has a license or privilege to occupy; the owner retains legal possession of the property and maintains control of it.
- Reserved ticket seats
  - Patrons have a license to occupy the designated seats during an event (a limited act), but the owner retain control of the real estate and may revoke the license.
- Parking lot spaces
  - A landlord/tenant relationship does not exist; it is only a license to do a particular act (park) on the property.
- Storage in an undesignated warehouse space
  - This is not a landlord/tenant relationship; there is no set space and the products stored there could be moved by the real estate owner.
- Hunting privileges
  - A license to do a particular act on the land.
- Vending machine locations
  - A license, since the vending machine owner did not have exclusive possession or control of the area.
- Billboards
  - A license to do a particular act (advertise); the owner maintains control.

- Land "leases" for mineral extraction
    - Payments are actually for mineral extraction, even though the books and records classify them as "rents."

6. Annualize Rent in Short Period

Taxpayers must annualize rents on all short-period returns.[32] As with proration, taxpayers must use the *number of days method* to annualize rent. To arrive at annualized rent, multiply the rent expense by 365.25 and then divide the product by the number of days in the short period.

- Annualized Rent = (Rent Expense x 365.25) ÷ # of Days in the Short Period
    - The rent expense comes from GAAP accounting records, unless GAAP accounting records are not maintained by the taxpayer.

Example

The tax period is January 1st to June 30th. Real estate rents of $60,000 were expensed for the tax period per GAAP basis financial records. These rents represent the taxpayer's only tangible property owned or used in Tennessee during the tax period. The franchise tax property base (Schedule G) is greater than the net worth base (Schedule F1) and is used in computing the franchise tax liability. In this example, the rents are annualized and the franchise tax is prorated, resulting in a tax liability of $1,200.

- Annualized Rents are $121,077.35
    - ($60,000 x 365.25) ÷ 181 = $121,077.35
- Franchise tax property base reported on Schedule G is $968,618.78
    - $121,077.35 x 8 = $968,618.78
- Prorated franchise tax base is $480,000
    - ($968,618.78 x 181) ÷ 365.25 = $480,000
- The franchise tax is $1,200
    - $480,000 x .0025 = $1,200

7. Termination Fees, Renewals, and Software Fees

Termination Fees

Costs paid to terminate an existing lease are not Schedule G rents. Termination fees are not paid for the use of property, but are a form of liquidated damages for breaking a lease.

Lease Renewals

A lease may have an initial term for a set period with guaranteed renewals of an additional period. The annual rental during the initial period may differ significantly from the rental during the renewal period. Under GAAP, the annual lease expense is recorded based on a level lease stream over the life of the lease, including the renewal. This GAAP basis leveling is not followed for federal income tax purposes and is reported as a federal Schedule M-1 or M-3 adjustment. If GAAP basis records are maintained, the amount reported on Schedule G is the same as reported under GAAP: the adjusted-leveled-lease amount. Contrarily, the Schedule N apportionment factor amount is always from tax basis records; so, the property factor amount is the rent expense reported on the federal return.

Software

Software licenses, leases, subscriptions, and software research and development costs expensed in GAAP financial statements are not considered rents of tangible personal property for the franchise and excise tax base and should not be reported as rents on Schedule G.

Excess Rents

Excess real estate rents, per Tenn. Code Ann. § 67-4-2006(b)(1)(N), should be excluded from Schedule G. See the discussion of excess rents in Chapter 11 – Excise Tax.

8. Common Lease Terms

Auditors may request and review copies of lease agreements to determine the proper treatment of lease expenses for franchise tax purposes. The following are common lease terms that may be present in a lease agreement:

Gross Lease

Tenant pays a flat rental amount, and the landlord pays for all property charges normal to property ownership. The flat rental amount paid is reported as Schedule G real property rents.

Fully Serviced Lease

The fixed monthly rent charge includes the cost of certain types of services that may include janitorial services, trash collection, utilities, water and sewer charges, property taxes, etc. The entire amount paid is includable on Schedule G. The code and Rule 28 require the *addition* of "in lieu of" payments to rents reported on Schedule G, but there is no provision for a *deduction* from rents when the lessor makes payments like utilities that are normally paid by the lessee. For example:

- A lessee's payments under a lease agreement are $120,000 annually. The lease specifies that the lessor is responsible for payment of utilities, taxes, janitorial services, and maintenance, and interest charges.

    - The lessee/taxpayer is only responsible for the annual rental payment of $120,000, and this is the amount reported on Schedule G.

    - No deduction from the $120,000 rental amount is allowed for utilities, etc.[33]

Modified Gross Lease

A modified gross lease is similar to a full-service gross lease, except that some of the base services are not included by the landlord (taxes, maintenance, insurance, janitorial, and utilities).

This type of lease is common in multi-tenant buildings, where different tenants have varying needs for electrical or janitorial services. The base rent is includable on Schedule G plus any additional amounts required to be paid by the terms of the lease that are in lieu of rent.

If a payment includes rent and other charges unsegregated, the amount of rent, "in lieu of rent," and other charges shall be determined by considering the relative values of the rent and the other items. For example:

- A lessee paid rent of $120,000 annually plus a monthly CAM charge that varied in amount. The total paid for CAM was $9,743 for the year. The charge covered repairs, insurance, and janitorial services, but it was not itemized.

- Because the CAM charges include both in lieu of rent items (repair and insurance) and items that were not in lieu of rent (janitorial), an estimate was made in arriving at the Schedule G rent amount.

- In this case, the value of janitorial services was estimated at $4,000 resulting in $125,743 ($120,000 + $9,743 - $4,000) being reported as rents on Schedule G.

- Under the terms of the lease, the lessee pays $120,000 for rent plus additional amounts for utilities ($12,123), taxes ($1,200), janitorial ($4,000), and property repairs ($3,200).

    - Because payments for taxes and property repairs would have been paid by the lessor had it not been for the lease agreement, they are considered payments in lieu of rent and are included in the rent amount on Schedule G.

    - The utilities and janitorial costs are true expenses of the lessee and are not considered payments in lieu of rent.

    - The rent reportable on Schedule G is $124,400 ($120,000 + $1,200 + $3,200).

Common Area Maintenance ("CAM")

CAM charges are fixed or variable charges that can cover a wide range of expenses that are normally the responsibility of the landlord, including: repairs, insurance, property maintenance, and in some cases, the salaries of administrators who manage the facility.

CAM charges may be in lieu of rent payments to the extent that they are for taxes, insurance, and repairs. No portion of CAM charges for janitorial costs, administrative services, etc. should be considered rent.

Load Factor

The load factor is a method of calculating total monthly rent costs that combines usable square feet and a percentage of square feet of common areas. The addition of a percent of the common area expenses to monthly rent is known as the load factor.

- For franchise tax purposes, both the base rental amount and the load factor amount are considered rent on Schedule G; the load factor is just a method for arriving at the rent charge.

Net Lease

A net lease is a lease that requires the tenant to pay, in addition to rent, some or all the property expenses that are normally paid by the landlord/lessor.

- Expenses include:
  - real estate taxes,
  - insurance,
  - maintenance,
  - repairs,
  - utilities, and
  - other items.
- *Single net lease* – lessee pays property taxes as well as the base rent.
- *Double net lease* – lessee pays the taxes and insurance associated with use of the property in addition to monthly rent for use of the actual space.
- *Triple net lease* (net-net-net lease or NNN lease) – lessee pays all or part of the taxes, insurance, and maintenance associated with use of the property, in addition to the tenant's regular monthly rent.
  - Payments for rent, taxes, and insurance would be includable on Schedule G.
  - Maintenance charges would also be included if they were primarily for repairs, as opposed to janitorial type services.

Base Year

The base year is a unit of measurement used to calculate the rent charge. In general, a base year is calculated on a calendar year basis or the first 12 months of a tenant's occupancy. The base operating expense account is the floor over which any increases in operating expenses will be passed on to tenants of a building.

9. Operating and Finance Leases

Leases are classified as either "finance" or "operating" for financial accounting and federal tax purposes. GAAP and federal tax guidelines dictate how a lease transaction is reported on financial statements and tax returns.[34] **Therefore, it is not uncommon for a GAAP basis finance lease to be treated as an operating lease for tax purposes, and vice versa.**

Operating Leases

Under an operating lease, a lessee's rental payments are reported as rent expense on GAAP basis income statements. This rent expense is reported in the rental section of Schedule G, since this schedule is based on GAAP basis records.

⚠ **Rent expense found on Schedule G a will not be found on the federal income tax return if the lease was capitalized for federal tax purposes.**

Finance Leases

Finance lease transactions are sometimes referred to as sales-type leases or direct-financing leases and are treated as sales of leased property. Under a finance lease, the lessee is treated as the owner. The lessee capitalizes the value of the leased asset and reports a depreciable asset along with a liability for the lease obligation. The capitalized value, net of accumulated amortization/depreciation, is reported in the first section of Schedule G for owned property.

Finance lease payments are not posted as rent expense. However, entries will be posted to the following accounts:

- Obligation under finance lease;
- Interest expense; and
- Amortization/Depreciation expense

⚠ **Rent expense found on a federal income tax return may not be found on Schedule G if the lease was capitalized under GAAP.**

Operating and Finance Leases on GAAP Financial Statements

The presentation of leases on GAAP financial statements has recently changed.[35] Essentially, all leases, whether they are classified as operating or finance leases, are now reported on the face of the balance sheet, with some exceptions.[36] All leases, whether classified as an operating or finance lease, create a *right-of-use asset* and a *lease liability* that should appear on the lessee's balance sheet. Below is an example of a GAAP basis balance sheet and income statement that present both operating and finance leases:

	Balance Sheet	
	Assets	
	Property, plant, & equipment:	
a	Finance lease right-of-use asset	$ 108,237
b	Less: Accumulated depreciation	(21,647)
c	Finance lease right-of-use asset, net	86,590
d	Operating lease right-of-use asset	18,595
	Total assets	$ 105,185
	Liabilities	
	Current liabilities:	
e	Finance lease liability	$ 20,568
f	Operating lease liability	9,070
	Long-term liabilities:	
g	Finance lease liability	68,081
h	Operating lease liability	9,525
	Total liabilities	107,244
	Equity	(2,059)
	Total liabilities and equity	$ 105,185
	Income Statement	
i	Lease expense	$ 10,000
j	Interest expense	5,412
k	Depreciation expense	21,647
	Net loss	$ 37,059

Based on the above example, the "**c** Finance lease right-of-use asset, net" amount of $86,590 will be reported in the owned property section of Schedule G. Lines **d, f**, and **h** refer to operating leases. These lines are not used in completing the franchise and excise tax return; however, they *do* alert the auditor to look to the income statement for rent expense to be reported on Schedules G, and Schedules 170NC and 174NC, if applicable.

The above income statement shows the expense accounts associated with the finance and operating leases in this example. The "**i** Lease Expense" amount of $10,000 should be reported in the rental section of Schedules G and 170NC, if applicable.

Even though the financial presentation of leases under GAAP has changed,[37] the basic concepts on how leases are reported on Schedule G have not. For franchise tax purposes, finance leases are reported on Schedule G as an owned asset at net book value, and operating leases are reported at the net annual rental[38] amount times the applicable multiple (8, 3, 2, or 1).

Leases on Schedules G, N, 170NC, and 174NC

In addition to Schedule G, lease information is reported on other schedules. For example, the standard franchise and excise tax apportionment schedule, Schedule N, is used to apportion net worth on Schedule F1 and net earnings subject to excise tax on Schedule J. Property values reported on Schedule N come from tax basis records. Owned assets, including those from finance leases, are valued at tax basis cost and all rents, including those from operating leases, use a multiple of 8.

Schedules 170NC and 174NC are used to apportion consolidated net worth on Schedule F2. Property values come from GAAP records. Owned assets, including those from finance leases, are valued at GAAP basis cost and all rents, including those from operating leases, use a multiple of 8. Please refer to Chapter 9 of this manual for a discussion on apportioning consolidated net worth between affiliated group members on Schedules 170NC, 170SF, 174NC, and 174SC.

The following chart highlights the reporting differences between schedules for leases:

SCHEDULE	GAAP RECORDS	TAX RECORDS	FINANCE LEASE	OPERATING LEASE	RENT EXPENSE	CAPITALIZED COST	CAPITALIZED BOOK VALUE
G – Owned (Lines 1-9)	X		X				X
G – Rental (Lines 11-14)	X			X	X ***Multiple: 1,2,3,8***		
N – Owned (Lines 1-3)		X	X			X	
N – Rental (Line 12)		X		X	X ***Multiple: 8***		
170NC and 174NC – Owned	X		X			X	
170NC and 174NC – Rental	X			X	X ***Multiple: 8***		
N – Captive REIT – Owned		X	X			X	
N – Captive REIT – Rental		X		X	X ***Multiple: 8***		

Leases on Federal Schedules M-1 and M-3

Federal Schedules M-1 and M-3 reconcile financial statement "book" net income (loss) to "tax" net income (loss). Part III, Line 34 of Schedule M-3 (Form 1120) [39] is titled "Purchase versus lease (for purchasers and/or lessees)" and it shows the "book" to "tax" reconciliation for leases.

The instructions to Schedule M-3 state:

- Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a purchase or a lease may, under some circumstances, be characterized as the opposite for tax purposes.

- If a transaction is treated as a lease, the purchaser/lessee reports the periodic payments as gross rental expense. If the transaction is treated as a purchase, the purchaser/lessee reports the periodic lease payments as payments of principal and interest, and they also report depreciation expense/deductions with respect to the purchased asset.

Schedule M-3 has columns (a) through (d), with (a) being the "book basis" income statement amounts and (d) being the "tax basis" income statement amounts. Taxpayers are instructed to report in column (a) gross rent expense for a transaction treated as a lease for financial accounting purposes *but as a sale for U.S. income tax purposes*, and to report in column (d) gross rental deductions for a transaction treated as a lease for U.S. income tax purposes *but as a purchase for financial accounting purposes.*

In addition, taxpayers are instructed to report interest expense for such transactions on Part III, Line 8, column (a) or (d), as applicable, and to report depreciation expense or deductions for such transactions on Part III, Line 31, column (a) or (d), as applicable. Columns (b) and (c) of Part III, Lines 8, 31, and 34 are often used to report the differences between columns (a) and (d) for such recharacterized transactions. For example:

- Corporation X acquires property in a transaction, which it treats as a lease (rental) *for financial accounting purposes*.

- Because of the lease terms, the transaction is treated as a purchase *for U.S. income tax purposes*. X must treat the periodic payments it makes as partial payments of principal and partial payments of interest.

  - In its financial statements, X treats the difference between the financial accounting and U.S. income tax treatment of this transaction as a temporary difference.

- X reports in its financial statements $1,000 of gross rental expense that, for U.S. income tax purposes, is recharacterized as a $700 payment of principal and a $300 payment of interest, accompanied by a depreciation deduction of $1,200 (based on other facts).

- On its Schedule M-3, X must report the following on Part III, Line 34, column (a): $1,000, its financial accounting gross rental expense; column (b): -$1,000; and column (d): zero.
- On Part III, Line 8, X reports zero in column (a) and $300 in columns (b) and (d) for the interest deduction.
- On Part III, Line 31, X reports zero in column (a) and $1,200 in columns (b) and (d) for the depreciation deduction.

Auditors may review the federal Schedule M-3, and they may make additional inquiries if entries involving leases are noted. They will expect to see lease transactions reported differently between Schedule G and Schedule N of the franchise and excise tax return, since the franchise tax schedules are based on GAAP records and the excise tax schedules are based on federal tax basis records.

10. Industrial Development Corporation

Property leased from an industrial development corporation (formed under Tenn. Code Ann. § 7-53-1) may be treated as either a finance lease or as an operating lease. The taxpayer may elect whichever treatment it prefers, but it may only change its election once during the term of the lease. Generally, the taxpayer will elect to treat the lease as an operating lease until the capitalized lease under GAAP is depreciated down and becomes less than the lease payments.[40]

Ownership in a General Partnership

A general partner is a partner who is personally liable for partnership debts. A general partnership is composed only of general partners.[41] General partnerships file federal Form 1065 with the "general partnership" box checked on Schedule B.

General partnerships are not directly subject to franchise and excise tax as a separate taxpaying entity. They are not required to file franchise and excise tax returns. However, their activity may be subject to the tax if they are directly or indirectly owned by an entity that offers limited liability protection, like a corporation, LP or LLC.[42]

Ownership of a general partnership may create a filing requirement for its partner. For example:

- A corporation's only connection to Tennessee is its indirect ownership in a general partnership that is doing business and has substantial nexus in the state. This corporation, which did not otherwise have a filing requirement before acquiring an ownership interest in the general partnership, must now register with the Department and file a franchise and excise tax return that includes both its own activities and its share of the general partnership's activities.

A general partnership that is owned directly or indirectly by an entity that provides limited liability protection will, in effect, be taxed at the first level of ownership that provides limited liability protection. Taxpayers reflect the general partnership's activity on their franchise and excise tax returns based on their pro rata ownership share. A partner's ownership percentage is found on its Schedule K-1 (Form 1065).

1. Owned Property Held by a General Partnership

Real and tangible property reported on Schedule G includes a taxpayer's share of any specific property held by a general partnership, where such taxpayer has a direct or indirect ownership interest in the general partnership. For reporting purposes, the general partnership's real and tangible property is reported at book value and treated as if it were owned by the respective partners. In the following example, $7,000 is entered on Schedule G, Line 6 "Ownership share of real and tangible property of a partnership that does not file a return."

For example:

- A general partnership has two partners: Partner A, Inc. and Partner B, an individual. Partner A owns 70% of the general partnership, and Partner B owns the remaining 30%. The general partnership has equipment located in Tennessee with a book value of $10,000. Partner A will include on Schedule G its share of the book value of this partnership property, computed as follows:

$10,000	Equipment in Tennessee
70%	Partner A's ownership percentage
$7,000	**Report on Schedule G, Line 6**

- Audit Procedures:
  - First, find the partner's ownership percentage, reported on the taxpayer's federal Schedule K-1 issued by the general partnership.
  - Second, multiply that ownership percentage by the book value of the general partnership's owned property located in Tennessee.

A general partnership's owned real and tangible property may also include land, buildings, leasehold improvements, vehicles, prepaid supplies, inventories, and more. The pro rata share of all these items is reported on Schedule G, Line 6 of the taxpayer's return.

2. Property Leased by a General Partnership

The taxpayer's share of a general partnership's rents paid for property used in Tennessee is also reported on Schedule G of the taxpayer's return. The following example is similar to the one above, except that the general partnership paid $20,000 in office equipment rents, measured by GAAP. Partner A's Schedule G will include its share of these rents, computed as follows:

$20,000	Office equipment rents in Tennessee
70%	Partner A's ownership percentage
$14,000	Report on Schedule G, Line 13, before multiple
2	Multiple from the form[43]
$28,000	**Report on Schedule G, Line 13, after multiple**

Leases between Limited Liability Taxpayers and Related General Partnerships

If the general partnership (lessee) is leasing property from the franchise and excise taxpayer/partner (lessor), the rental income received by the franchise and excise taxpayer from the general partnership would be considered sub-rental income to the taxpayer that must be subtracted from its ownership percentage share of the general partnership rental expense to arrive at the net annual rental to be reported on Schedule G (before the applicable multiple). The taxpayer, as the owner of the property being leased to the general partnership, must also include the property's net book value on Schedule G (as owned property).

- Example where *taxpayer* leases property **to** a *related general partnership*:

a. General Partnership Rental Expense Paid to Taxpayer:	$10,000
b. Taxpayer Ownership Percentage (Sch. K-1):	70%
----------	
c. Taxpayer/Partner's Share of Rental Expense (a. x b.)	$7,000
d. Sub-rental Income Received by F&E Taxpayer:	$10,000
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e. Rent Expense Reported by Taxpayer/Partner on Schedule G (c. less d., but not less than zero)	$0

Note that the *taxpayer* **(lessor)** will include the book value of the property it is leasing as an owned asset on Schedule G, Lines 1, 2, or 3.

Contrarily, if a general partnership (lessor) is leasing property to a franchise and excise taxpayer/partner (lessee) who pays rent to the general partnership, the franchise and excise taxpayer's ownership percentage share of rental income received by the general partnership would be sub-rental income. This sub-rental income must be multiplied by the taxpayer's ownership percentage share, and the result must be subtracted from the taxpayer's rental expense paid to the general partnership to arrive at the net annual rental to be reported on Schedule G (before the applicable multiple). Under Tenn. Code Ann. § 67-4-2108(a)(6)(E), the taxpayer must also include its ownership percentage share of the general partnership's owned property that is being leased to the taxpayer on Schedule G because the taxpayer is occupying the property.

- Example where *taxpayer* leases property **from** a *related general partnership*:

a. Sub-rental Income Received by General Partnership	$10,000
b. Taxpayer's Ownership Percentage (Sch. K-1):	70%
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c. Taxpayer/Partner's Share of Rental Income (a. x b.)	$7,000
d. Taxpayer's Rental Expense	10,000
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e. Rental Expense Reported by Taxpayer/Partner on Sch. G (d. less c., but not less than zero)	$3,000

Note that the *taxpayer* **(lessee)** will include its pro rata share of the general partnership's owned assets on Schedule G, Lines 1, 2, or 3.

3. Audit – Ownership of a General Partnership

During an audit in which the taxpayer has an ownership interest in a general partnership, the auditor may perform some or all of the following audit procedures:

- Request and review all federal Form 1065, Schedule K-1s received by the taxpayer and identify those that are from general partnerships.

- Inquire as to any connection that the general partnership has to Tennessee, including ownership or use of real and tangible property in the state.

- Identify the taxpayer/partner's ownership percentage of any general partnership that is doing business in the state (shown on Schedule K-1).
- Obtain a GAAP basis balance sheet and income statement, or similar financial information, for the general partnership. (Note that the owned and rented assets on these statements may include assets not owned or used in the state.)
- Request rent/lease documents in order to determine the appropriate rental multiple.
- Calculate the taxpayer's pro rata share of the property owned or used by the general partnership in the state that should be included on Schedule G.
- Inquire as to whether there are any leases between the taxpayer/partner and the general partnership and calculate the Schedule G inclusion amount after allowing for sub-rents.

Ownership in a Pass-through Entity Not Subject to the Tax

The franchise tax property base (Schedule G, Line 15) includes a taxpayer's ownership share of the real or tangible property owned or used by any general or limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal tax purposes *that is not subject to the franchise tax* and in which the taxpayer has an ownership interest, either directly or indirectly through one or more such entities.[44]

In other words, the previous section concerning a taxpayer's ownership of a general partnership also applies when a taxpayer owns other types of pass-through entities that own or use property within the state, when such pass-through entities are <u>not</u> subject to the franchise tax. This scenario is rare; generally, most pass-through entities will be subject to the franchise tax on a separate-entity basis. For more information, see Chapter 3 – Nexus.

Property Used and Neither Owned nor Rented

If property used by a taxpayer is neither owned nor rented or is rented for a nominal amount, a reasonable market rental rate may be used to determine the value of the property reported for franchise tax purposes.[45] For example:

- A restaurant paid management fees (instead of rents) to the owner of the property where the restaurant operates. There are no written agreements between the restaurant and the property owner and no documentation of any services that the property owner performed for the restaurant.

- Here, a reasonable market rental rate may be used to determine the value of the rental for franchise tax purposes.

[1] The book value of real and tangible property owned or used within the state is determined by generally accepted accounting principles (GAAP) accounting records, when available.
[2] Tenn. Code Ann. § 67-4-2108(a)(1)
[3] *Id*.
[4] Tenn. Code Ann. § 67-4-2108
[5] Tenn. Code Ann. § 67-4-2108(a)(3)
[6] Important Notice #04-30
[7] https://assessment.cot.tn.gov/RE_Assessment/
[8] Under GAAP, the taxpayer might also employ use of the specialized accounting rules for *nonmonetary transactions* codified at ASC 845.
[9] *GAAP Guide – Restatement and Analysis of Current FASB Standards* (2014)
[10] Tenn. Code Ann. § 67-4-2108(a)(3)
[11] Tenn. Code Ann. § 67-4-2115(b); TENN. COMP. R. & REGS. 1320-06-01-.29
[12] Tenn. Code Ann. § 67-4-2108(a)(4); TENN. COMP. R. & REGS. 1320-06-01-.27(3)
[13] TENN. COMP. R. & REGS. 1320-06-01-.18(3)
[14] Tenn. Code Ann. § 67-4-2108(a)(1)
[15] Tenn. Code Ann. § 67-4-2108(a)(6)(B)-(C)
[16] Tenn. Code Ann. § 67-4-2108(a)(2); TENN. COMP. R. & REGS. 1320-06-01-.18(4)
[17] *Crown Enterprises, Inc. v. Woods*, 557 S.W.2d 491, 493 (Tenn. 1977)
[18] Tenn. Code Ann. § 67-4-2108(5)
[19] Tenn. Code Ann. §§ 67-4-2108(a)(5)(C), 67-4-2004(9)
[20] Tenn. Code Ann. § 67-4-2109(b)(2)(B)
[21] Tenn. Code Ann. §§ 67-4-2108(a)(6)(G), 67-4-2108(a)(1)
[22] A single unit of property consists of all components that are functionally interdependent, such that one component cannot be placed in service without the other components.
[23] Tenn. Code Ann. § 67-4-2108(a)
[24] Tenn. Code Ann. § 67-4-2108(a)(3)
[25] Tenn. Code Ann. § 67-4-2108(a)(6)(D); TENN. COMP. R. & REGS. 1320-06-01-.18(1)
[26] The net annual rental amount is the gross annual rent paid, less the gross rent received for sub-rental.
[27] Tenn. Code Ann. § 67-4-2108(a)(6)(D); TENN. COMP. R. & REGS. 1320-06-01-.18(1)
[28] TENN. COMP. R. & REGS. 1320-06-01-.18(1)
[29] Revenue Ruling 01-06
[30] *Id*.
[31] Tenn. Code Ann. § 67-4-2108(a)(6)(D). For apportionment factor, see TENN. COMP. R. & REGS. 1320-06-01-.28(2)(c)(2).
[32] Tenn. Code Ann. § 67-4-2115
[33] The final sentence of Rule 28(2)(c)(2) does not function to exclude any expense from the computation, but only limits the "in lieu of" inclusion amount. See Letter Ruling 06-08.
[34] GAAP Standard ASC 842; IRS Publication 535

[35] The new lease accounting standard was introduced by FASB Accounting Standards Update No. 2017-13, and it became effective for public business entities for fiscal years beginning after December 15, 2018.
[36] Leases with a term of 12 months or less and leases of property with a value of less than $5,000 are not required to be reported on the balance sheet.
[37] The new lease accounting standard was introduced by FASB Accounting Standards Update No. 2017-13, and it became effective for public business entities for fiscal years beginning after December 15, 2018.
[38] The net annual rental amount is the gross annual rent paid less the gross rent received for sub-rental.
[39] For partnerships, see Schedule M-3 (Form 1065) Part III, Line 28.
[40] Tenn. Code Ann. § 67-4-2108(b)
[41] Federal Form 1065 instructions
[42] Tenn. Code Ann. § 67-4-2108(a)(3)
[43] *Id.*
[44] *Id.*
[45] TENN. COMP. R. & REGS. 1320-06-01-.18(2)