TN Department of Revenue

Contents

Chapter 11: Excise Tax

Overview

All persons, except those with nonprofit status or otherwise exempt,[1] are subject to a 6.5% corporate excise tax on the net earnings from business conducted in Tennessee for the fiscal year. Corporations, partnerships, LLCs, and business trusts, as entities that offer their owners limited liability protection, are subject to the excise tax. The excise tax return is filed on a separate entity basis for the same tax period covered by the corresponding federal return, but an entity may be exempt from this tax if the requirements of Public Law 86-272 are met.[2] See earlier chapters of this manual for a discussion of Taxable Entities, Exemptions, Public Law 86-272, and Return Filing.

The code defines *net earnings* differently for:

- A corporation or entity treated as a corporation for federal income tax purposes;
- A corporation electing S-corporation status;
- A financial institution that forms a unitary business;
- An entity treated as a partnership for federal tax purposes;
- An entity treated as a partnership for federal tax purposes that is directly or indirectly owned by a public REIT;
- An SMLLC whose single member is a general partnership;
- An SMLLC that is treated as an individual taxpayer for federal income tax purposes;
- A captive REIT affiliated group;
- A business trust; or
- Any other person doing business in the state not specifically listed above.[3]

The way net earnings are reported for federal income tax purposes depends on the taxpayer's entity type and its corresponding federal tax return form. For example, the federal taxable income of a corporation is found on a single line (Line 28) near the bottom of the first page of federal Form 1120, but a partnership return filed on federal Form 1065 uses multiple lines on different pages of the return to report ordinary and other types of income (losses). These federal reporting differences are addressed on the excise tax return, Schedules J1 through J4. Each of these schedules begins with the taxpayer's net income or loss from the federal income tax return and ends with a number that is carried to Schedule J, Line 1 (adjusted federal income or loss). Taxpayers should complete only one Sub-J Schedule (J1, J2, J3, or J4) based on their entity type before completing Schedule J of the excise tax return. Example of an incorrect filing:

- The business is a corporation, according to the Tennessee Secretary of State.
- The business registers with the Department as an LLC and claims the self-employment deduction on Schedule J1, Line 6.
- This is an improper filing because corporations must use Schedule J4, which has no line to deduct earnings subject to self-employment tax.

The starting point for computing net earnings for excise tax purposes begins with federal taxable income, as reported on federal Forms 1120, 1120S, 1065, 1040, 990T, or other variants of these forms. The first line of each Sub-J Schedule asks for the ordinary income (loss) from the applicable federal income tax return (based on entity type), and then subsequent lines make adjustments to federal taxable income that are specific to the type of federal form filed. Tennessee excise tax law requires certain *addition* and *subtraction* modifications to federal taxable income to arrive at net earnings subject to excise tax.

Virtual currency transactions are reportable for franchise and excise tax purposes. Virtual currency is treated as property and is reported as an asset on book basis financial statements. This asset may be used in business transactions or held as an investment. Because the Tennessee excise tax computation begins with the net income reported on the taxpayer's federal income tax return, federal tax principles applicable to property transactions would apply. In addition, the franchise tax net worth base would include the book basis of any virtual currency asset. See IRS Notice 2014-21 – Virtual Currency – for more information on the application of federal tax principles.

Recent Form Changes[4]

Some line numbers on Schedules J1, J2, J3, J4 and Schedule J changed in 2017 and in 2020. For example, identical information found on each of the Sub-J Schedules was moved to a single line on Schedule J. Also, information found on the pre-revision Schedule J that did not apply to all entity types was moved to the applicable Sub-J Schedule. Minor line number changes are expected in future years.

Partnerships - Schedule J1

LPs and LLCs[5] that file a federal Form 1065 complete Schedule J1. These taxpayers are considered pass-through entities and are not subject to federal income tax because the profit or loss is “passed through” to the owners subject to federal income tax at the individual owner level. Each partner/owner/member receives a federal Schedule K-1 that they use to report their share of the pass-through entity’s activity on their respective individual return. Income and loss items are reported on Schedule K-1, Lines 1-13. The totals of all individual K-1s equal the amounts reported on Form 1065, Schedule K, which is the primary schedule used in preparing the excise tax return.

Entities treated as partnerships need more than one line to report their income (loss) so that the character of the items stays the same when reported at the partner/owner level. For example, contribution expense is reported on Schedule K, Line 13a, so that it maintains its character as a contribution when it is reported on the owner’s individual federal return where it is subject to limitations and reporting requirements of the individual owner.

1. Addition - Ordinary Income (Loss) from Form 1065

The amount entered on Schedule J1, Line 1 represents ordinary income (loss) and can be found on federal Form 1065, Page 1, Line 22 or federal Form 1065, Page 4, Schedule K, Line 1. The same amount is reported in both places on Form 1065.

2. Addition - Income Items Specifically Allocated to Partners, Including Guaranteed Payments

The amount reported on Schedule J1, Line 2 represents income items specifically allocated to partners, including guaranteed payments, and is the sum of the amounts reported on federal Form 1065, Schedule K, Lines 2-11.[6] These lines show the partners’ distributive shares of:

- Rental real estate;
- Other rents;
- Guaranteed payments;

- Interest income;
- Dividends;
- Royalties;
- Capital and ordinary gains (losses); and
- Other income (loss).

These amounts are in addition to the income and expense amounts shown on Form 1065, Page 1. For example, Page 1 does not have a line for interest or royalty income because these amounts are reported on Form 1065, Schedule K, Lines 5 and 7, respectively.

Guaranteed payments are reported on both Form 1065 (Page 1), as a deduction, and Form 1065, Schedule K (Page 4), as income. *Guaranteed payments* are payments made to partners for services or for the use of capital (without regard to the partnership's profitability) and are deducted in arriving at ordinary income reported on Form 1065, Page 1. Additionally, these amounts are reported as separately stated income on Schedule K to be reported on the applicable partner's Schedule K-1.

For franchise and excise tax purposes, the ordinary income (loss) reported on Schedule J1, Line 1 includes the guaranteed payment expense, and the distributive share items reported on Schedule J1, Line 2 include the guaranteed payment income. Therefore, the net effect is zero. The taxpayer will ultimately get to deduct the guaranteed payment expense on Schedule J1, Line 6, as part of the amount subject to self-employment taxes, as discussed below. The following table indicates the lines of the federal and excise tax returns, respectively, on which the guaranteed payment amounts can be found and shows the netting effect of the deduction.

Guaranteed Payment	**Guarantee Payment Amount**	**Excise Tax Return – Schedule J1 Line**
Form 1065, Page 1, Line 10	(279,903)	1
Form 1065, Page 4, Line 4	279,903	2
Form 1065, Page 4, Line 14a	(277,917)	6

Even though the guaranteed payments are reported in three different places on the federal Form 1065, a properly completed excise tax return will allow this deduction only once. The net deduction allowed is $277,917.[7]

Form 1065, Schedule K, Lines 3a, 3b, 4a, 4b, 6b, 6c, 9b, and 9c may be ignored for franchise and excise tax purposes because their purpose is to provide additional information that is not needed for state tax. Only the far-right column of Schedule K is used in the excise tax calculation.

3. Addition - Any Net Loss or Expense Distributed to a Publicly Traded REIT

Schedule J1, Lines 3 and 8 address situations where a publicly- traded REIT owns the taxpayer in full or in part (directly or indirectly). See Chapter 17 for more information on REITS.

During an audit, an auditor will likely perform the following activities when an entity treated as a partnership is owned directly or indirectly by a publicly traded REIT.[8]

- Identify the name and federal employer identification number (FEIN) of the public REIT. The current instructions to Schedule J1, Line 8 requests that taxpayers attach a schedule listing the name and FEIN of the REIT. Nevertheless, this information should be maintained by the taxpayer and be available to auditors.

- Determine that the REIT's stock/shares are traded on a national securities exchange. The REIT must be publicly traded, as defined in Tenn. Code Ann. § 67-4-2004(39).[9] Some REITs may appear to meet this definition, but fail to do so because they are traded on an over-the-counter (OTC) exchange or a private exchange.[10] In addition, not all REITs that file with the Securities Exchange Commission are traded on a national exchange, in which case the taxpayer would not be allowed the reversal adjustments on Schedule J1, Lines 3 and 8.

- Obtain Schedule K-1s and/or an organization chart to verify that the pass-through entity is owned directly or indirectly by the public REIT.

- Determine that the amounts reported are correct. If the pass-through entity is indirectly owned by a REIT, the auditor will need to see all the K-1 schedules between the pass-through entity and the REIT in order to recalculate the adjustment amount for distributions made to a public REIT.

4. Deduction - Expense Items Specifically Allocated to Partners

The amount reported on Schedule J1, Line 5 represents expense items specifically allocated to partners and equals the sum of the amounts shown on federal Form 1065, Schedule K, Lines 12, 13a-13d with three exceptions. Items not reported on Schedule J1, Line 5 are as follows:

- Payments for partner/member qualified pension or benefit plan expenses.
    - The deductions for partner/member pension and benefit costs must be reported on Schedule J1, Line 7, instead of Line 5. This separate reporting is needed to identify amounts that must be reversed on Schedule K (of the franchise and excise tax return), ensuring that the costs do not create or increase a net operating loss.

- Amounts that were reported on federal Schedule K, Line 13 for Section 743(b) adjustments (code V).[11]

- Do not include excess business interest expense under 163(j) reported on federal Form 1065, Schedule K, 13d with a code K for years beginning after December 31, 2017 and before January 1, 2020. However, for tax periods beginning after January 1, 2020 the amount may be reported as an excise tax deduction. See the manual section Tax Cuts and Jobs Act of 2017 for additional information.

The deductions commonly reported on Schedule J1, Line 5 are for the partners' distributive share of Section 179 expense, contributions, investment interest, I.R.C. § 59(e)(2) expense, and other deductions. These amounts are in addition to the income and expense amounts shown on Form 1065, Page 1. Federal Schedule K and its attachments may include information that is needed by partners/members for them to accurately file their federal Forms 1040, but some of these amounts are not included in the total reported on Schedule K, Line 13d. For example, domestic production activity information is referenced to Line 13d, but the amounts are not actually included in the Line 13d total.

For excise tax purposes, caution should be taken to deduct only amounts included in the federal Schedule K, Line 13d number. There may be "white paper" attachments to the federal return that provide helpful information to the partners, but if their distributive amounts are not included in the federal Line 13d total, they should not be reported on Schedule J1, Line 5.

5. Deduction - Amount Subject to Self-employment Taxes Distributable or Paid to Each Partner or Member

Net earnings subject to self-employment taxes are deducted on Schedule J1, Line 6 to the extent that they do not create or increase any net loss.[12] This amount is net of medical insurance payments previously deducted to determine ordinary income (loss) on Form 1065. If the amount is negative, the taxpayer must enter "0." [13] Any deduction on Line 6 is reversed out (added back) on excise tax Schedule K - Determination of Loss Carryover Available.[14] Because this amount is backed out, an audit adjustment may not, in some cases, change the current year loss available for carryover. In the simplified example shown below, an audit adjustment disallowed the $700 deduction for income subject to self-employment taxes, but this adjustment did not change the current year loss available for carryover of $1,000 shown on the last line of Schedule K.

Excise Tax Schedules . . .selected lines	*As filed by TP*	*Audited*
Schedule J1:		
1. Ordinary (loss)	($1,000)	($1,000)
Deductions:		
6. Subject to S-E	(700)	0
11. Schedule J1 Total	($1,700)	($1,000)
Schedule J:		
1. Federal income (loss)	($1,700)	($1,000)
27. Total business loss	(1,700)	(1,000)
Schedule K:		
1. Loss from line 27	(1,700)	(1,000)
3. Add: S-E from J1, 6	700	0
6. Current year loss c/o	($1,000)	($1,000)

In many cases, the self-employment deduction will impact the excise tax base. A discussion of the self-employment deduction follows.

What income is subject to self-employment tax?

The federal tax definition of self-employment income can be complicated, but the concept is fairly simple. Generally, self-employment tax applies to wages, tips, and net earnings. The taxpayer calculates net earnings by subtracting ordinary and necessary trade or business expenses from gross income derived from their business. Self-employment income includes guaranteed payments made for services or use of capital and net income from a trade or business. Self-employment income does *not* include interest or dividend income earned from investments, rental income from real estate, or gains and losses from the sale of capital assets.[15]

Who is subject to self-employment tax?

Corporations are not subject to the federal self-employment tax; only individuals are subject. Pass-through entities report profit (loss) subject to self-employment tax on Schedule K-1s issued to their partners who are individuals. Individuals report these numbers on their federal Form 1040 individual income tax returns and pay the applicable self-employment tax. A partner's "net earnings from self-employment" is generally their distributive share of the partnership's income arising out of the trade or business plus any guaranteed payments they receive from the partnership.[16]

Even though subchapter S-corporations issue Schedule K-1s to their owners, their income is not subject to self-employment tax. The only Sub-J Schedules with a deduction for amounts subject to self-employment tax are Schedules J1 and J2.

Where is income subject to self-employment tax reported on federal Form 1065?

The net earnings (loss) amount from self-employment is found on federal Form 1065, Schedule K (Page 4), Line 14a.

How do taxpayers calculate the number reported on Form 1065, Schedule K, Line 14a? May the auditor question this amount?

Generally, the Department accepts the numbers reported on the taxpayer's federal return as being correct. However, it is worth noting that the self-employment number reported on Form 1065, Schedule K, Line 14a does not change the entity's net income (loss), and it may not receive a high level of review for accuracy by the taxpayer. For example:

- A partnership with ordinary income from a retail store may report that income as self-employment income on Line 14a. If the partners were individuals or general partners, this would be correct.

- However, if all the partners were corporations, no amount should be reported on Line 14a, since corporations are not subject to self-employment tax.

- This error could potentially go undetected because, regardless, the correct federal income tax liability would still be paid by the partners on their individual returns.[17]

The instructions to federal Form 1065 (on page 39) include a Worksheet for Figuring Net Earnings (Loss) From Self Employment, and amounts allocated to corporations are deducted on Line 3b of this worksheet. There are lines for other adjustments on the worksheet.

Taxpayers should be able to provide auditors with this worksheet in support of the amount reported on Schedule J1, Line 6. Auditors should briefly review this worksheet and generally be aware of its availability to support the "net earnings from self-employment" reported on federal Schedule K, Line 14a.

Why do the instructions for Schedule J1, Line 6 contain the wording "net of any pass-through expense deducted elsewhere on this return"?

Federal Form 1065, Schedule K, Line 14a reports net earnings from self-employment. This amount comes from the corresponding federal worksheet and is not reduced by I.R.C. § 179 or contribution expenses. Because the federal Schedule K self-employment amount is not reduced by these expenses, if the Department allowed the entire self-employment amount to be deducted on Schedule J1, Line 6, the taxpayer would be deducting the expenses twice, first on Schedule J1, Line 5 (expense items) and again on Line 6 (amount subject to self-employment taxes).

6. Deduction - Amount of Contribution, Not Previously Deducted, to Qualified Pension or Benefit Plans of any Partner or Member, Including all I.R.C. 401 Plans

Schedule J1, Line 7 represents the contribution to qualified pension or benefit plans, including all I.R.C. § 401 plans. This line item is not found on the other Sub-J Schedules. It is needed on Schedule J1 because expenses deducted for contributions to qualified pension (I.R.C. § 401 plans) or benefit plans *for partners or members* may not create or increase a net loss.[18] To ensure this requirement is met, pension expense is reported on Schedule J1, Line 7 and reversed on Schedule K, Line 3 of the loss carryover schedule found on page 4 of the franchise and excise tax return.[19]

The amount entered on Line 7 comes from federal Form 1065, Schedule K, Line 13d - code R. The 13d line may include other types of deductions, so it is important that only the one with code R (retirement) is reported on Line 7. A supporting schedule to the federal form lists the amounts reported on Line 13d and their respective codes.

Retirement plan and deferred compensation plan expenses paid to *non-partners* are deducted on page 1 of the federal Form 1065, Line 18 and are included in the partnership's ordinary business income (loss), which is reported Schedule J1, Line 1. However, pension plan expenses paid to *partners* are not included in the partnership's ordinary income (loss) but are separately reported on Form 1065, Schedule K, Line 13d - code R.[20]

All amounts reported on federal Form 1065, Schedule K, Lines 1-14a are reportable on Schedule J1 (Lines 2, 5, 6, and 7).

- Lines 2 and 5 separately report pass-through income and expenses.
- Lines 6 and 7 are needed to report expenses that, by statute, cannot create or increase a net operating loss.

If a taxpayer does not have a current year net operating loss or loss carryforward, the instruction to separately report pension and benefit costs on Schedule J1, Line 7 can go unheeded with no tax impact. However, the Department should ensure these deductions are allowed only once in arriving at the total deductions on Line 10. Also, care should be taken to not allow informational (white paper) amounts to be deducted in this total.

7. Deduction - Any Loss on the Sale of an Asset Sold within 12 Months after the Date of Distribution

Schedule J1, Line 9 represents amounts resulting from a pass-through entity that distributes an asset to one of its partners when the partner sells the asset for a loss within 12 months of the distribution. A loss on the sale of an asset by a partner is reflected on the franchise and excise tax return of the taxpayer that made the distribution, not the one that eventually sold the asset for a loss.[21] For example:

- Partnership distributed an asset to Partner on January 1, 2017. Partner sold the asset for a loss on October 1, 2017. Partnership will deduct the loss on its franchise and excise tax return due April 15, 2018 (assuming a calendar year taxpayer). This is the case even though Partnership distributed the asset to Partner and Partner sold it.

The result is substantially different when a distributed asset is sold for a loss rather than a gain.[22] Given the distribution and sale scenario mentioned above, the distributing taxpayer must deduct the loss if the following two requirements are met:

- The taxpayer is treated as a pass-through entity; and
- The distribution is to the taxpayer's owner (partner/member/shareholder).

Note that Tenn. Code Ann. § 67-4-2006(b)(2)(K) does not say the partner, member or shareholder is a nontaxable entity, so a loss reported on the seller's return would have to be reversed in addition to posting the deduction adjustment to the distributing taxpayer's return. For example:

- Taxpayer, LP distributes an asset to Partner, Inc. (also a Tennessee taxpayer), and Partner, Inc. sells the asset within 12 months at a loss. For excise tax purposes, the loss is recognized by Taxpayer, LP rather than by Partner, Inc.

⚠ **The wording on Form FAE 170, Schedule J, Line 17 (and the related instructions) for tax years beginning prior to 7/1/2016 were in error and are not supported by excise tax law. These prior year forms and instructions erroneously included this deduction on Schedule J, which is applicable to all entity types subject to excise tax. This deduction may only be taken by partnerships on Schedule J-1 and S corporations on Schedule J-3.**

Single-Member LLC Filing as Individual – Schedule J2

SMLLCs filing as individuals must complete Schedule J2.[23] In cases where an SMLLC is owned by an individual, the business activities of the SMLLC will be included on the owner's individual federal tax return, Form 1040, e.g., Schedules C, D, E, and F and on Form 4797. The SMLLC should only include information from these schedules that represent its business activity. For example:

- An individual may file several Schedule C forms, but only the ones reporting the activity of the SMLLC would be used in computing the franchise and excise tax.

Auditors should request the tax basis trial balance of the SMLLC and the net profit (loss) should be traced to the applicable federal schedules, and ultimately, to the excise tax return.

⚠ **Auditors will ask for the SMLLC's tax basis income statement in order to substantiate the total income/loss of the business, since its activity may be reported on multiple forms filed with the federal Form 1040.**

1. Addition - Net Profit or Loss

Although the IRS labels Form 1040, Schedule C "Profit or Loss from Business (Sole Proprietorship)," this form is also used to report the ordinary income activities of an SMLLC filing as an individual. The first section of Schedule C asks for the business name and other information that should readily identify the SMLLC. Net profit is listed on **Form 1040, Schedule C, Line 31**, which is reported on FAE 170 Schedule J2, Line 1.

An SMLLC owned by an individual may make an election on Form 8832 to file as a corporation on federal Form 1120. In that case, the taxpayer would file federal Form 1120, as opposed to Form 1040 schedules. For excise tax purposes, an SMLLC electing to be taxed as a corporation would complete Schedule J4 instead of Schedule J2.

2. Addition - Capital Gains or Losses

Schedule J2, Line 2 is where SMLLCs should report capital gains and losses. These amounts are found on federal **Form 1040, Schedule D** along with the gains/losses from sources other than the SMLLC. Because capital gains/losses from various sources are reported on this schedule, the taxpayer should be ready to provide detailed schedules that tie the gains/losses to the SMLLC's books and records in the case of an audit. Capital gains and losses result from the sale or exchange of capital assets. Capital assets are generally investments, as opposed to depreciable business property (the sale of which is reported on Form 4797).

For federal income tax purposes, capital losses are only deductible up to the amount of capital gains plus $3,000 ($1,500 if married filing separately); losses that exceed this limit may offset gains and income in future periods. This federal limit is not applicable for franchise and excise tax purposes, where capital losses are recognized in full in the year incurred. Only current year capital gain/loss activity should be included in the Tennessee taxable income/loss of the excise tax return. Any limitations or carryovers shown on Schedule D should be disregarded for excise tax purposes.

3. Addition - Rental Real Estate and Royalty Income or Loss

Schedule J2, Line 3 represents rental real estate and royalty income and loss amounts related to the SMLLC. The reportable amount comes from federal **Form 1040, Schedule E, Line 21**. Real estate rents are never subject to self-employment tax and should not be included in the deduction on Schedule J2, Line 9.

Income or loss from ownership interests in pass-through entities is found on page 2 of Form 1040, Schedule E. This information is reported on Schedule J2 if the SMLLC has an ownership interest in the pass-through entity. Normally, partnership and S-corporation amounts reported on the back of Form 1040, Schedule E are from ownership by individuals, and not by the SMLLC, and as such would not be included on Schedule J2.

In an audit, the auditor will likely reconcile the amounts reported on Schedule J2 to the SMLLC's books and records to ensure that the excise tax return reflects only the transactions of the SMLLC and not of its individual owner.

4. Addition - Profit or Loss from Farming

Schedule J2, Line 4 represents an SMLLC's profit or loss from farming activities. This amount is found on federal **Form 1040, Schedule F, Line 34** and may include amounts from sources other than the SMLLC. The auditor should reconcile the amounts reported on the sub-schedule to the SMLLC's books and records in addition to Form 1040, Schedule F.

5. Addition - Ordinary Gain or Loss – Depreciable Property

Schedule J2, Line 5 represents the SMLLC's ordinary gain or loss from the sale or exchange of depreciable property used in the business. The sale of business property is reported on federal **Form 4797** as either a short or long-term gain or loss. Schedule J2 will generally include amounts from Form 4797, Line 18b, but only for amounts that can be sourced to the SMLLC's books and records.

6. Deduction – Amount Subject to Self-Employment Taxes Distributable or Paid to the Single Member

An SMLLC owned by an individual may deduct the income that is subject to federal self-employment tax, provided this amount shall not create or increase any net loss for Tennessee excise tax purposes. Schedule J2, Line 8 represents this amount. Generally, the SMLLC's net earnings reported on Form 1040, Schedule C are subject to self-employment tax and would be reported on federal Schedule SE. Income not subject to self-employment tax includes income from interest, dividends, investments, rental income from real estate, and gains or losses from the sale of capital assets. These types of income are generally reported on federal schedules other than Schedule C.

Subchapter S-Corporations – Schedule J3

A Subchapter S-corporation is a corporation that has made a federal election whereby it does not pay any federal income tax. Instead, the corporation's income and deductions are passed through to its shareholders. The shareholders must report the income and deductions on their own income tax returns. The S-corporation files federal Form 1120S and reports its ordinary income and other pass-through amounts on Schedule K, Lines 1-12. The ordinary income amount reported on 1120S, Schedule K, Line 1 originates from page 1, Line 21 and is reported on Schedule J3, Line 1. Note that Subchapter S-corporations do not receive a deduction for income subject to self-employment tax, as they are not subject to self-employment tax.

1. Addition/Deduction - Income and Expense Items as if no "S" Election

Schedule J3 Lines 2 and 4 require the S-corporation to recalculate income and expenses as if the entity were not an S-corporation. For excise tax purposes, "net earnings" means federal taxable income calculated as if the corporation had not elected S status.[24] Net earnings include ordinary business income plus any pass-through items of income or deduction. Schedule J3 begins with the ordinary business income (loss) amount from Form 1120S, Schedule K, Line 1, adds pass-through income items reported on Schedule K, Lines 2-10, and deducts pass-through deduction items reported on Schedule K, Lines 11-12. The additions are reported on **Schedule J3, Line 2**, and the deductions are reported on **Schedule J3, Line 4**.

2. Deduction - Any Loss on the Sale of an Asset Sold within 12 Months after the Date of Distribution

Schedule J3, Line 5 represents amounts resulting from an S-corporation that distributes an asset to its shareholder when the shareholder sells the asset for a loss within 12 months of the distribution. A loss on the sale of an asset by a shareholder is reflected on the franchise and excise tax return of the taxpayer that made the distribution, not the one that eventually sold the asset at a loss.[25] For more information, see the discussion at Partnerships – Schedule J1, Line 9.

Schedule J4 – Corporations and Other Entities

Corporations file on federal Form 1120. Line 28, which reports "taxable income before net operating loss deduction and special deductions," is the amount that should be reported on Schedule J4, Line 1. Taxpayers should not use Line 30 "taxable income," because that line is net of the federal net operating loss deduction and special deductions. Tenn. Code Ann. § 67-4-2006(a)(1) specifically states that "net earnings" or "net loss" is defined as federal taxable income or loss *before* the operating loss deduction and special deductions.

Any taxpayer filing federal Form 1120 or any variation of that form, except for a corporation electing S-corporation status, should complete Schedule J4. Entities using Schedule J4 include:

- Business trusts;
- Entities not chartered as a corporation (like an LLC) that have made a federal election to file as a corporation; and
- "Other" taxable entities not includable on Schedules J1, J2, or J3, such as organizations exempt from federal income tax that file federal Form 990-T to report taxable business income from nonexempt activities.
    - "Others" may include joint-stock associations, national banks, regulated investment companies, state-chartered banks, and federal or state chartered financial associations.[26]

REITs report their net income on Schedule J4, Line 2a and any dividends paid deduction on Schedule J4, Line 2b. The franchise and excise tax forms were revised in 2018 to provide a dedicated line for the dividends paid deduction. Prior to 2018, the amount reported on federal Form 1120-REIT, Line 21(b), was netted against taxable income shown on federal Form 1120-REIT, Line 20, and the balance was reported on Schedule J4, Line 3 (2017).

1. Addition - Domestic Production Activities Deduction (2017)

Schedule J4, Line 4 (2017) represents the federal deduction for the domestic production activities deduction ("DPAD") under the provisions of IRC § 199. This deduction was repealed by the federal Tax Cuts and Jobs Act ("TCJA") and is unavailable for tax years after 2017. However, taxpayers should add back the deduction in years in which the deduction was utilized for federal income tax purposes because Tennessee disallows this deduction.[27]

Individuals, corporations, cooperatives, estates, and trusts calculate their DPAD deduction on federal Form 8903 and report the deduction on Form 1040, Line 35 or Form 1120, Line 25. Not all taxpayers qualify for this deduction. The IRS created the deduction in 2005 to encourage domestic production activities. This federal deduction is "federal fiction" and is not an expense requiring an actual cash outlay. The amount is reported on federal Schedule M-1 or Schedule M-3, Part III, Line 22 as a reconciling item between book and tax income. The federal DPAD is not allowed for excise tax purposes and should be shown as an add-back.

2. Addition/Deduction - Contributions

Schedule J4, Lines 5 and 8, address the timing difference that may exist as to when a taxpayer may deduct a charitable contribution for state excise tax versus federal income tax purposes. For excise tax purposes, charitable contributions may be deducted in full in the year in which the contribution was made, even though the full deduction may not be allowed for federal income tax purposes in that year. Corporations[28] report on Schedule J4, Line 8 current year charitable contributions that were not allowed as a deduction for federal income tax purposes due to the federal limitation. If a corporation did not have current or previous year contribution limitations, both the state and federal contribution deduction would be the same. No entries would be made on Schedule J4, Lines 5 or 8.[29]

The IRC states that the charitable contribution deduction cannot exceed 10% of net taxable income.[30] However, any unused amount may be carried forward and used on subsequent federal tax returns for up to five years. This federal limitation and the associated carryover are not recognized for Tennessee excise tax purposes. The deduction is allowed in the year made for excise tax purposes.

Taxpayers should report on Schedule J4, Line 5 federal charitable contribution carryovers from prior periods that were deducted on federal Form 1120 in arriving at the corporation's current year federal taxable income but were deducted for excise tax purposes in a prior year (when incurred). The number reported on this line will be included in the federal Schedule M-1 or M-3 reconciliation.

The GAAP book-to-tax reconciliation for charitable contributions is found on federal Form 1120, Schedule M-1, Line 8b or Schedule M-3, Part III, Line 21.[31] Note that Line 21 does not allow entries under the per books "column a – income statement." Entries on this line only reflect federal timing differences. Initially, a taxpayer may not be allowed to deduct all of its contributions because of the 10% limitation and would enter the disallowed amount on Line 21, column b as a negative amount. In subsequent years, when the carryover amounts are used, those amounts would be entered as a positive number in column b. In years in which a carryover deduction is claimed on the federal return, auditors should disallow it by reporting it as an add-back on Schedule J4, Line 5.

Whenever a contribution is claimed on federal Form 1120, page 1, auditors should determine if the amount is a current year deduction, a carryover deduction, or a combination of both. Schedule M-3 will help in that regard. Also, several types of tax preparation software generate worksheets that provide this information.

3. Addition - Capital Gains Offset by Capital Losses

Schedule J4, Line 6 represents any capital loss carryovers that offset capital gains on the current federal income tax return. Tennessee allows the full capital loss deduction in the initial year (the year incurred) without limitation, whereas the I.R.C. places a limit on the capital loss deduction (see below). Because the entire loss is recognized in the initial year for Tennessee excise tax purposes, any capital loss carryovers that reduce federal taxable income in subsequent years are not permitted and are reported on this line as an add-back. See federal Form 1120 Schedules M-1, Line 8 or M-3, Part II, Line 24 and any detailed schedule attachments associated with federal Schedule D. The capital loss temporary difference is reported on Form FAE 170 Schedule J4, Line 9 in the initial year.[32] See the discussion of federal Schedule D and capital gains/losses below for more information.

4. Deduction - Capital Loss, Deduction

Schedule J4, Line 9 represents any current year capital loss not deducted when calculating federal taxable income (loss). Taxpayers may fully deduct capital losses in the year they were incurred for Tennessee excise tax purposes, but certain limits apply federally and all or part of the capital loss may not be deducted for federal tax purposes. The amount reported on this line is from federal Form 1120 Schedule M-1, Line 3 or Schedule M-3, Part II, Line 24.[33] See the Schedule J4, Line 6 section above for additional discussion, including the excise tax treatment when a capital loss is offset by a capital gain in a subsequent period.

Federal Schedule D – Capital Gains and Losses

Businesses report capital gains and losses on federal Form 1120, Schedule D. For a corporation, capital losses may be used to offset capital gains, but are never a deduction on their own. Any capital losses in excess of capital gains are *not* transferred to federal Form 1120 as a deduction. Unused capital losses may be carried back three years[34] and then forward five years for federal tax purposes.

The amount of "unused capital loss carryover" brought into a current year return is reported on federal Form 1120, Schedule D, Part 1, Line 6. This amount should be reported as a Schedule J4 add-back to the extent that it offsets current year capital gains. For example:

- Form 1120, Schedule D shows a $100,000 capital loss incurred in another tax period but carried forward to the current year return where it offsets a current year capital gain of $40,000.

- No capital gain or loss amounts are reported on page 1 of Form 1120. Instead, the capital gain is fully offset by the capital loss, and the unused loss of $60,000 ($100,000 - $40,000) would go on federal Schedule D, Part 1, Line 6 of the subsequent year's return.

- Schedule J4, Line 6 will report $40,000. This is the current year capital gain that was offset by the capital loss carryover.

Pass-through Entity - Adjustment Not Needed

This adjustment will never apply to pass-through entities, like partnerships, LLCs, and S-corporations because they pass through all capital gains and losses to their owners on federal Schedule K-1. Any federal limitation is applied at the partner/shareholder level. Note that the partnership federal Form 1065, Schedule D, does not have any limitation, but allows the entire gain or loss amount to pass through to its owners. As a result, no excise tax add-back or deduction is needed.

Audit Procedures – Capital Gain Offset by Capital Loss

A common issue for taxpayers is applying the I.R.C. to Tennessee filings and erroneously filing amended excise tax returns to claim a loss carryback. Another issue is taxpayers erroneously filing an excise tax return by failing to add back a capital loss carryforward deducted on its federal return.

The add-back amount that should be reported on Schedule J4, Line 6 is found on federal Schedule M-1, Line 8[35] or Schedule M-3, Part II, Line 24. In the case of an audit, the auditor should review federal Schedule D (including detailed attachments). These documents should show any capital gains that were offset by capital loss carryovers.

Federal Schedule M-3, Part II, Line 24 is used to report both capital loss limitations and carryforwards used. Regarding loss carryforwards, the schedule's instructions state, "[i]f the corporation utilizes a capital loss carryforward on Schedule D in the current tax year, report the carryforward utilized as a *negative* amount on Part II, line 24, columns (b) or (c), as applicable, and column (d)." This line is also used to report the amount by which the current year capital losses exceed the current year capital gains. These amounts are not deductible for federal income tax purposes but would be reported as a Schedule J4 deduction. Federal Schedule M-3's instructions also state, "report as a *positive* amount on line 24, columns (b) or (c), as applicable, and (d) the excess of the net capital losses over the net capital gains reported on Schedule D."

The Line 24 positive and negative amounts need to be interpreted in conjunction with Line 23a. Note that Line 24 does not permit an entry in column (a) for a "per book" amount. Likewise, Line 23a does not permit an entry in column (d) for a "per tax" amount. To fully understand the book versus tax reconciliation, both Lines 23 and 24 need to be considered.

The example above would show that the current year gain of $40,000 was the same for both book and tax purposes (Lines 23(a) and 24(d)). Even though both book income and tax income reflected a current year gain, for tax purposes that gain will be offset by the loss carryforward. This would be reflected on Line 24. When "income per tax return – column (d)" Lines 23 and 24 are combined, they net to zero. In other words, the current year net gain of $40,000 was fully offset by carryover losses. If this was the taxpayer's only transaction, Line 30 would show net income per books of $40,000 and net income per tax return of $0.

The excise tax add-back and deduction lines serve the sole purpose of allowing the capital loss to be fully deducted in the year incurred and to reverse the impact of any federal return capital loss carryovers for excise tax purposes.

In the above example, there was a current year capital gain of $40,000 that was offset by a loss carryover of $100,000. Since the $100,000 loss was fully deducted in the year it was incurred for excise tax purposes, the current year gain should be fully taxable for excise tax purposes. Therefore, $40,000 would be reported on Schedule J4, Line 6.[36]

Schedule J Computation of Net Earnings Subject to Excise Tax - All Entity Types

Tenn. Code Ann. § 67-4-2006(b) provides guidance on computing net earnings subject to excise tax. Section (1) of that statute lists the additions to net earnings and losses, and section (2) lists the deductions from net earnings and losses. These add-backs and deductions are reported on Schedule J, Lines 2-13 and Lines 15-27, respectively, and are generally applicable to all types of entities, including those filing as partnerships, SMLLCs, and corporations. Statutory additions or deductions that apply only to a specific type of entity are found on Schedules J1, J2, J3 or J4 instead of Schedule J.

The Schedule J line references below may be different from the ones on a return under audit, because there have been numerous form revisions. For example, the 2020 FAE170 was revised to include two new lines for changes related to interest expense and the 2018 form was revised in the fall of 2019 for changes related to repatriated earnings and global intangible low-taxed income ("GILTI").

1. Schedule J, Line 1 – Federal Income (Loss)

Every taxpayer should complete Schedule J1, J2, J3, or J4, depending on the federal form filed. The amount from the last line of the applicable sub-schedule is entered on Schedule J, Line1. It is the adjusted federal income or loss before any state imposed add-backs or deductions that are applicable to all entity types.

2. Addition – Intangible Expense

Schedule J, Line 2 represents an intangible expense paid, accrued, or incurred to an affiliated taxpayer, which was deducted for federal income tax purposes. It is reported on this line as an add-back.

"Intangible property" includes patents, patent applications, trade names, trademarks, service marks, franchise rights, copyrights, licenses, research, formulas, designs, patterns, processes, formats, and similar types of intangible assets.[37]

"Intangible expense" is an expense related to, or in connection with, the acquisition, use, maintenance, management, ownership, sale, exchange, license, or any other disposition of intangible property, to the extent such amounts are allowed or allowable as deductions or costs in determining federal taxable income on a separate entity basis.[38]

"Affiliate" is any entity:

- In which the taxpayer, directly or indirectly, has more than fifty percent (50%) ownership interest;
- That, directly or indirectly, has more than fifty percent (50%) ownership interest in the taxpayer; or
- In which an entity described in the above bullet point, directly or indirectly, has more than fifty percent (50%) ownership interest.[39]

All taxpayers reporting a deduction on their federal returns for royalties, license fees, or other intangible expenses paid to an affiliate must add back the deduction on Schedule J, Line 2. The law concerning intangibles has changed several times since it was first enacted in 2004, but the add-back requirement has not changed.

In the case of an audit, the auditor will likely search for intangible expense deductions taken on the federal return and verify that the required intangible expense add-back has been made. The taxpayer must report the add-back or be subject to the minimum negligence penalty if the deduction is taken.[40]

The penalty is calculated when it is determined that:

- The taxpayer deducted an intangible expense (royalties/licenses) paid to an affiliate on its federal return and the taxpayer computed its excise tax based on the federal net income (loss) without adding back the intangible expense on Schedule J, Line 2; or
- The taxpayer added back the intangible expense on Schedule J, Line 2 and deducted the expense on Schedule J, Line 21 but did not attach the Intangible Expense Disclosure form.

The excise tax and penalty calculation:

- The excise tax is computed without the deduction; and
- A nondisclosure penalty is calculated:
    - Determine the difference between the excise tax calculated with the deduction and without the deduction. Multiply that difference by 50% to arrive at the penalty that may be assessed.
    - *For tax years beginning on or after 1/1/2009*, the minimum penalty is $10,000 for each year there was a failure to disclose the intangible expense. For example:

Intangible Expense Nondisclosure Penalty	2017	2018	Total
Royalty Expense not reported as an add-back	$9,273,706	11,829,595	
Apportionment ratio	0.002879	0.002781	
	26,699	32,898	
Excise Rate	0.065	0.065	
	1,735	2,138	
Penalty Rate	0.5	0.5	
Computed Penalty	$868	$1,069	
Minimum Penalty	$10,000	$10,000	$20,000

Royalties, license fees, and similar intangible expenses are often included on the "Other deduction" line of the federal return. In the case of an audit, the auditor may review the detailed schedule for that line, including scanning the account titles of a detailed trial balance to identify intangible expense accounts. The auditor may also ask the taxpayer to provide a listing of payments made to various affiliates that own intangible property, including the date, amount, and reason for the payment. The United States Patent and Trademark Office maintains a database of intangibles owners on its website. http://www.uspto.gov/trademarks/index.jsp.

⚠ **Taxpayers failing to add-back the intangible expense will be subject to a minimum negligence penalty that is the greater of $10,000 or 50% of any adjustment to the initially filed return.**

See a discussion of the intangible expense deduction (Schedule J, Line 22) below and Important Notice #17-27 – Intangible Expense Deduction.

3. Addition - Bonus Depreciation

Schedule J, Line 3 represents:

- depreciation expense deducted on the federal income tax return under the provisions of IRC Section 168 for "bonus depreciation";[41] and
- any expense/depreciation deducted as the result of a "safe harbor" lease election.

IRC Section 168 Bonus Depreciation

Tennessee permanently decoupled from federal bonus depreciation for assets acquired on or after July 15, 2002. This means the state does not allow the deduction for bonus depreciation in arriving at net earnings subject to excise tax. Except for bonus depreciation, the federal depreciation method and life used for depreciable assets are the same as what should be used for excise tax purposes.

What is commonly called "bonus depreciation" is also referred to as "special depreciation" on federal forms and instructions. The "bonus" or "special" depreciation deduction is reported on federal Form 4562, Part II, Line 14 and Part V, Line 25. Bonus depreciation is a form of accelerated depreciation that allows businesses to depreciate an additional percentage of the cost of new or used,[42] depreciable assets in the same year in which they were placed into service. When the first-year bonus depreciation is applied, the federal basis of the property is then reduced by this extra first-year bonus depreciation allowance, and the remaining adjusted basis is depreciated from year one through the life of the asset under the Modified Accelerated Cost Recovery System ("MACRS") federal depreciation provisions.

When I.R.C. § 168 was first enacted in 2001, the additional amount was 30% of the asset's depreciable basis, but this percentage has changed over the years and can be as much as 50% or 100%. Federal bonus depreciation, as extended under the TCJA, is 100% of qualified property placed in service between September 28, 2017 and December 31, 2022 and may include used qualified property.

Asset Acquired After:	Bonus Percentage:
9-10-2001	30%
5-5-2003	50%
9-8-2010	100%
12-31-2011	50%
9-28-2017	100%

Under the decoupling provisions, the excise tax is calculated using the asset depreciation model that existed prior to 2002. That depreciation model is MACRS.

Timing Difference

Bonus depreciation creates a timing difference that exists every year between state and federal depreciation until the asset is fully depreciated. If the asset is disposed of before being fully depreciated, there will be a difference in the state and federal gain or loss amount. If the asset is held for its entire life, the same amount of depreciation will have been taken over the full term for both state and federal purposes. However, under bonus depreciation, more of the depreciation expense is taken in the initial year of the asset's life, and less is taken in later years. For example:

- At the end of its useful life, an asset costing $100 will report $100 in accumulated depreciation, no matter which method of depreciation was used. But if bonus depreciation was used for federal income tax purposes, more of the expense will have been deducted earlier rather than later.

There are three Schedule J lines devoted to reporting the differences between state[43] and federal depreciation:

- The depreciation add-back (Line 3);
- Deduction (Line 15); and
- Adjustment for gain or loss (Line 16).[44]

The sum of the Schedule J adjustments taken during the life of an asset should net to zero at the end of the asset's life or at the time of sale or disposal. If bonus depreciation was *never* taken on an asset, the state and federal depreciation expense should be the same. This situation is somewhat uncommon because, for federal income tax purposes, taxpayers are required to take bonus depreciation unless they elect to opt out of taking it.

Reporting the Depreciation Adjustment on Schedule J

The instructions to Schedule J, Lines 3 and 15 indicate that the amounts reported on these lines should only include amounts for assets actually subject to federal bonus depreciation.[45] However, taxpayers report the state/federal depreciation adjustment in a variety of ways on Schedule J. Three common methods are listed below, but the most common method is listed first. All methods are acceptable, and each should result in the correct net increase or decrease being made to the excise tax base.

Common Reporting Methods:

- A Schedule J add-back is reported for the total depreciation expense deducted on the federal income tax return, and a Schedule J deduction is reported for the total state depreciation expense. In other words, entries on Schedule J, Line 3 reverse out the entire federal depreciation expense and entries on Schedule J, Line 15 claim the entire state depreciation expense. This method is commonly referred to as the total-federal-expense-reversal method).

- One amount is reported on a single Schedule J line. This amount is the difference between the total federal depreciation expense and total state depreciation expense.

- The federal *bonus* depreciation expense claimed in the current year is reported as an add-back, and a Schedule J deduction is reported for the difference between federal and state depreciation for those assets on which *bonus* depreciation was claimed in the current or a previous year. The entries on Schedule J, Lines 3 and 15 reflect the federal/state differences for just those assets for which bonus depreciation was currently or previously claimed.

Depreciation Schedules Generated by Computer Software

Most taxpayers use computer software to prepare depreciation schedules. Schedules are normally maintained for GAAP books, federal tax books, federal alternative minimum tax books, and all the various state tax books. In the case of an audit, auditors should request that taxpayers provide paper or digital schedules based on specific audit criteria. For example:

- An auditor may request a detailed schedule that:
  - Can be tied to the federal income tax return;
  - Sorts assets by location, including state;
  - Shows bonus depreciation taken;
  - Lists asset description, cost, date of purchase, and date of sale (if applicable); and
  - Shows the depreciation method and estimated life used.

Auditors should verify that the depreciation expense deducted in arriving at Tennessee taxable income agrees with the Tennessee state depreciation schedule. This schedule should not show a deduction for bonus or special depreciation. Entries on Schedule J, Lines 3 and 15 are supposed to report the add-back of the current year's bonus depreciation and report the current year's additional state depreciation for assets that claimed bonus depreciation in previous years. Taxpayers report the state/federal depreciation adjustment on Schedule J in a variety of ways, as discussed in the prior section "Common Reporting Methods." Regardless of the method used, the depreciation deduction for excise tax purposes is based on depreciation schedules that have not deducted bonus depreciation.

Most detailed depreciation schedules follow a similar format, but the numbers may be presented in various ways. All depreciation schedules should list the same basic information, such as asset description and acquisition date, but will vary in the way they subtotal and organize information. For example, some schedules may require the user to sum the Bonus column, the Section 179 column, and an Annual Depreciation column to arrive at the year's total depreciation expense.

Generally, auditors should review, but not necessarily recalculate depreciation expense on individual asset items or foot the columns on the depreciation schedule. All auditors should be familiar enough with the schedule to determine the current year's depreciation expense (federal and state) and recognize any significant errors.

Some obvious errors would include accumulated depreciation exceeding an asset's cost basis or the "beginning of the year values" not tying to the "end of year values" of the prior period. The depreciation method and life used in computing depreciation expense for Tennessee excise tax purposes should be the same as what was used for federal income tax purposes, except for bonus depreciation. The Section 179 deduction is permitted for both federal and state purposes.

Audit Procedures - Depreciation

In the case of an audit, below is a general checklist the auditor may use in auditing depreciation.

- Request state and federal detailed depreciation schedules.
- Determine that the total depreciation expense from the federal detailed depreciation schedule ties to the pro forma federal income tax return.
    - With complex organizational charts, it is important to consider that the detailed listing given to the auditor may include or exclude lower-tier entities in error, so agreeing the total federal depreciation expense to the pro forma federal income tax return should be done.
- Determine that the difference in total state and federal tax depreciation expense per detailed schedules agree to the *net* adjustment made to the excise tax base, as shown on Schedule J. As long as the net adjustment is correct, it does not matter which Schedule J lines were used.
- Request state and federal gain/loss schedules of depreciable assets disposed of during the audit year, and determine that the amount shown on Schedule J, Line 16 effectively reverses out the federal gain/loss and replaces it with the state gain/loss. The same depreciation software that calculates depreciation expense also generates the gain/loss report.

Example: Asset Trade-in

The depreciable cost basis of an asset will be the same for state and federal tax purposes if it is purchased for cash. However, the cost basis may be different if there was a trade-in. The following example shows how a new forklift purchased with cash and a trade-in, can have a different depreciable cost basis for state and federal tax purposes:

- Forklift #1 is purchased for $10,000.
- State tax depreciation taken on it totals $2,000.
- Federal tax depreciation (which includes $5,000 bonus depreciation) totals $6,000.
- Later, Forklift #2 is purchased (no MACRS or bonus depreciation was claimed on Forklift #2). Payment is made by trading in Forklift #1 and paying $6,000 cash.

Depreciable cost basis (state and federal) of Forklift #2:

- State cost basis is **$14,000**
  Reason: $6,000 cash plus $8,000 book value of trade-in
  (book value is $10,000 cost - $2,000 accumulated depreciation)

- Federal cost basis is **$10,000**
  Reason: $6,000 cash plus $4,000 book value of trade-in
  (book value is $10,000 cost - $6,000 accumulated depreciation)

Example: Gain or Loss on Sale or Disposal

Depreciable assets normally incur a gain or loss when sold or disposed. If bonus depreciation was never taken on the asset, the resulting gain or loss would be the same for both federal and state tax purposes.[46] However, if the taxpayer has taken bonus depreciation on the asset for federal income tax purposes and the asset is not fully depreciated at the time of disposal, the gain or loss will be different for federal and state tax purposes.

In the above example, if Forklift #2 was sold for $13,000, there would be a federal tax gain of $3,000 and a state tax loss of $1,000. This $4,000 difference is solely attributable to the bonus depreciation taken on the trade-in (Forklift #1). Because Forklift #1 was traded in and not sold outright, the gain/loss was deferred and recognized when Forklift #2 was sold.

	Bonus Depreciation	MACRS Depreciation	Total
Federal	$5,000	$1,000	$6,000
State	- 0-	$2,000	$2,000
Difference	$5,000	($1,000)	**$4,000**

Under the first reporting method discussed previously (the total-federal-expense-reversal method):

- The taxpayer would report a Schedule J add-back of the total depreciation expense reported on the federal income tax return of $6,000.
- The $6,000 amount is given in the example narrative and is comprised of $5,000 bonus depreciation and $1,000 MACRS depreciation that is calculated on Forklift #1's depreciable basis after bonus depreciation.
- Schedule J, Line 15 would reflect the total state depreciation expense for Forklift #1 (computed without bonus depreciation) of $2,000.
- In addition, since Forklift #2 was sold for $13,000, the federal return would have reported a gain of $3,000. However, because it had a different cost basis for state tax purposes, an entry should be made on Schedule J, Line 16 for the excess gain from the basis adjustment resulting from Tennessee permanently decoupling from federal bonus depreciation.
- The loss for state tax purposes is $1,000 ($13,000 - $14,000). The Schedule J, Line 16 *deduction* amount should reflect the reversal of the federal amount and replacement with the state amount ($3,000 + $1,000). Schedule J, Line 16 would report $4,000. The amounts reported on the Schedule J lines for this example are as follows:

Schedule J Lines:	Amount:
Add-back (Ln. 3)	$6,000
Deduction (Ln. 15)	$2,000
Excess G/L (Ln. 16)	$4,000

4. Addition - Gain on the Sale of a Distributed Asset & Repatriated and GILTI Adjustment (2018)

Schedule J, Line 4 represents any gain on the sale of an asset sold within 12 months after the date of distribution to a nontaxable entity. Generally, the entity that distributed the asset is the entity that should report the gain. If an asset was distributed to a member, partner, shareholder, or certificate holder and no sale has taken place, or if the asset was sold 12 or more months after distribution, no entry is required. **Failure to report this gain may result in a 50% negligence penalty.**

Gain Reportable by Entities Not Normally Subject to Tax

Prior to July 1, 2004, Tennessee law permitted taxpayers to distribute assets to a nontaxable entity (like an individual), which would in turn sell them at a gain within 12 months of the distribution. In such cases, no gain was reported by either entity. However, effective July 1, 2004, the gain on this type of transaction is subject to excise tax. The gain is taxed to either the distributing taxpayer[47] or the seller[48] (who is not normally subject to tax).

While the gain generally reverts to the taxpayer that makes the distribution, the seller may be subject to the tax if Tenn. Code Ann. § 67-4-2007(f) applies. Subsection (f) was enacted in 2004[49] and lists four criteria under which the gain is taxed to a seller that is not normally subject to tax:

- The distributor ceases to exist prior to a sale that occurred within 12 months of the distribution. For example:

    - Taxpayer XYZ is owned by Mr. Clark. All company assets are distributed to Mr. Clark in a liquidating distribution and the business is closed. As a result, Taxpayer XYZ is no longer subject to the franchise and excise tax. Mr. Clark sells a tractor that he received in the XYZ asset distribution at a $1,000 gain within 12 months of the distribution. Generally, individuals are not subject to the excise tax; however, because Taxpayer XYZ no longer exists, Mr. Clark is subject to a 6.5% excise tax on the gain ($65) and he must file Form FAE170 to pay the tax.[50]

- The nontaxable seller received the asset through a merger, liquidation, or similar event with the taxpayer within 12 months of the sale.

- The seller qualified for exemption as an obligated member entity within 12 months of the sale.

- The asset was distributed by an affiliate subject to tax during the 12 months prior to the sale by the nontaxable entity.

Important Notice #08-06 explains the taxability of distributed assets and why, in some cases, an otherwise nontaxable entity or individual should file Form FAE 170.[51] These four situations are discussed in more detail in the paragraphs that follow.

A) Ceases to Exist

If a taxpayer distributes an asset to an entity not subject to the excise tax, which then sells the asset within 12 months of the distribution at a gain, and the original distributing taxpayer does not exist at the time of the asset sale, the gain from the sale would be taxed to the selling entity that is normally not subject to excise tax.[52]

B) Merger or Liquidation

Usually a merger, liquidation, or similar event results in one entity surviving and one terminating. The surviving entity will be the one that makes the sale within the 12-month period. If the survivor is a taxable entity, the asset sale would be automatically included in the taxpayer's net income; no Schedule J adjustment would be needed. However, even if the survivor is normally a nontaxable entity, it would be subject to tax on the gain from the asset sale.[53] See Revenue Ruling 11-53 for a more detailed example.

C) Obligated Member Entity

If a taxpayer distributes assets to an obligated member entity ("OME") that sells them for a gain, the gain would *not* be taxable to the OME if it had qualified for the exemption *more* than 12 months prior to the sale. Note that the 12-month period in this subsection refers to when exempt status was given and not the distribution date.[54] For example:

- An LLC qualifies for the OME exemption on December 31, 2016. A taxpayer distributes an asset to the OME on January 1, 2018, and the OME sells the asset that same day at a gain.

- The OME does not have to pay tax on the gain, because it did not qualify for the exemption within the 12-month period immediately prior to the sale.

- Nonetheless, the gain from the sale does not go untaxed. Tenn. Code Ann. § 67-4-2006(b)(1)(I) would require the distributing taxpayer to pay the tax, because the asset was sold within 12 months of the distribution to a nontaxable entity. Revenue Ruling 08-20 provides guidance on Tenn. Code Ann. § 67-4-2007(f)(1)(C) concerning the taxation of OMEs.

D) Affiliate Distributes Asset

This last section criterion[55] specifically identifies the distributing entity as an affiliate, but it does not specify that the distributing affiliate ceases to exist. Thus, both Tenn. Code Ann. §§ 67-4-2006(b)(1)(I) and 67-4-2007(f)(1)(D) could potentially apply to the same fact scenario, but under § 2006(b)(1)(I), the gain would be taxed to the *distributing* entity and under § 2007(f)(1)(D), the gain would be taxed to the *selling* entity.

Therefore, if a taxpayer distributes an asset to an entity not subject to tax, and that entity sells the asset at a gain within 12 months of the distribution, the gain would be reported as an add-back on the distributing taxpayer's return.[56] However, if the tax is not collected from the distributing entity, regardless of the reason, Tenn. Code Ann. § 2007(f)(1)(D) permits the collection of the tax from the seller that is normally not subject to tax. In no event may the tax be imposed twice or imposed on an entity with a not-for-profit status.

Distributions Reported on Federal Income Tax Returns

Taxpayers report distributions made during the tax period on their respective federal income tax return Forms 1065/1120/1120S, page 5, Schedule M-2. Schedule M-2 only informs the reader that a distribution was made for a certain amount. The auditor would need to evaluate additional information before concluding that the provisions of this section apply.

Amount equal to Five Percent of Repatriated Earnings and Global Intangible Low-taxed Income ("GILTI")

The 2018 Form FAE 170 instructs taxpayers to report the taxable portion of repatriated earnings and GILTI on this line. The taxable portion is always five percent of the total/gross income per Public Chapter 306, enacted in 2019. Repatriated earnings and GILTI are in federal taxable income (the starting point for the excise tax return) but are reversed out of the excise tax base via the deduction reported on Schedule J, Line 18 (2018 form). For more information, see Important Notices # 19-13 and 19-14. Also, see the *Tax Cuts and Jobs Act of 2017* section in this chapter and the discussion at the beginning of this section, *Schedule J Computation of Net Earnings Subject to Excise Tax*. Beginning in 2019 the 5% add-back is made on Schedule J, Line 12.

5. Addition – Tennessee Excise Tax Deducted on Federal Return

Schedule J, Line 5 represents Tennessee excise tax deducted on the federal income tax return, which must be added back for excise tax purposes. Only the Tennessee excise tax (not the franchise tax) is added back. The amount reported is the amount that was actually deducted in determining federal net earnings.[57]

In the case of an audit, the add-back for excise tax does *not* come from the actual tax payments made during the audit period. The add-back is solely based on the excise tax deducted on the federal tax return for the tax period. For example:

- An accrual basis taxpayer may accrue excise tax expense on December 15, 2014, for the 2014 tax period, but make the actual tax payment in 2015.

- The add-back should be reported in the same year in which it was deducted on the federal return. Since the taxpayer maintains its book and tax records on an accrual basis, the deduction would have been reflected on its 2014 tax return.

An over-accrual of tax in a prior year can cause the current year's federal return to report a negative "deduction." In this event, the amount reported as an add-back on Schedule J, Line 5 can be negative. Tennessee excise tax refunds are excluded from net income to the extent they have been included in federal taxable income in the year of the refund.

Taxpayers often accrue both the franchise and excise tax liabilities in one journal entry that posts to a single "state tax expense" account. The portion representing the excise tax expense add-back can sometimes be found in the taxpayer's supporting work papers, but if it is not, the auditor may use their judgment based on the facts and circumstances to determine an appropriate add-back amount.

6. Addition - Gross Premiums Tax

Schedule J, Line 6 represents the gross premiums tax ("GPT") paid by the taxpayer. GPT is paid to the Department of Commerce and Insurance by self-insurers of workman's compensation. The amount at issue is always net of the .4% TOSHA surcharge. Not all taxpayers paying the GPT are required to make the Schedule J add-back, only those claiming the GPT credit on Form FAE 170, Schedule D, Line 1. Taxpayers are given the *choice* of either taking the *deduction* (as shown on their federal income tax return) or taking the franchise and excise tax *credit*. Auditors that see an entry on Schedule D, Line 1 should make sure the same amount is shown as an add-back on Schedule J, Line 6.[58]

Actual Premiums Tax before Surcharge that Corresponds to the Franchise, Excise Tax Period

The GPT credit and corresponding Schedule J adjustment should be based on the self-insurance premium tax invoice amount, regardless of when the actual cash outlay was made. Even though premiums are billed and paid in advance, taxpayers should base their credit on the invoice from the Department of Commerce and Insurance for the period that corresponds with the tax year of their franchise and excise tax return. Taxpayers will receive numerous invoices from the Department of Commerce and Insurance during a given year, so auditors should match the amount to the correct invoice. The invoices may report estimated numbers, actual numbers, and TOSHA surcharge amounts. Only the "actual" tax amount *before* the .4% TOSHA surcharge should be used for the credit.

7. Addition - Interest Income of States and Political Subdivisions

Schedule J, Line 7 represents interest income on obligations of states and their political subdivisions. Interest income on obligations of states and their political subdivisions, less allowable amortization, is exempt from federal income tax but not Tennessee excise tax. Therefore, this type of interest (net of amortization) is entered on Schedule J, Line 7 as an add-back.[59]

Federal Forms and Schedules

The add-back amount may be found in several places on federal forms and schedules:

- Federal Schedule M-1, Line 7 "tax-exempt interest" is recorded as a reconciling item between book and tax income.
- Federal Schedule M-3, Part II, Line 13.
- Federal Form 8916-A, Part II, Line 1. Form 8916-A is a supporting schedule to Schedule M-3, and it must be filed for each separate entity that is required to file a Schedule M-3. Tax-exempt interest income is reported on this line.
- Federal Form 1120, Schedule K, Line 9, "tax-exempt interest received or accrued."

- Partnerships report tax-exempt interest income on federal Form 1065, Schedule K, Line 18a.
- S-corporations similarly report tax-exempt interest income on Form 1120S, Schedule K, Line 16a.

Federal Form 8916-A, Part III, Line 4 is where expenses related to tax-exempt interest may be reported along with other interest expenses. Auditors should not assume that all interest expense reported on Line 4 should be netted against the tax-exempt interest income add-back. Only "interest expense disallowed for federal purposes pursuant to 26 U.S.C. [I.R.C.] §§ 265 and 291" should be netted against the interest income.[60]

Amortization of Bond Premium

If a bond yields tax-exempt interest, any *premium* must be amortized for federal income tax purposes. For example: a bond with a maturity value of $1,000 bought for $1,050 would have a $50 premium. The premium is part of a bond's basis. This generally means that each year, over the life of the bond, a part of the premium is used to reduce the interest income amount. If the bond yields tax-exempt interest income, this amortized amount is not deductible in determining federal taxable income. However, each year, the basis of the bond and tax-exempt interest income are reduced by the bond premium amortization for the year.[61]

For federal income tax purposes, both the tax-exempt interest income and the related amortization are excluded from taxable income. This income and related expense are not excluded for Tennessee excise tax purposes. Therefore, the exempt federal interest income amount, *net of amortization expense*, is reported as an add-back on Schedule J.

Expenses Incurred in Connection with Assets Producing Tax-exempt Interest

Generally, a non-bank taxpayer cannot deduct expenses or interest incurred in connection with acquiring or carrying assets that produce tax-exempt interest. This rule was designed to prevent taxpayers from excluding from taxable income the interest income earned on tax-exempt securities while at the same time deducting interest expense used to purchase these investments.

Banks were not initially subject to these rules, but they are now, with one exception. None of the interest expense incurred to carry or purchase tax-exempt obligations is deductible unless it is a "qualified tax-exempt obligation," also known as a "bank qualified obligation." Financial institutions can deduct 80% of the interest expense to carry or acquire "bank qualified obligations."[62]

Net Adjustment – Excise Tax

The excise tax add-back for tax-exempt interest income recognizes that taxpayers may have been denied deductions related to the tax-exempt interest on their federal returns, as discussed above. Therefore, the add-back for excise tax purposes should reflect the federal tax-exempt interest income *net of the related expenses that are disallowed for federal income tax purposes*.

8. Addition - Depletion

Schedule J, Line 8 represents the difference between "percentage" and "cost" depletion and is reported as an add-back on this line. This number will be included in the amount reported on federal Schedule M-1, Line 8 or M-3, Part III, Line 30 as a difference between book and tax income.

Capital assets and natural resources are not fully expensed when purchased. The wear, tear, and exhaustion of capital assets are deducted over several years as depreciation expense. Similarly, the diminishing of natural resources is deducted over several years as *depletion expense*. *Depletion* is a deduction that recognizes the exhaustion of natural resources, such as mines, wells, and timberlands. Tennessee permits a deduction for "cost" depletion, but not for "percentage" depletion, so any deduction for "percentage" depletion in excess of "cost" depletion must be added back on Schedule J, Line 8.[63]

Annual Federal Election

For federal tax purposes, taxpayers annually choose between two depletion methods, cost or percentage depletion. Each year, the taxpayer's cost basis of the property is reduced (but not below zero) by the amount of depletion deducted for that year. Depletion expense is an estimate, because the total number of units of the natural resource owned is itself an estimate. Calculations under the two methods are as follows:

- *Cost depletion* – Estimate the total units (tons, gallons, barrels) of the natural resource owned, and then divide the total cost by the estimated number of units to arrive at the cost per unit. The number of units extracted/used multiplied by the per-unit cost equals the annual depletion expense. *The expense ends once the cost less depletion reaches zero*.

- *Percentage depletion* – This depletion is based on gross income from the property, rather than its cost. To calculate percentage depletion expense, multiply the gross income from the property by the depletion percentage for a specific mineral. The percentage factor varies according to the type of mineral (e.g., 5% for gravel, 15% for gold, etc.). Because this method is based on gross income rather than cost, it is possible for percentage depletion to exceed the cost basis of the asset. The asset's basis is reduced by the amount of depletion taken until the basis of the property reaches zero. *However, percentage depletion may continue, even after "zero basis" has been reached.*

GAAP Depletion

GAAP requires that a method like the "cost depletion" method mentioned above be used for financial reporting purposes. The book versus tax difference in depletion expense is reported on federal Schedule M-3, Part III, Line 30. If the taxpayer has elected to use percentage depletion, the Schedule M-3 difference amount is also the difference between cost and percentage depletion, which is an add-back for Tennessee excise tax purposes. This will always be a positive amount because, for federal reporting purposes, the taxpayer is required to use the method resulting in a greater depletion expense.

Tennessee Law – Depletion

Tennessee law does not specifically mention depletion, but requires a deduction taken under 26 U.S.C. §§ 611-617, when "added with similar deductions in prior years, [to] exceed the cost of the property."[64]

For Tennessee audit purposes, annual cost depletion is allowed because it meets the above requirement, whereas this is not always true for percentage depletion. Auditors should report as a Schedule J add-back the excess of percentage depletion over cost depletion. This difference will be found on federal Schedule M-1, Line 8 or federal Schedule M-3, Part III, Line 30.

9. Addition – Excess Fair Market Value over Book Value of Property Donated

Schedule J, Line 9 represents non-cash charitable contributions to the extent that the fair market value of the property exceeds its book value. For excise tax purposes, only the book value of property donated to charity is allowed as a deduction in determining net earnings subject to excise tax.[65] *Book value* in this case is the tax basis of the asset, which is generally the asset's cost less accumulated depreciation.

The adjusted federal income or loss reported on Schedule J, Line 1 may include a federal deduction for a non-cash charitable contribution, which has been adjusted to fair market value. Both the federal income tax deduction and the GAAP expense[66] will generally include a fair market value adjustment where a donated asset's fair market value exceeds its book value. However, for excise tax purposes, the deduction is limited to the asset's book value. The excess of the fair market value over the book value of the donated property must be reported as an add-back on Schedule J. Inventory is a common example of donated property that has a book value different from its fair market value.

Both GAAP and tax guidance provide for a fair market value adjustment to the charitable contribution expense/deduction. The GAAP guidance is found at ASC 720-25 and the tax guidance is found at I.R.C. § 170, but none of the fair market value adjustments permitted by this guidance are permitted for excise tax purposes. The Schedule J add-back is <u>not</u> the difference between the book expense and the tax expense but is the difference between the tax basis fair market value and the tax basis book value of the donated asset.

Federal Form 8283

Federal Form 8283 reports information about noncash charitable contributions. This form provides detailed information concerning donated property, including the donor's tax cost basis and fair market value. Taxpayers may not be consistent in how they complete Form 8283 or the numbers that they report in columns a and d of the Schedule M-3, Part III, Line 19, "Charitable contribution of cash and tangible property." However, when Form 8283 is filed, auditors should always consider whether the federal deduction amount includes an amount that represents a fair market value over book value of donated property—the excise tax add-back.

> ⚠ **Taxpayers filing Form 8283 may be asked to provide additional information concerning any noncash donations. This may include the book and tax journal entries recording the transaction(s), including any fair market value adjustments. Also, a schedule reconciling the donated property's book value to the tax deduction may be requested.**

IRC § 170

The Tennessee charitable contribution deduction for excise tax purposes conforms to I.R.C. § 170, except for:

- percentage limitations (discussed at Schedule J4, Lines 5, 8), and
- the valuation of non-cash donations.

I.R.C. § 170 has many provisions and Tennessee conforms to all of them, except as noted above. For example, political contributions expensed under GAAP are not deductible for federal income tax purposes or for excise tax purposes.

10. Addition – Excess Rent to/from an Affiliate

Schedule J, Line 10 represents the amount of rent that is deducted on the corresponding federal income tax return in excess of "reasonable rent" for real property owned by an affiliate[67] and must be added back on this line. Additionally, a taxpayer receiving excess rent, to the extent that it is added back to net earnings by its affiliate, may enter a negative amount on this line.[68]

"Reasonable rent" is rent that does not exceed 2% per month of the appraised value of the property for property tax purposes. The rent must be for "industrial and commercial property," which includes "all property of every kind used, directly or indirectly, or held for use, for any commercial, mining, industrial, manufacturing, trade, professional, club whether public or private, nonexempt lodge, business, or similar purpose, whether conducted for profit or not" and includes real property with two[69] or more rental units used for dwelling purposes.[70]

⚠ **If a taxpayer fails to make this adjustment, and the failure is determined to be due to negligence, a 50% negligence penalty may be assessed.**

Example – Excess Rents

A.C.M.E., Inc. rents commercial buildings and equipment to its affiliates (greater than 50% owned). Excess rents do not apply to personal property, so columns (e)-(g) of the chart below are marked "n/a" for Skip's Pizza, Inc. The remainder of the chart shows that the rents that Van's Floral and Sandy's, Inc. paid to A.C.M.E were excessive. In other words, their monthly rent expense was greater than 2% of the property's appraised value. Column (f) of the chart shows one month's excessive rent and column (g) shows the Schedule J add-back for the entire year, assuming the property was rented all year. Van's Floral would report $1,200 on Schedule J, Line 10 and Sandy's would report $120,000. Since Van's Floral and Sandy's were partially denied their rent expense deduction, A.C.M.E. can adjust its corresponding rental income. A.C.M.E. would report a negative $121,200 on Schedule J, Line 10.

Affiliate Name (a)	Property & Location (b)	Appraised Value (c)	Monthly Rent (d)	2% of Col. (c) (e)	Excess rent (d) less (c) (f)	Schedule J Add-back (g)
Skip's Pizza, Inc.	Oven - Paris	20,000	350	n/a	n/a	n/a
Van's Floral, LP	Shed - Norris	30,000	700	600	100	1,200
Pand Music, Inc.	Bldg. - Erin	2 million	25,000	40,000	n/a	n/a
Sandy's, Inc.	Bldg. - Erin	1 million	30,000	20,000	10,000	120,000

11. Addition – Net Loss or Expense Received from a Pass-through Entity Subject to the Excise Tax

This line applies to situations where a taxpayer owns a pass-through entity that is also subject to the excise tax and is filing an excise tax return. Without this add-back line, the benefit of a net loss or expense attributed to a pass-through entity could potentially be recognized by the pass-through entity and again at the owner level.

The federal income tax return of the owner will automatically include their share of the items of income or loss from the pass-through entity (as reported on federal Schedule K-1). Because the Tennessee excise tax computation begins with federal taxable income, Schedule J, Line 11 reverses out losses and expenses from pass-through entities that are themselves subject to excise tax and filing an excise tax return. In addition, this same concept would also apply to income or gains. Schedule J, Line 24 reverses the portion of the pass-through entity's gain and net income received by the taxpayer and included on its federal return.

Lower-tier pass-through entity is not subject to franchise and excise tax or is exempt from tax

If a franchise and excise taxpayer receives pass-through income or loss from an entity that is not subject to the franchise and excise tax, then the pass-through income/loss is *not* reversed out in arriving at the taxpayer's Tennessee taxable income. For example, a general partnership issues a Schedule K-1 to a Tennessee taxpayer filing a franchise and excise tax return. No Schedule J reversals are made because the general partnership is not subject to the tax.[71] However, if the lower-tier entity is a type of entity that would be subject to the tax (e.g., an LP or LLC), *if it were not for the fact that the entity has qualified for a franchise and excise tax exemption*, the pass-through income or loss *should* be reversed out on the taxpayer's return. For example:

- Obligated Member Entities ("OME") are entities that would otherwise be subject to the tax, but they qualify for the OME exemption if all of the members are fully obligated for the entity's debts and obligations. As a result of qualifying for this exemption, the OME does not have to file a franchise and excise tax return, but instead is required to file the Annual Exemption Renewal (Form FAE 183).

- None of the OME's pass-through income or loss should be included on any tax return and should be reversed out. In short, if an entity's income/loss is not includable on an excise tax return by virtue of the entity qualifying for a franchise and excise tax exemption, then its income/loss is also not included in the flow-through attributes of its taxable owners.

- To the extent that any obligated member, or any owner of an obligated member, provides limited liability protection, the obligated member entity will owe the excise tax on the portion of income and equity attributable to such obligated member. See Chapter 2 discussion of a partially exempt OME. An owner of a partially exempt OME should reverse out any pass-through income or loss from the OME as evidenced by the Schedule K-1 received from the OME.

Audit procedures when a taxpayer owns an interest in a pass-through entity[72]

- Obtain copies of all Schedule K-1s received by the taxpayer for the audit period. If this is overly burdensome on the taxpayer, obtain a listing of all pass-through entities owned by the taxpayer that includes their names and FEINs.

- Determine which pass-through entities are subject to and filing a Tennessee excise tax return by reviewing the Department's internal records (TR3) to confirm this information.

- General partnerships do *not* pay franchise and excise tax on their own, so their pass-through income (loss) is subject to tax at the first level of ownership by an entity that is subject to the excise tax.

- A venture capital fund is not subject to excise tax and does not file an excise tax return. If it is formed as an LLC or partnership, its partners/members would not reverse the pass-through items on their returns.

- Reversals are not applicable to entities that are subject to the franchise tax but not the excise tax. In other words, a pass-through entity that pays only the minimum $100 franchise tax because it is registered with the Tennessee Secretary of State, does not meet the requirement of a taxpayer that is subject to and filing a Tennessee excise tax return.

- Entities that file a franchise and excise tax return and claim exemption from excise tax under P.L. 86-272, do not meet the "subject to and filing" criteria, and their pass-through activity should *not* be reversed out on Schedule J, Lines 11 and 24.

- Pass-through entities with all "In Tennessee" apportionment factors of zero are presumed not to be doing business in Tennessee and are therefore not "subject to the excise tax." In this case, no amount should be reported on Schedule J to reverse out pass-through amounts received from such entities.

- Verify the accuracy of the amounts reversed on Schedule J, Lines 11 and 24. Determine that any pass-through amount reversed was in fact included in the taxpayer's federal return taxable income. Because pass-through entities are subject to excise tax on a separate-entity basis, the state does not tax the pass-through income again at the owner level. Auditors should verify that the adjustment only reverses an amount already included in the taxpayer's net income/loss. Generally, the flow-through amounts will be reported as "other income or loss" on the owner's federal income tax return. This would be Lines 10 (income) and 26 (loss) on federal Form 1120 and Line 7 on Form 1065. Pass-through amounts from Schedules K-1 retain their character, so interest income, capital gains, etc. will be reported on the appropriate lines of the recipient's income tax return.

Taxpayers will sometimes erroneously include 100% of the pass-through entity's income/loss on the Schedule J reversal lines instead of their distributive share, as shown on Schedule K-1. Generally, the amounts reported on Schedule K-1 are computed by multiplying the pass-through entity's total amounts on Schedule K by the partner's ownership percentage, but this is not always the case (a method other than percentage ownership may be used[73]). For excise tax purposes, it is always best to obtain a copy of the Schedule K-1 issued to the taxpayer, trace the items of income/expense to the taxpayer's federal income tax return, and then allow the reversals on Schedule J if the pass-through entity was itself subject to the excise tax.

Sometimes, taxpayers will correctly report a gain or income from a pass-through entity and claim a deduction on Schedule J, Line 24 in a given year, but in another year, fail to report an add-back for a loss or expense from a pass-through entity. For this reason, it is important for auditors to not only verify the numbers reported on the excise tax return but to also look for the omission of add-back amounts.

12. Amount Equal to Five Percent of IRC Section 951A Global Intangible Low-Taxed Income

Please see the Tax Cuts and Jobs act of 2017 section below for a discussion of repatriated earnings and global intangible low-taxed income. The amount entered on Schedule J, Line 12 is equal to five percent of the amount deducted on Line 26.

13. Business Interest Expense

Please see the Tax Cuts and Jobs act of 2017 section below for a discussion of the business interest expense limitation. For tax periods beginning on or after January 1, 2020 the state decoupled from the federal limitation. An add-back line and a deduction line on Schedule J serves to fully reverse the federal interest expense and to report the deductible amount for excise tax purposes. The amount reported on Schedule J, Line 13 is the total interest expense embedded in the federal net income or loss reported on Schedule J, Line 1. However, *Schedule J, Line 13 is only completed by taxpayers that file federal Form 8990 Limitation on Business Interest Expense Under Section 163(j).* Small business taxpayers with annual gross receipts of $26 million or less for the 3 prior tax years generally would not file this federal form and they would not enter anything on Schedule J, Line 13 or Line 27a.

14. Total Additions

The total additions amount reported on Schedule J, Line 14 includes the statutory add-backs that apply to all entity types. Adjustments that apply to specific entity types are reported on the applicable Schedules J1, J2, J3 or J4.

15. Deduction – Depreciation

Schedule J, Line 15 represents depreciation under the provisions of IRC § 168 permitted for excise tax purposes due to Tennessee permanently decoupling from federal bonus depreciation. See the previous *Schedule J, Line 3* section (on the corresponding add-back) for a complete discussion of the Schedule J depreciation-related adjustments.

"Bonus depreciation" accelerates the depreciation deduction by allowing a greater deduction in the initial year the asset was placed in service. Consequently, a lesser deduction is claimed in subsequent years. Since Tennessee does not allow the deduction for federal bonus depreciation, the state deduction will be less than the federal deduction in the initial year and greater in subsequent years. Schedule J, Line 3 is used to report the federal versus state depreciation adjustment in year one, and Line 15 is used to report this difference in later years. However, as discussed previously, taxpayers may report the depreciation adjustments in different ways.

16. Deduction – Excess Gain/Loss on Asset with Bonus Depreciation

Schedule J, Line 16 represents the excess gain (or loss) reported for federal tax purposes from the basis adjustment resulting from Tennessee permanently decoupling from federal bonus depreciation. This subtraction is the difference between an asset's higher Tennessee basis and its lower federal basis (resulting from bonus depreciation taken on the federal return but disallowed on the state return). Note that the taxpayer will not enter anything on this line (it cannot take the deduction) if it was not subject to the state's excise tax during any portion of the period in which the taxpayer took depreciation expense on the property for federal income tax purposes.[74] For an in-depth example of this concept, See *Hilloak Realty Co. v. Chumley*, 233 S. W. 3d 816 (Tenn. Ct. App. 2007).

See also the depreciation discussion under the previous *Schedule J, Line 3* section for examples of assets that had taken bonus depreciation and were disposed of before being fully depreciated.

17. Deduction – Dividends Received

Schedule J, Line 17 represents all dividends received from corporations that are at least 80% owned.[75] Dividend income is found on federal Forms 1120, page 1, Line 4 and 1065, page 4, Schedule K, Line 6. Additionally, the same amount is reported on Form 1120, page 2, Schedule C, Line 23. Partnership returns do not have a federal Schedule C, but instead report the additional dividend information on an attachment to federal Schedule K.

All taxpayers may deduct dividends received from corporations in which they own 80% or greater of their stock. While federal Form 1120, Schedule C provides information concerning the percentage of stock ownership, it may not provide sufficient information to determine if the 80% test has been met. The auditor should obtain federal Form 851 – Affiliations Schedule – for additional ownership information. As an alternative, auditors could obtain an organization chart that shows ownership percentages.

⚠ **The dividends received deduction does NOT apply to indirect dividends. See Revenue Ruling 19-02 for a comprehensive, fact-based example.**

The deduction is for taxpayers that have a direct ownership interest in the entity from which they are receiving a dividend, regardless of the fact that the dividend payout process may have started with a lower-tier entity.

A "gross up" dividend is fictitious income (never paid nor received by the taxpayer) that is reported on federal Form 1120, Schedule C, Line 18 and is included in dividend income on the federal return. If this amount comes from stock ownership meeting the 80% test, then it can be deducted as such. If the 80% test is not met, it can be shown as non-business income. Either way, it is deducted for excise tax purposes. The preferred treatment is to report a "gross up" dividend on excise tax Schedule M – Nonbusiness Earnings Allocation.

A "Subpart F" dividend is not fictitious, but is deferred income based on foreign profits and is reported on federal Form Schedule C, Line 16. Subpart F deemed dividend income may be deducted from the excise tax base only if it meets the 80% test or, in rare situations, is found to be non-business earnings.

If dividend income is deducted or removed from the excise tax base for any reason, then it must be added-back on Form FAE 170, Schedule K, Line 2 to calculate the loss carryover available from the current year to the next year.[76]

The federal Tax Cuts and Jobs Act ("TCJA") requires taxpayers to report repatriated earnings on their 2017 and 2018 federal income tax returns. Also, Global Intangible Low-Taxed Income is reported in 2018 and later. These amounts should not be reported on Schedule J, Line 17 as dividends received. However, there is an exception related to the 2017 tax year for repatriated earnings, which is explained in Important Notice #18-05. See the *Tax Cuts and Jobs Act of 2017 (TCJA)* section below for additional discussion.

18. Deduction – Donations to Qualified Public School Support Groups and Nonprofit Organizations

Schedule J, Line 18 represents donations to qualified public school support groups and nonprofit organizations. All taxpayers may deduct charitable contributions from their Tennessee taxable income in the year in which the contributions were made. In addition to the normal charitable contribution deduction, taxpayers may also deduct 75% of monetary contributions made to qualified public school support groups and other nonprofit organizations if certain requirements are met. Therefore, a taxpayer may potentially deduct 175% of certain monetary contributions in arriving at Tennessee taxable income.

The primary requirements for the additional 75% deduction are:

- The receiving entity is not an individual, but is an entity whose sole purpose is to promote and enhance Tennessee *public schools or* any *nonprofit organization* exempt from federal taxation under 26 U.S.C. §§ 501(c)(3), 501(c)(4), 501(c)(5), or 501(c)(6).

- The taxpayer has a certification form signed by the recipient certifying that the donated funds were spent on goods or services subject to sales and use tax and that the tax was actually paid.

- The taxpayer/donor did not specify a specific purpose for the donation.

Auditors should review the taxpayer's certification form(s) in support of the deduction. If the nonprofit organization or public school support group makes a false certification, it must pay sales or use tax and any applicable penalties and interest, as if the donation had actually been spent on items subject to the tax.[77] See Important Notices # 04-17 and 05-04 for additional information.

19. Deduction – Federal Expense Reduction Related to Federal Credit

Schedule J, Line 19 represents expenses not deducted in determining federal taxable income, other than income taxes, for which a credit against the federal income tax is allowable.[78] There are numerous federal tax credits, and many of them do not result in federal or state adjustments to taxable income. Only credits that require the related expense be reduced on the federal income tax return are at issue. An excise tax deduction is reported on Line 19 when an expense is reduced for federal income tax purposes because a related credit against the federal income tax was taken. The amount of the federal credit is not necessarily the amount that is deducted on Schedule J. The excise tax deduction is *the amount that the federal expense was reduced* because the credit was taken. In the case of an audit, the auditor must read the federal instructions for the credit to determine the amount that is deducted from the federal expense, if any, because of the credit taken. Doing a search/find within the federal return instructions for "reduce" is often helpful.

Businesses typically make a federal tax journal entry to arrive at taxable income, and the difference will likely show up as a book-to-tax difference on Schedule M-3. For example, federal Form 5884 – Work Opportunity Credit – Line 2 reports the amount by which the salaries and wages expense is reduced because of the credit taken. This amount would also be reported as a permanent difference on federal Schedule M-1 or M-3 and should be reported on Schedule J, Line 19.

Some credits reduce both expenses and capital assets. The Tennessee code specifically states that this adjustment is for an “expense” that is not deducted in determining federal taxable income, so an adjustment to an “asset” account would not qualify for the Line 19 deduction.

Below is a list of several common federal tax credits, along with links to the corresponding federal forms and applicable line items.

Federal Form Title – Credits	**Federal Form:**	**See Federal Instructions for Line:**	**Line 19 Deduction Allowed?**
Federal Form 3800 – General Business Credit – page 3 provides a list of all credits (including the following) that require a reduction to the related expense:			
Credit for Federal Tax Paid on Fuels	4136	17	Yes*
Work Opportunity Credit	5884	2	Yes*
Credit for Increasing Research Activities	6765	17	Yes*
Orphan Drug Credit	8820	2a	Yes*
Disabled Access Credit	8826	6	Yes*
Empowerment Zone Employment Credit	8844	2	Yes*
Indian Employment Credit	8845	4	Yes*
Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips	8846	4	Yes*
Credit for Small Employer Pension Plan Startup Costs	8881	2	Yes*
Credit for Employer-Provided Childcare Facilities and Services	8882	7	Yes*
Low Sulfur Diesel Fuel Production Credit	8896	8 or 10	Yes*
Alternative Motor Vehicle Credit	8910	6	Yes*
Alternative Fuel Vehicle Refueling Property Credit	8911	7	Yes*
Mine Rescue Team Training Credit *(expired after 2017)*	8923	2	Yes*
Credit for Employer Differential Wage Payments	8932	2	Yes*
Credit for Small Employer Health Insurance Premiums	8941	-	Yes*
Federal Credit Forms – **No impact for TN excise tax** 3468, 6478, 8586, 8611, 8834, 8835, 8847, 8864, 8874, 8900, 8906, 8907, 8908			No
***Based on a federal tax journal entry that shows the expense account was reduced by the credit**			

20. Deduction - Safe Harbor Lease

A safe harbor lease is a sale/leaseback transaction enacted by federal legislation in 1981 and repealed in 1982. It is not commonly seen on franchise and excise tax returns. The state does not recognize safe harbor leases; therefore, any federal tax journal entries made in relation to safe harbor leases should be reversed for excise tax purposes on Schedule J, Line 20.

Any amount included in federal taxable income solely as a result of a safe harbor lease election or any depreciation or other expense that could have been deducted, had it not been for a safe harbor lease election, is deductible on Schedule J. GAAP also does not recognize safe harbor leases. Book-to-tax differences will be shown on federal Schedule M-1 or M-3 and may include adjustments to rental income, sale/lease interest expense, depreciation/amortization, and brokerage fees.[79]

Safe harbor leases were established as part of the federal Economic Recovery Tax Act (ERTA) in 1981. This type of lease transferred tax benefits of ownership (depreciation and debt tax shield) from the lessee, if the lessee could not use them, to a lessor that could use them. The number of leases written under ERTA jumped dramatically in 1982, creating a loss in tax revenue, so Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982 to restore the lost revenue. This new act *repealed* safe harbor leasing and replaced it with the "finance lease." The Department estimates that approximately 25 taxpayers in the state still have safe harbor leases that originated in 1981-1982.

Only three tests had to be met to qualify for a safe harbor lease:

- Lessor is a corporation;
- Lessor's minimum investment in the leased asset is never less than 10%; and
- The term of the lease did not exceed 90% of the useful life of the asset or 150% of the present class life of the asset.

If all these requirements were satisfied, the transaction would qualify as a lease for tax purposes, regardless of other factors previously disallowed (e.g., bargain purchase options, limited-use property).

A feature of safe harbor leasing was the tax benefit transfer (TBT) lease. This enabled lessors to structure a lease with direct matching of incoming rentals and debt payments to make a single payment to the lessee for the tax benefits. This aspect of the law quickly led to major sales of tax shelters to "nominal lessors" who were not normally in the leasing business. Several major companies did not pay taxes that year due to their tremendous participation in the TBT marketplace.

The state does not recognize safe harbor leases, and they are not commonly seen on franchise and excise tax returns. Therefore, if an old safe harbor lease from 1981 is still on the taxpayer's books, any taxpayer entries made for the safe harbor lease should be reversed for excise tax purposes. Auditors should review the book/tax journal entries concerning these leases and determine that the correct reversals have been reported on Schedule J, Line 20.

21. Deduction – Nonbusiness Earnings

Schedule J, Line 21 represents the amount reported on Form FAE 170, Schedule M, Line 8. Nonbusiness earnings are allocated and not apportioned; as such, they are removed from apportionable business income by deducting them on Line 21.[80] See Chapter 8, the *Business/Nonbusiness* section of this manual for definitions of business and nonbusiness earnings. Nonbusiness earnings directly allocated to Tennessee are reported on Schedule M, Line 9 and then transferred to Schedule J, Line 32. To clarify, *total* nonbusiness earnings (including those directly allocable to Tennessee) are deducted on Schedule J, Line 21, and the nonbusiness earnings that are *directly allocated* to Tennessee are then added back to the excise tax base (after apportionment of business earnings) on Schedule J, Line 32.

22. Deduction – Intangible Expense Paid to an Affiliate

The Schedule J, Line 22 deduction for intangible expenses paid to an affiliate is only permitted *after* the taxpayer adds back the intangible expenses on Schedule J, Line 2. See the earlier discussion for *Schedule J, Line 2* above. The statutes concerning this deduction have changed several times since the initial disclosure requirement was enacted in 2004. The last major change occurred with the Revenue Modernization Act ("RMA") in 2015. The RMA repealed previous statutes that required taxpayers to use Form IE-A and IE-N. Those forms became obsolete for tax periods beginning on or after July 1, 2016. The current form used by taxpayers to report intangible expenses is Form IE. This form must be completed and attached to the franchise and excise tax return before claiming a deduction for intangible expenses paid, accrued or incurred to an affiliate.

Tenn. Code Ann. § 67-4-2006(b)(2)(N) states the intangible expense paid to an affiliate may be deducted when the expense has been disclosed on a new disclosure form and either:

- The affiliate receiving the intangible income is filing and paying the franchise, excise tax; or
- The affiliate receiving the intangible income is located in a foreign nation that is a signatory to a comprehensive income tax treaty with the United States or the affiliate is otherwise not subject to the excise tax.

The auditor may verify that the affiliate receiving intangible income is filing a franchise and excise tax return or is located in a foreign nation that is a signatory to a comprehensive income tax treaty with the U.S. or is otherwise not subject to the tax. The RMA made audit procedures easier, because under economic nexus, affiliates receiving intangible income will generally be subject to franchise and excise tax. Auditors may verify that the expense amount reported by one affiliate agrees with the intangible income amount booked by another affiliate.

In addition to the earlier discussion regarding intangible expenses:

- Important Notice #17-27 explains changes to intangible expense reporting resulting from the Revenue Modernization Act, effective July 1, 2016, and links to the current form used to report intangible expenses, Form IE.
- Important Notice #12-16 discusses the intangible expense deduction approval process for tax periods ending on or after July 1, 2012 until June 30, 2016. This notice includes discussion of Forms IE-N and IE-A.

23. Deduction – Intangible Income

If an affiliate with intangible expenses either voluntarily, or as the result of an audit, does *not* deduct its intangible expenses, then the corresponding intangible income shown on the taxpayer's pro forma federal return should be reversed out on Schedule J, Line 23. The net effect between the two companies cancels one another out.[81]

24. Deduction – Net Gain or Income Received from a Pass-through Entity Subject to the Excise Tax

This line applies to situations where a taxpayer owns a pass-through entity that is also subject to the excise tax and is filing an excise tax return. Without this deduction line the net income or gain attributed to a pass-through entity could potentially be recognized by the pass-through entity and again at the owner level. The federal income tax return of the owner will automatically include its distributive share of the items of income or loss from the pass-through entity (as reported on federal Schedule K-1).

Because taxpayers calculate the Tennessee excise tax base beginning with federal taxable income, Schedule J, Line 24 reverses out activity from pass-through entities that are themselves subject to excise tax and filing a Tennessee excise tax return.[82]

Please see the suggested audit procedures found under the previous discussion of *Schedule J, Line 11*. Taxpayers will sometimes erroneously reverse 100% of the pass-through entity's income/loss on Schedule J instead of only the taxpayer's distributive share, as shown on Schedule K-1. Generally, the amounts reported on Schedule K-1 are computed by multiplying the pass-through entity's total amounts on Schedule K by the partner's ownership percentage, but this is not always the case (a method other than percentage ownership may be used). For excise tax purposes, it is always best to obtain a copy of the Schedule K-1 issued to the taxpayer, trace the items of income/expense to the taxpayer's federal income tax return, and then allow the pass-through reversals on Schedule J if the pass-through entity was itself subject to excise tax.

25. Deduction – Grants (2018)

The federal Tax Cuts and Jobs Act of 2017 began imposing federal income tax on state grants for tax years beginning on or after January 1, 2017. Property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or to enable the corporation to expand its operating facilities, is now subject to federal income tax.[83] Tennessee has decoupled from this provision; thus, taxpayers should use Schedule J, Line 25 to reverse out any state grants included in federal taxable income.[84]

26. IRC Section 951A Global Intangible Low-Taxed Income

Any global intangible low-taxed income ("GILTI") included in Schedule J, Line 1 (adjusted federal income) is deducted on Sch. J, Line 26. The amount entered is before any related IRC Section 250 deduction.

P.C. 306 made an amount equal to 5% of GILTI, before any related deductions, subject to the excise tax. The 5% amount is reported on Sch. J, Line 12. See the Tax Cuts and Jobs act of 2017 section below for more information on global intangible low-taxed income and Important Notice #19-13.

27. Business Interest Expense

Tennessee followed the Tax Cuts and Jobs act of 2017 amendment that limited deductible interest under IRC 163(j) for tax years beginning after December 31, 2017 and ending before January 1, 2020. However, the state decoupled from this federal limitation for tax periods beginning on or after January 1, 2020.

For tax periods beginning on or after January 1, 2020, a business interest expense deduction is reported on Schedule J, Line 27a, but only if federal Form 8990 was filed and Schedule J, Line 13 was completed.[85] The business interest expense deduction is:

- The current period expense before any IRC 163(j) limitation; and
- Any 2018 and 2019 carryforward interest deducted on the pro-forma federal income tax return.

The current period expense is the sum of lines 1 and 4 of the separate entity proforma federal Form 8990. In addition, If the taxpayer owns an entity that files federal Form 1065 but does not file an excise tax return, you may also include your share of the pass-through entity's current year excess business expense from Form 8990, Schedule A, Line 43, Column (c) on Schedule J, Line 27a.

Carryforward Interest

The carryforward interest expense included on Schedule J, Line 27a is the expense from 2018 and 2019 deducted on the current year federal income tax return. A proforma federal Form 8990 may be used to determine this amount. When the "allowable business interest expense" deducted in arriving at taxable net income exceeds the current year interest expense evidence exists that a carryforward amount was utilized. The "allowable business interest expense" amount is found on pro-forma Form 8990, Line 30[86] prepared without considering any amounts reported on Line 3 of the Form 8990 that are: 1) attributed to partnerships filing an excise tax return, and 2) partnerships not filing an excise return and not having contributed to the initial business interest expense deduction carryforward balance. A worksheet titled Excise Tax Table of Business Interest Expense Carryforward is available to establish the 2018 and 2019 carryforward available at 1/1/2020 and to track its utilization and remaining balance. Also, an example of a completed table is linked to a tax article[87] on the Department's website.

The worksheet is not required to be completed or submitted with the franchise and excise tax return, however [Important Notice 20-16] explains that for audit purposes, taxpayers should maintain in their records information sufficient to verify the 2018 and/or 2019 carryforward amount(s) taken, including but not limited to: total interest expense before the 163(j) limitation, interest expense deducted under the 163(j) limitation, carryforward available at the beginning of the 2020 tax year, carryforward deducted for federal income tax purposes by tax year, and carryforward balance remaining by tax year.

Tennessee taxpayers that are members of a federal consolidated group should allocate the federal consolidated group's carryforward of business interest expense for its 2018 and 2019 tax years in the same manner as the allocation of the group's interest expense deduction for these tax years. Please see [Important Notice # 19-18] for additional information as to how this allocation is calculated.

The 2018 and 2019 interest carryforward balance, after any current year deduction, is reported on Schedule J, Line 27b.

See the Tax Cuts and Jobs act of 2017 section below for more information on the federal interest limitation under IRC 163(j) and the worksheet available for taxpayers that are members of a federal consolidated group.

28. Calculated Amounts

After making all the required additions to and deductions from federal taxable income, the Total Business Income (Loss) is reported on Schedule J, Line 29. The total business income is then multiplied by the apportionment ratio found on Line 30 to arrive at the Apportioned Business Income (Loss) on Line 31. If applicable, there will then be an add-back for any nonbusiness earnings directly allocated to Tennessee on Line 32 (from Schedule M, Line 9). If the taxpayer has any loss carryovers from prior years (see Schedule U), these will be deducted from the apportioned business income on Line 33. Ultimately, the amount of net earnings subject to excise tax is reported on Line 34 and is carried forward to Schedule B, Line 4.

Ownership of a Pass-through Entity

A taxpayer that owns a pass-through entity that is not subject to franchise and excise tax and not filing a return, should include on its Schedule J any required add-backs and deductions associated with amounts received from the pass-through entity. The add-back and deduction provisions of the excise tax code apply to pass-through entities not doing business in Tennessee; their activities are included in the excise tax base to the extent that they are owned by an entity that is subject to excise tax and filing an excise tax return. Therefore, the Schedule J additions and deductions apply. For example:

- A Tennessee corporation owns 10% of a partnership that is not filing on its own in the state.

- The corporation would include its share of the partnership's property, payroll, and sales on Schedule N and its share of Schedule J add-back or deduction items on Schedule J.

- The partnership's tax-exempt interest income would automatically be included in the corporation's return as tax-exempt interest income; so, no additional inclusion on Schedule J would be needed.[88] In other words, the Schedule K-1 issued by the partnership to the corporation would disclose the partnership's amount of tax-exempt interest income distributable to the corporation, and the corporation would include that amount as tax-exempt interest income on its federal Form 1120 (as an information item on Form 1120,Schedule K, Line 9).

    - The corporation would report the tax-exempt interest income shown on Form 1120 as an excise tax Schedule J, Line 7 add-back, including the corporation's share of the partnership's tax-exempt interest income.

Partnerships' Schedule K-1 items of income and expense flow to their owners without losing their character, such as ordinary income, capital gains, contributions, and exempt interest.

Not all Schedule J add-back and deduction items are separately disclosed on a pass-through entity's Schedule K-1. For example, bonus depreciation is not separately disclosed. While it is technically correct to make the Schedule J adjustments for pass-through entities, it is sometimes impossible to do this because the Tennessee taxpayer only receives a federal Schedule K-1 and does not always have the necessary information to make such adjustments. However, in other cases, the corporation and the pass-through entity may be closely affiliated, and the necessary information might be readily available to the corporate owner.

The auditor should use their judgment in auditing this issue. If the taxpayer has made these adjustments, the auditor should verify the accuracy of the adjustments made, since they are technically correct. If the taxpayer did not consider making these adjustments, they still might have been made automatically (like the exempt interest situation previously discussed). Bonus depreciation is an add-back adjustment that will not be automatically recognized, but it is also a timing difference. Over the life of an asset, the same amount of expense will be taken whether the Schedule J adjustments were made or not. In most cases, audit work in this area will not result in a material tax impact and can be very time consuming.

Tax Cuts and Jobs Act of 2017 (TCJA)[89]

The federal Tax Cuts and Jobs Act of 2017 ("TCJA") (enacted in December 2017) has many provisions that impact all types of taxpayers. Since the Tennessee excise tax computation begins with federal taxable income or loss, these tax reforms are embedded in the state excise tax return. Tennessee did not decouple from most of these changes. However, there are several provisions from which the state *did* decouple.[90] In this section, we will discuss the business expense limitation for large taxpayers, the taxability of state grants, repatriated earnings, and global intangible low-taxed income ("GILTI").

1. Interest Expense Limitation

Tennessee decoupled from the federal provision that limits the interest expense deduction for tax years beginning on or after January 1, 2020. Note that any 2018 and 2019 federal limits on interest expense should be reflected on the excise tax return, because the state did not decouple until 2020.

I.R.C. § 163(j), in general, imposes a limitation on interest deductions incurred by certain large businesses.[91] For most large businesses, business interest expense is limited to any business interest income plus 30[92] percent of the business's adjusted taxable income. A problem exists when the franchise and excise taxpayer is included in a consolidated federal corporate return that limits interest. The federal interest limitation is computed at the consolidated level; not the separate entity level.

Members of a federal consolidated group should allocate the federal consolidated group's allowed business interest expense deduction among the group members who had business interest expense during the year. The allocation is made on a pro rata basis according to the amount of interest expense each member paid to entities outside the federal consolidated group.

A member's business interest expense deduction is the sum of its intercompany interest expenses paid or accrued plus its allocation of the group's federal interest expense deduction. The Department has an Excise Tax Interest Expense Worksheet on its website to assist with this calculation. See also Important Notice #19-18 for additional information regarding the interest expense computation.

⚠ **Carryforward: I.R.C. § 163(j) provides that taxpayers may carryforward unused business interest expenses. For the 12/31/2018 and 12/31/2019 tax periods, when the state is coupled with the limitation, members of a federal consolidated group should allocate the federal consolidated carryforward using the formula outlined above. The carryforward amount balance at 1/1/2020 may be deducted in tax years beginning after 1/1/20 but the amount is subject is subject to limitation.**

Beginning on January 1, 2020, taxpayers will be allowed to fully deduct their current year interest in computing their excise tax base without the limitation imposed by the TCJA. In addition, the balance of any interest expense from 2018 and 2019 that has not been deducted as of January 1, 2020 may be deducted in 2020 and subsequent years, but only to the extent that the carryforward interest has been deducted federally. In other words, the carryforward is limited in the same manner it is for federal income tax purposes under Section 163(j), as amended by the TCJA. The January 1, 2020 carryforward balance deducted for federal income tax purposes will be included on Schedule J, Line 27a, of the franchise and excise tax return along with the current year's business interest expense. See Important Notice #20-16 for information on the business interest expense carryforward allowed for excise tax purposes and the records required to be maintained by the taxpayer.

2. State Grants

The state decoupled from the TCJA provision that concerns the taxability of state grants. For federal income tax purposes, state grants are now included in federal taxable income.[93] The state did not adopt this provision of the TCJA. State grants are not subject to the excise tax. See the Schedule J, Line 25.

3. Repatriated Earnings for 2017

The TCJA amended I.R.C. § 965. This section requires certain United States shareholders to pay a transition tax on the *untaxed foreign earnings* of certain specified foreign corporations as if those earnings had been repatriated to the United States. For federal income tax purposes, these deemed "repatriated earnings" are subject to a transition tax for the 2017 and 2018 tax years.

For the 2017 tax year, Corporations and S-Corporations will not report these deemed earnings on their respective federal Forms 1120 and 1120S; therefore, they will not be included in the excise tax base.

Partnerships will report repatriated earnings and the related exclusion amount on federal Form 1065. These amounts should be included in the net earnings calculation on Schedule J1. A deduction for dividends received from an 80%-or-more owned corporation may be made on Schedule J in the amount of the repatriated earnings less any exclusion amount. The partnership's apportionment formula should include repatriated earnings less the related exclusion amount and dividends received deduction. (Note that the guidance for 2018 is completely different.)

Finally, REITs are required to report repatriated earnings, net of any exclusion amount, on federal Form 1120-REIT as "Other Income" but can deduct them on federal Schedule A as dividends paid. As such, the net earnings calculation on Schedule J4 will include repatriated earnings less dividends paid. The amount received from an 80%-or-more owned corporation, net of any exclusion amount, may be deducted to the extent they are included on Schedule J4. The apportionment formula should include repatriated earnings less the related exclusion amount and any dividends received deduction.

Guidance for reporting repatriated earnings on a 2017 franchise and excise return is found in Important Notice #18-05. Repatriated earnings on 2018 returns are reported differently because of an amendment[94] to Tenn. Code Ann. §§ 67-4-2006(b)(1), (2).

4. Repatriated Earnings and Global Intangible Low-Taxed Income, beginning in 2018

Both repatriated earnings (I.R.C. § 965(a)) and global intangible low-taxed income (I.R.C. § 951(A)) are addressed in P.C. 306, effective for tax periods beginning on or after January 1, 2018. Simply put, 5% of repatriated income and GILTI, before any related deductions, will be in the excise tax base.[95]

The 965(a) and 951(A) income is in federal taxable income (the starting point in determining Tennessee taxable income). Franchise and excise taxpayers will reverse out these amounts in full and then add back 5% of the amounts; the net effect is that only 5% is in the excise tax base. The 5% is computed on the gross amount before any 965(c) or Section 250 deductions. The 965(c) deduction relates to repatriated earnings.

The Section 250 deduction relates to GILTI and foreign-derived intangible income ("FDII") and is reported on federal Form 1120, Schedule C, Line 22, column (c). For federal income tax purposes, this amount is considered a special deduction and is included on Form 1120, page 1, Line 29b. The Tennessee excise tax return starts with federal Form 1120, Line 28; the Section 250 deduction included on Line 29b is not allowed. The 5% add-back for GILTI is computed on 951(A) income before any deductions under Section 250.

The franchise and excise tax forms have lines on Schedule J to report:

- The subtraction of GILTI and repatriated income (before any deduction); and
- The add-back of 5% of the total amount subtracted.[96]

The full subtraction of GILTI/repatriated income means that no other related deductions are permitted. For example:

- A partnership's Form 1065, Schedule K, Line 13d, Code X and an S-Corporation's Schedule K, Line 12d, Code K may include 965(c) deductions that are not allowed for franchise and excise tax purposes.
- The amount from these federal Schedule K lines are normally reported on Schedules J1 and J3; so, auditors will need to identify and disallow any deduction with Codes X and K.
- These repatriated deductions (965c) will only be reported for the 2017 and 2018 tax years.
- Searching for the X and K Codes may be limited to those years.
- GILTI may exist in years after 2018, but the related Section 250 deductions are *not* reported on federal return lines that are normally picked up in preparing Form FAE 170.

All entities filing Form FAE 170 will subtract repatriated earnings on Schedule J, Line 18 (2018 form) and add back 5% of that amount on Line 4 (2018 form). Taxpayers filing Form FAE 174 will subtract repatriated earnings on Schedule J, Line 22 (2018 form) and add back 5% of that amount on Line 7 (2018 form).

See the following charts for information on where the income and deductions are found on 2018 federal returns.

Location of income on federal return^	**Repatriated IRC 965a**	**GILTI IRC 951A**
Corporation, 1120	Schedule C, Line 15 Column (a)	Schedule C, Line 17, Column (a)
S-Corporation, 1120-S	Schedule K, Line 10, Code F	Schedule K, Line 10, Code E

Partnership, 1065	Schedule K, Line 11, Code G	Schedule K, Line 11, Code F[97]
^ reverse out & then add-back 5% of amount reversed for F&E		

Location of deduction on federal return*	Repatriated IRC 965c	GILTI Section 250
Corporation, 1120	Schedule C, Line 15 Column (c)**	Schedule C, Line 22, Column (c)**
S-Corporation, 1120-S	Schedule K, Line 12d, Code K **	Schedule K, Line 14d**
Partnership, 1065	Schedule K, Line 13d, Code X **	Schedule K, Line 16d, Code E**
***deductions not allowed for F&E**	**lines **not** picked up for F&E	

Additional guidance for reporting repatriated earnings on a 2018 franchise and excise tax return is found in Important Notice #19-14 and guidance on reporting global intangible low-taxed income (GILTI) is found in Important Notice #19-13.

M-3 and M-1 Federal Schedules

Federal Form 1120, Schedule M-3 and Form 1065, Schedule M-3 reconcile financial statement (book) income (loss) to federal taxable income (loss). The reconciliation is not "state tax" to "federal tax," so most reconciling items are not relevant for franchise and excise tax purposes. Nonetheless, many of the excise tax adjustments are found on these schedules. These schedules provide a quick way to identify potential Schedule J adjustments. They also serve as a double check[98] to ensure that Schedule J-type adjustments reported elsewhere on the federal return were not overlooked. All audits should include a review of the M-1 or M-3 schedule to identify potential Schedule J adjustments.

Small businesses with assets under $10 million dollars use Schedule M-1, and large businesses with assets of over $10 million dollars use Schedule M-3.[99] Small taxpayers may voluntarily choose to complete Schedule M-3 instead of M-1. Both schedules serve the same purpose and provide the same information, even though they are formatted differently. Schedule M-3 provides much more detail.

Schedule M-1 is located on page 4 or 5 of the corresponding federal income tax return, immediately below the balance sheet (Schedule L). Schedule M-3 is 3 pages long and is attached to the basic 4- or 5-page federal income tax return. There are versions of Schedule M-3 for both corporate[100] and partnership tax filers.[101] Schedule M-1 works well for small taxpayers with uncomplicated returns, but large businesses with more complicated returns should use the multipage Schedule M-3 to more fully reconcile book income with tax income.

1. Schedule M-3

Schedule M-3 reports the amount of net income (loss) "per books" at the bottom of page 2 of the 3-page schedule (Schedule M-1 shows this information on its first line). The first page of this schedule is where general information is reported, including:

- Whether the financial statements were audited.
- Whether a Form 10-K was filed with the SEC.
- The consolidated net income (loss) amount.

Occasionally, the information concerning the availability of SEC and audited financial statements may be helpful, but pages 2 and 3 of the schedule are the most useful.

For consolidated corporations, Schedule M-3, page 1 is completed once by the consolidated corporate parent. Pages 2 and 3 are completed for each member of a consolidated group. There are check boxes at the top of these pages to indicate if a given Schedule M-3 page was prepared for the:

- Consolidated group
- Parent corporation
- Consolidated eliminations
- Subsidiary corporation

Multiple M-3 schedules may be filed with the appropriate boxes checked. The one marked "subsidiary corporation" should match the net income of a taxpayer filing on a separate entity basis. The partnership version of the M-3 schedule does not have the check boxes for consolidated group, parent, etc. because they are not applicable to a partnership return.

The second page of Schedule M-3 reconciles income and gain/loss items, and the third page reconciles expense and deduction items. The totals from Part III are carried to the bottom of page 2, and the last line of page 2 shows the total net income (loss) "per book" and "per tax."

⚠ **An initial audit step is to tie Schedule M-3, page 2, Line 30, column (d) "Income (Loss) per Tax Return" to excise tax Schedule J4, Line 1.**

Schedule M-3 was created because of the increasing number of book/tax differences and because the amounts reported on Schedule M-1 were often combined or netted, rendering the schedule nearly useless to the IRS. Schedule M-3 solved that problem because it is very detailed. The income and expense items that are most likely to have book/tax differences are listed on pages 2 and 3. For items not specifically listed, taxpayers must attach detailed statements with the totals carried to the applicable "other" lines at the bottom of pages 2 and 3. Since *every* item of income and expense is listed, the totals at the bottom of page 2 will equal the entity's net income per book and per tax.

The differences between Schedule M-3, Parts II and III "book" column (a) income/expense amounts and "tax" column (d) amounts are reported individually as temporary differences in column (b) and permanent differences in column (c). For each income/expense line item, column (a) *plus* column (b) *plus* column (c) equals column (d). If a taxpayer reports a difference as temporary when it should have reported it as permanent, there is no federal tax impact. So, while the "permanent" and "temporary" designations *do* provide good information, the auditor should not be overly concerned as to which column the difference is located. Some Schedule J adjustments are permanent differences and others are temporary.

Temporary differences will reverse in future years. For example, different book/tax depreciation methods will cause the current year depreciation expense to differ for book and tax purposes, but at some point, both methods will result in the asset being fully depreciated. In this case, the question is not *whether* the depreciation expense is deductible, but rather *when* it will be deducted. On the other hand, *permanent differences* never reverse in future years; these differences result from adjustments made because of IRS rules, rather than generally accepted accounting principles (GAAP). For example:

- Qualified businesses, when calculating their federal taxable income, may take a deduction for Domestic Production Activities.
- However, no actual expense is ever recorded in the GAAP accounting records, because there was never a cash outlay or obligation.

If a corporation or partnership is unable to determine whether an adjustment is temporary or permanent, it should report the difference in column (c) as a permanent difference.

Corporations that own an investment interest in a partnership report their share of the partnership's income (loss), including the book/tax difference regarding exempt interest from the investment partnership, only on Schedule M-3, Part II, Line 9. The federal instructions for this line state that column (d) should reflect all amounts of income, gains, losses, or deductions reflected on the Schedule K-1 received from the partnership, without regard to any limitations computed at the partner level (e.g., limitations on utilization of charitable contributions, capital losses, and interest expense).

In other words, all information shown on a corporate-investment-partnership's Schedule K-1 is reflected on a single Schedule M-3 line, and any book/tax differences are reflected as differences on other Schedule M-3 lines that specifically address a given limitation. For example, the charitable contribution percentage limitation is reflected on Part III, Line 21 and the capital loss limitation is reflected on Part II, Line 24.

2. Chart of Schedule J4, J Adjustments

Schedule J, J4 Line Item	Federal Schedule M-3 Line	Book/Tax Difference[102]	Notes
Bonus Depreciation Schedule J, Line 3	Part III, 31	Temporary	Book/tax differences usually include more than bonus depreciation, so Schedule M-3 *isn't useful for F&E.* See federal Form 4562.
DPAD Schedule J4, Line 4 *(repealed with 2017 TCJA)*	Part III, 22	Permanent	The amount shown in column (d) should agree to federal Forms 8903 and 1120, page 1, and to Schedule J4, Line 4. Not applicable for pass-through entities. Repealed with TCJA of 2017.

Interest income on obligations of states Schedule J, Line 7	Part II, 13	Permanent	Book/tax differences may include more than interest from state obligations (i.e., "sale versus lease" book/tax differences). Also, this line does not report the applicable interest from pass-through entities owned by the F&E taxpayer. If the only reconciling item was exempt interest, it would be reported as a negative amount in column (c) of Schedule M-3. You can find the Schedule J add-back amount on federal Forms 1120, Schedule K, Line 9; 1065; and 1120S, Schedule K, Lines 18a and 16a, respectively.
Depletion Schedule J, Line 8	Part III, 30	Permanent	Generally, the book/tax difference will be the excess of percentage depletion over cost depletion.
Contribution carryover from prior period Schedule J4, Line 5	Part III, 21	Temporary	Not applicable for pass-through entities. Corporations using a carryover on Form 1120 in the current year will report it on F&E Schedule J4, Line 5. The amount reported on federal Schedule M-3, Line 21, column (d) should reconcile with F&E Schedule J4, Line 5.
Capital gains offset by capital loss carryover or carryback Schedule J4, Line 6	Part II, 24	Temporary	A negative amount on Schedule M-3, Line 24 reflects a capital loss carryover being utilized to offset current year capital gains. This is the excise tax add-back amount. However, auditors should review Schedule D to increase their understanding of the federal adjustment.
Excess fair market value over book value of property donated Schedule J, Line 9	Part III, 19	Permanent	Entries on this line may include book/ tax differences other than the excess of fair market value of donated property. Nonetheless, these entries, along with federal Form 8283, are the best sources to identify a potential add-back.

Like-Kind Exchanges

1. Overview

A like-kind exchange (also known as a "1031 exchange") is a transaction that involves the exchange of *like-kind* property that is held for use in a trade or business or for investment.[103] Properties are of *like-kind* if they have the same nature or character, without regard to their grade or quality.[104] For example, an improved apartment building and an unimproved office building are considered *like-kind* properties. Properties exchanged in a like-kind exchange must be used in a trade or business or held for investment in order to qualify for the exchange.[105] Real property that is held primarily for sale (i.e., as a taxpayer's inventory) does not qualify.[106]

⚠ **Under the federal Tax Cuts and Jobs Act of 2017, effective January 1, 2018, only exchanges of *real property* are eligible for like-kind exchanges. Exchanges involving *personal* or *intangible* property are no longer eligible.**

Taxpayers benefit from like-kind exchanges because a like-kind exchange permits the taxpayer to defer gain recognition on the exchange of like-kind property for federal income tax purposes. The taxpayer will eventually recognize the deferred gain when it ultimately sells the property received in the exchange ("replacement property") in a subsequent taxable transaction. Like-kind exchanges are often engaged in by taxpayers that invest in real estate. Properties that qualify for like-kind exchange treatment can be in different states. However, properties located outside the United States do not qualify.[107] When an out-of-state taxpayer enters a like-kind exchange and receives replacement property that is in Tennessee, the taxpayer generally will establish nexus for franchise and excise tax purposes.

In this section, an overview of the federal tax mechanics of like-kind exchanges is provided, and the potential Tennessee franchise and excise tax implications of like-kind exchanges are considered.

2. Federal Tax Mechanics

Form 8824 and Related Forms and Schedules

Taxpayers report like-kind exchanges on federal Form 8824. Part I of this form provides information regarding the like-kind property given up and received by the taxpayer and the date(s) on which the properties were transferred. Part III of this form provides important information as to the realized gain, recognized gain, and basis of the like-kind property received by the taxpayer in the exchange.

Throughout this section, various federal forms and schedules (e.g., federal Form 8824, Form 4797, and Schedule D) are referenced on which like-kind exchanges and related transactions are reported. An appendix is included at the end of this section that contains examples of these completed forms and schedules, which illustrate the reporting requirements associated with like-kind exchanges and subsequent taxable dispositions. The figures reported on those forms and schedules are derived from the example that is used throughout this section to illustrate an example like-kind exchange (see the Realized Gain section below).

Realized Gain

Although the term "like-kind exchange" seems to imply that *only* like-kind property (e.g., an apartment building for another apartment building) may be transferred in a qualifying like-kind exchange, this is not the case.[108] Of course, only real property that is held for use in a trade or business or for investment, and that is of *like-kind*, will qualify for deferral of gain (or loss) realized from the exchange for federal income tax purposes. However, if the like-kind properties that are being exchanged do not have an equal fair market value, then the party to the transaction who is transferring the like-kind property with a *lesser* fair market value will also have to transfer other property/consideration to equal the fair market value of the like-kind property received; in addition to the like-kind property given up, this party may transfer cash, transfer non-like-kind property (i.e., personal or intangible property), or assume liabilities of the other party[109] in order to effectuate the like-kind exchange. This is because the total value given up in a like-kind exchange must equal the total value received.

While the overall transaction previously described *still* qualifies as a like-kind exchange, the party that *receives* property/consideration that is *not* like-kind will recognize a partial gain from the exchange. Therefore, both parties to the exchange must calculate the gain realized from the exchange before determining what amount of the realized gain, if any, the parties must recognize on their respective federal income tax returns. The realized gain, whether deferred in part or in full as a result of the exchange, also factors into the calculation of the basis of the replacement property received in the exchange.

Consider the following example:

- An out-of-state taxpayer invests in real estate and leases its properties to tenants.

- The taxpayer enters into a like-kind exchange in which it plans to exchange an apartment building located in its home state ("relinquished property") with an office building located in Tennessee ("replacement property").

- The taxpayer's **original cost basis** in the relinquished property was **$950,000** and the taxpayer has taken **$617,500** in **depreciation** on the relinquished property, leaving the property with an **adjusted basis** of **$332,500** on the date of the exchange.

- The relinquished property has a **fair market value** of **$1,150,000** on the date of the exchange.

- The taxpayer also has a **liability** of **$142,500** that is **secured by the relinquished property**; the other party to the exchange has agreed to assume this liability.

- The replacement property has a **fair market value** of **$975,000** on the date of the exchange.

- The other party to the exchange will also transfer **$32,500 cash** to the taxpayer in exchange for the relinquished property.

- For the purpose of this example, it should be assumed that both parties to the exchange have met all other prerequisites for the exchange to qualify as a like-kind exchange.[110]

In this example, the taxpayer that received replacement property located in Tennessee will realize a gain of $817,500 from the like-kind exchange, calculated as follows:

Cash received	32,500
Liability assumed by other party	142,500
FMV of like-kind property received	975,000
Total value received	1,150,000
Less: adjusted basis of like-kind property given up	332,500
Realized gain	**817,500**

The realized gain is calculated as the difference between the total value (including the fair market value of both like-kind and non-like-kind property) received in the exchange and the adjusted basis of the property given up in the exchange. The realized gain can be found on Form 8824, Line 19. Note that the total value received is equal to the fair market value of the relinquished property on the date of the exchange. The total amount of the gain in this example, however, will *not* be recognized on the taxpayer's federal income tax return; the majority of this realized gain will be deferred as a result of the like-kind exchange.

Recognized Gain

In a qualifying like-kind exchange in which like-kind property is transferred *solely* for like-kind property with an equal fair market value, no gain (or loss) will be recognized by either party to the exchange in the tax year in which the exchange takes place for federal income tax purposes. Rather, any gains (or losses) realized by the parties, respectively, from the exchange will be deferred until either party sells or otherwise disposes of its replacement property received in the exchange in a subsequent taxable transaction, in which case the selling/disposing party will recognize any deferred gain or loss from the exchange. A party to a like-kind exchange *could* continue to defer gain or loss recognition by exchanging its replacement property in another qualifying like-kind exchange; however, upon the ultimate sale or disposition of the replacement property, the party will recognize any remaining deferred gains or losses.

Oftentimes, properties transferred in a qualifying like-kind exchange do not have an equal fair market value. As previously discussed, this necessitates the transfer of cash or other non-like-kind property to carry out the exchange. Cash or other non-like-kind property that is transferred in a like-kind exchange is commonly referred to as "boot." Whenever boot is transferred in a like-kind exchange, the party to the exchange that receives boot will recognize a gain in the year of the exchange. The **recognized gain** will be the *lesser* of the ***realized gain*** or the ***boot received*** in the exchange.[111] The recognized gain can be found on Form 8824, Line 23. Losses are not recognized in like-kind exchanges involving solely like-kind property, but rather will continue to be deferred until recognition at a later time.[112]

Continuing with the previous example, the out-of-state taxpayer transferred relinquished property with a fair market value of $1,150,000 in exchange for replacement property with a fair market value of $975,000 on the date of the exchange. Because the replacement property had a lesser fair market value than the relinquished property, the other party to the exchange also had to transfer boot totaling $175,000 that consisted of $32,500 cash and the assumed liability of $142,500. The taxpayer's realized gain on the exchange is $817,500; thus, the taxpayer will **recognize a gain of $175,000** based on the *lesser* amount of *boot received* in the exchange. The taxpayer will **defer recognition of the remaining $642,500 of realized gain** until it sells or otherwise disposes of the replacement property in a subsequent taxable transaction. Deferred gain associated with a like-kind exchange can be found on Form 8824, Line 24.

When a taxpayer recognizes gain as the result of boot received in a like-kind exchange, the taxpayer initially calculates the amount of gain to be recognized on Form 8824, as previously discussed. This gain will also be found on Form 4797 and/or Schedule D of the taxpayer's tax return. Depending on the depreciation method used to depreciate the relinquished property and when the property was placed in service, the total gain recognized by the taxpayer may be divided between ordinary gain and capital gain for federal income tax purposes;[113] Form 4797 distinguishes between the character of both types of gain (ordinary and capital), whereas Schedule D will show only the portion of the gain that is characterized as capital gain.

The way the gain is characterized for federal income tax purposes (ordinary or capital) has no impact on the excise tax treatment of the gain; the total gain is included in the excise tax base. For example, looking at Form 4797, the total of any amounts reported on Lines 5 and 16 should be included in the excise tax starting point reported on the appropriate sub-J Schedule. The gain amounts reported on Form 4797 (and Schedule D) can be traced to the income section on page 1 of the taxpayer's federal return; however, the capital portion of the gain will be added to any other capital gains of the taxpayer and offset against any capital losses, so the net capital gain included on page 1 of the return may not match the capital gain reported on Form 4797, Part I.[114]

Basis of Like-Kind Property Received

Determining the basis[115] of like-kind property received in a like-kind exchange is one of the most important aspects of the exchange. This is because any gain or loss on the future taxable sale or disposition of the property received in the exchange will be calculated with reference to this basis. Because like-kind exchanges are generally a nontaxable event, special consideration must be given to the determination of the tax basis for property received in the exchange.

In a qualifying like-kind exchange in which like-kind property is transferred *solely* for like-kind property with an equal fair market value, the basis of the like-kind property received will be the adjusted basis[116] of the like-kind property given up in the exchange.[117] In other words, the adjusted basis in the like-kind property given up is *substituted* for that of the like-kind property received (a "substituted basis"). Essentially, this is how the gain/loss deferral aspect of a like-kind exchange is accomplished. The basis of like-kind property received can be found on Form 8824, Line 25. There are two basic formulas that can be used to calculate the basis of like-kind property received in a like-kind exchange:

- **Fair market value of like-kind property received – Deferred gain + Deferred loss**
- **Adjusted basis of like-kind property given up + Gain recognized – Boot received + Boot paid – Loss recognized (*loss on non-cash boot given up*)**

Both above formulas should result in the same basis amount for the like-kind property received. However, one formula may be more advantageous to use than the other, depending on the information known about a given like-kind exchange. Continuing with the previous example, the basis of the like-kind property received in this example like-kind exchange is calculated as follows:

FMV of like-kind property received	975,000		Adj. basis of like-kind property given up	332,500
Less: deferred gain	(642,500)		Plus: gain recognized	175,000
Plus: deferred loss	-	**OR**	Less: loss recognized	-
Basis of like-kind property received	**332,500**		Less: boot received	(175,000)
			Plus: boot paid	-
			Basis of like-kind property received	**332,500**

Note that both of the above calculations result in the same basis amount of like-kind property received.[118] The like-kind property received has a substituted basis—the $332,500 adjusted basis of the like-kind property given up in the exchange.[119] The first calculation above shows that this is simply the difference between the fair market value of the like-kind property received in the exchange and the deferred gain. By taking a substituted basis in the like-kind property received, the deferred gain is essentially built into the basis of the replacement property.

When the replacement property is ultimately sold or disposed of in a taxable transaction, the deferred gain will be recognized for federal income tax purposes (assuming that the property continues to appreciate in value) because the gain on the subsequent taxable transaction will be measured with reference to the replacement property's substituted basis, which is *less* than the cost (fair market value) basis that the taxpayer would have otherwise had in the replacement property had the exchange ***not*** qualified as a like-kind exchange. When this occurs, the taxpayer will file Form 4797 with its tax return for the tax year in which the taxable disposition occurred.

Similar to boot gain (see the discussion in the previous Recognized Gain section), the taxpayer will calculate the total gain on the sale of the property (including any portion required to be recognized as ordinary income for federal income tax purposes). The total gain (ordinary and capital) can be traced to page 1 of the taxpayer's federal return[120] (via Form 4797 and Schedule D, respectively) and should be included in the excise tax base; however, the capital portion of the gain will be added to any other capital gains of the taxpayer and offset against any capital losses, so the net capital gain included on page 1 of the return may not match the capital gain reported on Form 4797, Part I. The total gain to be included on the appropriate sub-J Schedule of the excise tax return should be the same amount that is reported on Form 4797, Line 24 (or 30, if more than one property is being disposed of). Form 8824 will not be filed to report the taxable disposition; however, it should be confirmed that the basis amount reported on Form 4797, Line 21 for the replacement property in the year of the sale matches the amount originally reported on Form 8824, Line 25 for the replacement property in the year of the exchange.

For example, assume that the taxpayer subsequently sells the replacement property for $1,000,000. The taxpayer will recognize a total gain of $667,500 ($1,000,000 selling price less $332,500 adjusted (substituted) basis).[121] $642,500 of this recognized gain is the deferred gain from the previous like-kind exchange; the remaining $25,000 is the portion of the recognized gain that is attributed to the difference between the current selling price of the replacement property and the basis that the taxpayer would have otherwise had in the replacement property had the previous exchange ***not*** qualified as a like-kind exchange ($1,000,000 current selling price less $975,000 acquisition date fair market value of the replacement property on the date of the like-kind exchange).

3. Excise Tax Implications

Like-kind exchanges are governed by the Internal Revenue Code[122] and are a matter of federal tax law. However, like-kind exchanges are relevant to the Tennessee excise tax because they have the potential to impact the excise tax base. This is because the calculation of the excise tax base begins with a taxpayer's federal taxable income, as calculated in accordance with the Internal Revenue Code.[123] There are several excise tax-related implications to consider with respect to like-kind exchanges.

Deferred Gains and Losses

The excise tax base is a taxpayer's *net earnings (or net losses)*. The calculation of a taxpayer's net earnings subject to excise tax begins with a taxpayer's federal taxable income, followed by certain modifications[124] that are required under Tennessee excise tax law. Because this calculation begins with the taxpayer's federal taxable income calculated in accordance with the Internal Revenue Code, to the extent that a taxpayer defers recognition of gain or loss realized from a like-kind exchange for federal income tax purposes, such gain or loss will be *excluded* from the excise tax base in the year of the exchange. Likewise, to the extent that a taxpayer recognizes gain or loss from a like-kind exchange (e.g., from the receipt or payment of boot), such gain or loss will be *included* in the excise tax base in the year of the exchange.

Recognition of Deferred Gains and Losses

To the extent that a taxpayer subject to the Tennessee excise tax defers recognition of gain or loss realized from a like-kind exchange for federal income tax purposes, such gain or loss will effectively be deferred for excise tax purposes as well. Three questions flow from this mirrored tax treatment: ***Will*** *the deferred gain or loss eventually be recognized for excise tax purposes?* ***When*** *is the deferred gain or loss recognized for excise tax purposes?* ***How*** *is the deferred gain or loss measured for excise tax purposes upon recognition?*

- **Will the deferred gain or loss eventually be recognized for excise tax purposes?**

  - A taxpayer whose business activities are *solely* within the state of Tennessee and who has deferred recognition of gain or loss as the result of a like-kind exchange *will* eventually recognize such gain or loss for excise tax purposes upon the ultimate sale or disposition of its replacement property.[125]

  - For a taxpayer who has business activities *both inside and outside* the state of Tennessee (an "apportioning taxpayer"), the deferred gain or loss *may or may not* eventually be recognized for excise tax purposes.

    - If an apportioning taxpayer establishes nexus with Tennessee by receiving replacement property located in Tennessee, and the taxpayer subsequently sells or disposes of that replacement property in a taxable transaction, then the taxpayer *will* recognize the deferred gain or loss for excise tax purposes, regardless of whether the relinquished property[126] was located inside or outside of Tennessee.

    - Similarly, if an apportioning taxpayer has otherwise established nexus with Tennessee but *does not* own or use replacement property located in Tennessee, the taxpayer *still* recognizes any gain or loss previously deferred as the result of a like-kind exchange for excise tax purposes, if it recognizes such gain or loss for federal income tax purposes while having nexus with Tennessee, regardless of where the relinquished or replacement properties from the exchange were located.

    - Conversely, if an apportioning taxpayer enters into a like-kind exchange in which it exchanges Tennessee property for replacement property located in another state and then ceases all business activities in Tennessee (i.e., no longer has nexus with Tennessee), the taxpayer will *not* recognize the deferred gain or loss from the exchange for excise tax purposes, *even* if it subsequently recognizes such gain or loss for federal income tax purposes, if the taxpayer does *not* have nexus with Tennessee at such time when it recognizes the deferred gain or loss for federal income tax purposes.[127]

- **When is the deferred gain or loss recognized for excise tax purposes?**

  - If deferred gain or loss resulting from a like-kind exchange is recognized for excise tax purposes, it will be recognized on the excise tax return that coincides with the accounting period covered by the federal income tax return in which the gain or loss is recognized.[128]

- **How is the deferred gain or loss measured for excise tax purposes upon recognition?**

  - Any gain or loss previously deferred as the result of a like-kind exchange will be measured upon recognition for excise tax purposes in the same manner as it is for federal income tax purposes.

    - Because the calculation of the excise tax base begins with a taxpayer's federal taxable income, as calculated in accordance with the Internal Revenue Code, the gain or loss recognized on the taxpayer's federal return will be included in the computation of net earnings subject to excise tax.

4. Apportionment Implications

Multistate taxpayers that have the right to apportion for franchise and excise tax purposes ("apportioning taxpayers") need to give special consideration to the basis of like-kind property that is includable in the property factor, as well as gross receipts includable in the sales factor.

Property Factor – Basis of Replacement Property

Apportioning taxpayers that have received replacement property in a like-kind exchange will continue to include the *original cost* of the *relinquished property* given up in the exchange (as opposed to the substituted basis or original cost of the replacement property received), in the denominator of the property factor. If the replacement property is located in Tennessee, this same amount will also be reported in the property factor numerator.

A taxpayer's property factor is based on tax basis records.[129] The "original cost" of property included in the property factor is the basis of the property for federal tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc.[130] Note that depreciation is *not* included in these "federal adjustments."

Because the substituted basis of replacement property received in a like-kind exchange is determined with reference to the adjusted basis of the relinquished property given up in the exchange, it is appropriate to continue reporting the *original cost* of the *relinquished property* in the property factor. Similar to depreciation, which is not deducted from the basis of property included in the property factor, deferred gain or loss (which is taken into account in arriving at the substituted basis of replacement property)[131] is another "federal adjustment" that should be disregarded in determining the basis of replacement property to be included in the property factor for apportionment purposes. For example:

- An apportioning taxpayer enters into a like-kind exchange in which it exchanges real property A, with an original cost to the taxpayer of $950,000 and an adjusted basis of $332,500 on the date of the exchange, for real property B, with an original cost of $800,000 to the other party to the exchange. The taxpayer takes a substituted basis in the like-kind property received. The basis amount that the taxpayer should include in the property factor for the replacement property is $950,000 (the original cost of property A to the taxpayer).

Sales Factor – Gross Receipts from the Exchange

In the year of the like-kind exchange, if the taxpayer recognizes a partial gain due to the receipt of boot, or to the payment of non-cash boot (e.g., tangible personal property) that has appreciated in value, the taxpayer should include the gross receipts[132] attributed to the boot gain in the sales factor denominator. If the relinquished property (or non-cash boot paid) given up is located in Tennessee, then the boot gain should be sourced to Tennessee and the associated gross receipts included in the sales factor numerator.

Similarly, in the year in which the taxpayer sells or otherwise disposes of the replacement property received in the like-kind exchange in a taxable transaction for which a gain is recognized, the taxpayer should include the gross receipts[133] attributed with the gain in the sales factor denominator. If the replacement property disposed of is located in Tennessee, then the gain should be sourced to Tennessee and the associated gross receipts included in the sales factor numerator.

There may be instances in which it is appropriate to include the *net gain* (as opposed to the *gross receipts*) attributed to a particular property sale or disposition event in the sales factor.[134] For more information regarding this exception, please see Chapter 14 of this manual.

5. Franchise Tax Implications

Like-kind exchanges are a matter of federal tax law. Conversely, the Tennessee franchise tax base is a taxpayer's net worth, as calculated in accordance with generally accepted accounting principles (GAAP).[135] Because the franchise tax base is generally measured in accordance with GAAP,[136] as opposed to federal tax law, like-kind exchanges usually do not have any bearing on the franchise tax. Nevertheless, one potential franchise tax implication of like-kind exchanges concerns the proper valuation of like-kind property received in the exchange (replacement property) for franchise tax purposes.

Basis of Replacement Property – Schedule G

The franchise tax base is a taxpayer's *net worth* (total assets less total liabilities). However, the measure of the franchise tax cannot be less than the actual value of the real or tangible property owned or used by the taxpayer in Tennessee.[137] In other words, for a given accounting period, a taxpayer's franchise tax will be based on the *greater* of the taxpayer's *net worth* or the actual value of the *real or tangible property owned or used by the taxpayer in Tennessee*, as of the balance sheet date; for this purpose, property is valued at *cost less accumulated depreciation*, calculated in accordance with GAAP.[138] The determination of real and tangible property subject to the franchise tax is reported on Schedule G of the franchise and excise tax return.

For taxpayers who receive replacement property located in Tennessee through a like-kind exchange, the question arises as to what basis the taxpayer should report on Schedule G for the replacement property received in the exchange. In this situation, the taxpayer should report as the basis of the replacement property on Schedule G the *cost (fair value) basis* of the property. Generally, this will be the purchase price of the replacement property plus any other expenses that are properly capitalized to the replacement property under GAAP.[139]

The taxpayer will subsequently depreciate the replacement property in accordance with GAAP and report the net book value of the property on Schedule G. The taxpayer should report the cost basis of the replacement property on Schedule G, rather than the federal tax basis (substituted basis) of the replacement property attained through the like-kind exchange, because Tennessee franchise tax law requires that property be valued in accordance with GAAP. However, there is an exception to this general rule.

Tenn. Code Ann. § 67-4-2108(a)(3) provides that if a taxpayer,[140] does not maintain its books and records in accordance with GAAP, the taxpayer may value property subject to the franchise tax in accordance with the accounting method used by the taxpayer for federal tax purposes.[141] This exception commonly applies, but is not intended to be limited to, small and medium-size, privately-held companies that are not required to maintain financial statements prepared under GAAP. However, if a taxpayer maintains *both* GAAP *and* tax basis books and records, then this exception does ***not*** apply and the taxpayer ***must*** use its GAAP books and records to value its property subject to franchise tax.[142] Taxpayers who receive replacement property located in Tennessee through a like-kind exchange ***and*** who meet the exception to the GAAP valuation requirement for property,[143] will be permitted to report as the basis of the replacement property on Schedule G the *federal tax basis (substituted basis)* of the property. The taxpayer will subsequently depreciate the replacement property in accordance with the Internal Revenue Code and report the adjusted basis of the property on Schedule G.

6. Appendix (Like-Kind Exchanges) – Federal Forms and Schedules

The following are examples of federal return forms and schedules that a taxpayer would complete to report a like-kind exchange and the subsequent sale of like-kind property received in an exchange.[144] The figures on these forms and schedules are derived from the example like-kind exchange referenced throughout this section.

TN Department of Revenue

Form 8824 – Like-Kind Exchange

Form **8824**

Department of the Treasury
Internal Revenue Service

Like-Kind Exchanges

(and section 1043 conflict-of-interest sales)

► Attach to your tax return.

► Go to *www.irs.gov/Form8824* for instructions and the latest information.

OMB No. 1545-1190

2019

Attachment Sequence No. **109**

Name(s) shown on tax return	Identifying number
EXAMPLE TAXPAYER, INC.	XX-XXXXXXX

Part I **Information on the Like-Kind Exchange**

Note: Generally, only real property should be described on line 1 or 2. However, you may describe personal and/or real property on line 1 or 2 if you are filing this form to report the disposition of property exchanged in a previously reported related party like-kind exchange. If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.

1 Description of like-kind property given up:
APARTMENT BUILDING (OUTSIDE TN)

2 Description of like-kind property received:
OFFICE BUILDING (IN TN)

3	Date like-kind property given up was originally acquired (month, day, year)	3	XX/XX/199X
4	Date you actually transferred your property to the other party (month, day, year)	4	XX/XX/20X1
5	Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement	5	XX/XX/20X1
6	Date you actually received the like-kind property from other party (month, day, year). See instructions	6	XX/XX/20X1

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III ☐ **Yes** ☑ **No**

Note: Do not file this form if a related party sold property into the exchange, directly or indirectly (such as through an intermediary); that property became your replacement property; and none of the exceptions in line 11 applies to the exchange. Instead, report the disposition of the property as if the exchange had been a sale. If one of the exceptions on line 11 applies to the exchange, complete Part II.

Part II **Related Party Exchange Information**

8 Name of related party	Relationship to you	Related party's identifying number

Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange? ☐ **Yes** ☐ **No**

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? ☐ **Yes** ☐ **No**

If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is ***not*** *the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24* ***unless*** *one of the exceptions on line 11 applies.*

11 If one of the exceptions below applies to the disposition, check the applicable box.

a ☐ The disposition was after the death of either of the related parties.

b ☐ The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.

c ☐ You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation. See instructions.

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 12311A Form **8824** (2019)

Form 8824 (2019) Page **2**

Name(s) shown on tax return. Do not enter name and social security number if shown on other side. | **Your social security number**

EXAMPLE TAXPAYER, INC. | XX-XXXXXXX

Part III **Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received**

Caution: If you transferred **and** received **(a)** more than one group of like-kind properties or **(b)** cash or other (not like-kind) property, see **Reporting of multi-asset exchanges** in the instructions.

Note: Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.

12	Fair market value (FMV) of other property given up	12			
13	Adjusted basis of other property given up	13			
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale			14	
	Caution: *If the property given up was used previously or partly as a home, see* **Property used as home** *in the instructions.*				
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions			15	175,000
16	FMV of like-kind property you received			16	975,000
17	Add lines 15 and 16			17	1,150,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions			18	332,500
19	**Realized gain or (loss).** Subtract line 18 from line 17			19	817,500
20	Enter the smaller of line 15 or line 19, but not less than zero			20	175,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions			21	35,000
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions			22	140,000
23	**Recognized gain.** Add lines 21 and 22			23	175,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions			24	642,500
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23			25	332,500

Part IV **Deferral of Gain From Section 1043 Conflict-of-Interest Sales**

Note: This part is to be used **only** by officers or employees of the executive branch of the federal government or judicial officers of the federal government (including certain spouses, minor or dependent children, and trustees as described in section 1043) for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used **only** if the cost of the replacement property is more than the basis of the divested property.

26 Enter the number from the upper right corner of your certificate of divestiture. (**Do not** attach a copy of your certificate. Keep the certificate with your records.) ▶ –

27 Description of divested property ▶

28 Description of replacement property ▶

29	Date divested property was sold (month, day, year)			29	MM/DD/YYYY
30	Sales price of divested property. See instructions	30			
31	Basis of divested property	31			
32	**Realized gain.** Subtract line 31 from line 30			32	
33	Cost of replacement property purchased within 60 days after date of sale	33			
34	Subtract line 33 from line 30. If zero or less, enter -0-			34	
35	Ordinary income under recapture rules. Enter here and on Form 4797, line 10. See instructions			35	
36	Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797. See instructions			36	
37	**Deferred gain.** Subtract the sum of lines 35 and 36 from line 32			37	
38	**Basis of replacement property.** Subtract line 37 from line 33			38	

Form **8824** (2019)

Form 4797 – Boot Gain (Shows Ordinary and Capital Portions)

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return.
► Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2019
Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
EXAMPLE TAXPAYER, INC.	XX-XXXXXXX

1	Enter the gross proceeds from sales or exchanges reported to you for 2019 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	140,000
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	140,000

Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	35,000
17	Combine lines 10 through 16	17	35,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040 or Form 1040-SR), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040 or Form 1040-SR), Part I, line 4	18b	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2019)

TN Department of Revenue

Schedule D – Boot Gain (Shows Capital Portion Only)

SCHEDULE D (Form 1120)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1120, 1120-C, 1120-F, 1120-FSC, 1120-H, 1120-IC-DISC, 1120-L, 1120-ND, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 1120-SF, or certain Forms 990-T.

▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2019

Name	Employer identification number
EXAMPLE TAXPAYER, INC.	XX-XXXXXXX

Did the corporation dispose of any investment(s) in a qualified opportunity fund during the tax year? . . . . ▶ ☐ Yes ☑ No

If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I Short-Term Capital Gains and Losses (See instructions.)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term capital gain from installment sales from Form 6252, line 26 or 37	**4**	
5 Short-term capital gain or (loss) from like-kind exchanges from Form 8824	**5**	
6 Unused capital loss carryover (attach computation)	**6**	( )
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column h	**7**	

Part II Long-Term Capital Gains and Losses (See instructions.)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				

11 Enter gain from Form 4797, line 7 or 9	**11**	140,000
12 Long-term capital gain from installment sales from Form 6252, line 26 or 37	**12**	
13 Long-term capital gain or (loss) from like-kind exchanges from Form 8824	**13**	
14 Capital gain distributions (see instructions)	**14**	
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column h	**15**	140,000

Part III Summary of Parts I and II

16 Enter excess of net short-term capital gain (line 7) over net long-term capital loss (line 15)	**16**	
17 Net capital gain. Enter excess of net long-term capital gain (line 15) over net short-term capital loss (line 7)	**17**	140,000
18 Add lines 16 and 17. Enter here and on Form 1120, page 1, line 8, or the proper line on other returns . .	**18**	140,000

Note: If losses exceed gains, see *Capital Losses* in the instructions.

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. Cat. No. 11460M **Schedule D (Form 1120) 2019**

TN Department of Revenue

Form 1120 – Tracing Boot Gain to the Federal Return

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2019 or tax year beginning ____________, 2019, ending ____________, 20 ____

▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2019

A Check if: 1a Consolidated return (attach Form 851) ☐ b Life/nonlife consolidated return ☐ 2 Personal holding co. (attach Sch. PH) ☐ 3 Personal service corp. (see instructions) ☐ 4 Schedule M-3 attached ☐	**TYPE OR PRINT** Name: EXAMPLE TAXPAYER, INC. Number, street, and room or suite no. If a P.O. box, see instructions. City or town, state or province, country, and ZIP or foreign postal code	**B** Employer identification number: XX-XXXXXXX **C** Date incorporated **D** Total assets (see instructions) $

E Check if: **(1)** ☐ Initial return **(2)** ☐ Final return **(3)** ☐ Name change **(4)** ☐ Address change

Income	1a	Gross receipts or sales	1a			
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	
	2	Cost of goods sold (attach Form 1125-A)			2	
	3	Gross profit. Subtract line 2 from line 1c			3	
	4	Dividends and inclusions (Schedule C, line 23)			4	
	5	Interest			5	
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	140,000
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	35,000
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	175,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶			12	
	13	Salaries and wages (less employment credits)			13	
	14	Repairs and maintenance			14	
	15	Bad debts			15	
	16	Rents			16	
	17	Taxes and licenses			17	
	18	Interest (see instructions)			18	
	19	Charitable contributions			19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	
	21	Depletion			21	
	22	Advertising			22	
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	
	25	Reserved for future use			25	
	26	Other deductions (attach statement)			26	
	27	**Total deductions.** Add lines 12 through 26 ▶			27	
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	
	29a	Net operating loss deduction (see instructions)	29a			
	b	Special deductions (Schedule C, line 24)	29b			
	c	Add lines 29a and 29b			29c	
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28. See instructions			30	
	31	Total tax (Schedule J, Part I, line 11)			31	
	32	2019 net 965 tax liability paid (Schedule J, Part II, line 12)			32	
	33	Total payments, credits, and section 965 net tax liability (Schedule J, Part III, line 23)			33	
	34	Estimated tax penalty. See instructions. Check if Form 2220 is attached ▶ ☐			34	
	35	**Amount owed.** If line 33 is smaller than the total of lines 31, 32, and 34, enter amount owed			35	
	36	**Overpayment.** If line 33 is larger than the total of lines 31, 32, and 34, enter amount overpaid			36	
	37	Enter amount from line 36 you want: **Credited to 2020 estimated tax ▶**	Refunded ▶		37	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer | Date | ▶ Title

May the IRS discuss this return with the preparer shown below? See instructions. ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2019)

TN Department of Revenue

Form 4797 – Gain on Taxable Disposition (Shows Ordinary and Capital Portions)

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2019
Attachment Sequence No. **27**

Name(s) shown on return: EXAMPLE TAXPAYER, INC.
Identifying number: XX-XXXXXXX

1 Enter the gross proceeds from sales or exchanges reported to you for 2019 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions . . . 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	764,228
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	764,228

Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	24,182
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	24,182

18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.

a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040 or Form 1040-SR), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions . . . 18a

b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040 or Form 1040-SR), Part I, line 4 . . . 18b

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2019)

Form 4797 (2019) Page 2

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	OFFICE BUILDING (ACQUIRED IN 1031 EXCHANGE) - TENNESSEE	XX/XX/199X	XX/XX/20X9
B			
C			
D			

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	1,000,000			
21 Cost or other basis plus expense of sale	21	332,500			
22 Depreciation (or depletion) allowed or allowable	22	120,910			
23 Adjusted basis. Subtract line 22 from line 21	23	211,590			
24 Total gain. Subtract line 23 from line 20	24	788,410			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f	24,182			
g Add lines 26b, 26e, and 26f	26g	24,182			
27 **If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	788,410
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	24,182
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	764,228

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

			(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33		
34	Recomputed depreciation. See instructions	34		
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2019)

Schedule D – Gain on Taxable Disposition (Shows Capital Portion Only)

SCHEDULE D (Form 1120)
Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1120, 1120-C, 1120-F, 1120-FSC, 1120-H, 1120-IC-DISC, 1120-L, 1120-ND, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 1120-SF, or certain Forms 990-T.
▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123
2019

Name: EXAMPLE TAXPAYER, INC.
Employer identification number: XX-XXXXXXX

Did the corporation dispose of any investment(s) in a qualified opportunity fund during the tax year? ▶ ☐ Yes ☑ No
If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I Short-Term Capital Gains and Losses (See instructions.)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term capital gain from installment sales from Form 6252, line 26 or 37	4	
5 Short-term capital gain or (loss) from like-kind exchanges from Form 8824	5	
6 Unused capital loss carryover (attach computation)	6	( )
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column h	7	

Part II Long-Term Capital Gains and Losses (See instructions.)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				

11 Enter gain from Form 4797, line 7 or 9	11	764,228
12 Long-term capital gain from installment sales from Form 6252, line 26 or 37	12	
13 Long-term capital gain or (loss) from like-kind exchanges from Form 8824	13	
14 Capital gain distributions (see instructions)	14	
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column h	15	764,228

Part III Summary of Parts I and II

16 Enter excess of net short-term capital gain (line 7) over net long-term capital loss (line 15)	16	
17 Net capital gain. Enter excess of net long-term capital gain (line 15) over net short-term capital loss (line 7)	17	764,228
18 Add lines 16 and 17. Enter here and on Form 1120, page 1, line 8, or the proper line on other returns	18	764,228

Note: If losses exceed gains, see *Capital Losses* in the instructions.

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. Cat. No. 11460M **Schedule D (Form 1120) 2019**

TN Department of Revenue

Form 1120 – Tracing Gain on Sale to the Federal Return

Form **1120** Department of the Treasury Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2019 or tax year beginning ________, 2019, ending ________, 20 ____

▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123 — 2019

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

TYPE OR PRINT

Name: EXAMPLE TAXPAYER, INC.
Number, street, and room or suite no. If a P.O. box, see instructions.
City or town, state or province, country, and ZIP or foreign postal code

B Employer identification number: XX-XXXXXXX
C Date incorporated
D Total assets (see instructions) $

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income	1a	Gross receipts or sales	1a	
	b	Returns and allowances	1b	
	c	Balance. Subtract line 1b from line 1a	1c	
	2	Cost of goods sold (attach Form 1125-A)	2	
	3	Gross profit. Subtract line 2 from line 1c	3	
	4	Dividends and inclusions (Schedule C, line 23)	4	
	5	Interest	5	
	6	Gross rents	6	
	7	Gross royalties	7	
	8	Capital gain net income (attach Schedule D (Form 1120))	8	764,228
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)	9	24,182
	10	Other income (see instructions—attach statement)	10	
	11	**Total income.** Add lines 3 through 10 ▶	11	788,410
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶	12	
	13	Salaries and wages (less employment credits)	13	
	14	Repairs and maintenance	14	
	15	Bad debts	15	
	16	Rents	16	
	17	Taxes and licenses	17	
	18	Interest (see instructions)	18	
	19	Charitable contributions	19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)	20	
	21	Depletion	21	
	22	Advertising	22	
	23	Pension, profit-sharing, etc., plans	23	
	24	Employee benefit programs	24	
	25	Reserved for future use	25	
	26	Other deductions (attach statement)	26	
	27	**Total deductions.** Add lines 12 through 26 ▶	27	
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	
	29a	Net operating loss deduction (see instructions)	29a	
	b	Special deductions (Schedule C, line 24)	29b	
	c	Add lines 29a and 29b	29c	
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28. See instructions	30	
	31	Total tax (Schedule J, Part I, line 11)	31	
	32	2019 net 965 tax liability paid (Schedule J, Part II, line 12)	32	
	33	Total payments, credits, and section 965 net tax liability (Schedule J, Part III, line 23)	33	
	34	Estimated tax penalty. See instructions. Check if Form 2220 is attached ▶ ☐	34	
	35	**Amount owed.** If line 33 is smaller than the total of lines 31, 32, and 34, enter amount owed	35	
	36	**Overpayment.** If line 33 is larger than the total of lines 31, 32, and 34, enter amount overpaid	36	
	37	Enter amount from line 36 you want: **Credited to 2020 estimated tax ▶** **Refunded ▶**	37	

Sign Here — Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer | Date | Title

May the IRS discuss this return with the preparer shown below? See instructions. ☐ Yes ☐ No

Paid Preparer Use Only
Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN
Firm's name ▶ | Firm's EIN ▶
Firm's address ▶ | Phone no.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2019)

[1] Net earnings that are attributable to any activities unrelated to and outside the scope of the activities that give a nonprofit its exempt status are subject to the excise tax.
[2] Tenn. Code Ann. §§ 67-4-2006 and 67-4-2007(a)
[3] Tenn. Code Ann. § 67-4-2006(a)(1)-(9)
[4] There have been several changes to the line items on the excise tax return (Sub-J Schedules and Schedule J) in recent years due to federal tax reform and internal reformatting of the return. Throughout this chapter, unless otherwise indicated, all line item numbers are referenced from the 2020 Form FAE 170.
[5] LLCs that have made an election on federal Form 8832 to be taxed as a corporation would file on Form 1120 and should complete Schedule J4.
[6] Amounts reported on federal Schedule K, Line 11 (code F) for Section 743(b) adjustments are not included in the additional income items reported on excise Schedule J1, Line 2. Note the use of code F changed with the 2019 Form 1065 instructions.
[7] The ultimate self-employment deduction must be net of any other distributive items of expense or loss that have already been deducted elsewhere on the Sub-J Schedule. See the manual section "Why do the instructions for Schedule J1, Line 6 contain the wording "net of any pass-through expense deducted elsewhere on this return"?
[8] Tenn. Code Ann. § 67-4-2006(a)(5)(A)
[9] "Public REIT" means an entity that has an election in effect under § 856(c)(1) of the Internal Revenue Code that files with the securities and exchange commission and whose shares are traded on a securities exchange that is either registered as a national securities exchange with the securities and exchange commission under § 6 of the Securities Exchange Act of 1934, codified in 15 U.S.C. § 78f, or is a national securities exchange of a foreign country and regulated in a substantially similar manner by a foreign financial regulatory authority.
[10] *Over-the-counter* or *off-exchange* trading is done directly between two parties and is not a registered or national securities exchange.
[11] Code V was added to the 2019 Form 1065 instructions.
[12] The audit workpaper will automatically populate Schedule K. Never enter a negative number on Schedule J1, Line 6.
[13] Tenn. Code Ann. § 67-4-2006(a)(4)(B)
[14] TENN. COMP. R. & REGS. 1320-06-01-.21
[15] *See* I.R.S. Topic No. 554 – Self-Employment Tax – for more information.
[16] Some uncertainty exists concerning whether LLC members are subject to self-employment tax on their distributive share of business earnings. The IRS issued a proposed regulation many years ago that addressed this question, but there was so much controversy over it that it never made it to temporary or final regulation status. Most tax preparers, wishing to err on the side of caution, consider LLC member distributions arising out of trade or business activities and guaranteed payments to be self-employment income, and the Department has not questioned that position.

[17] As with certain other items reported on federal Schedule K, the self-employment number is reported merely for informational purposes so that the amount and character of this item is retained when it is passed through to the owners via Schedule K-1. However, this item does not impact the owners' individual federal income tax liability because federal self-employment taxes are paid *in addition to* individual federal income taxes on the individual return (Form 1040).
[18] Tenn. Code Ann. § 67-4-2006(a)(4)(C)
[19] See the previous discussion about audit time management when Schedule K reversals are involved, at section *Schedule J1, Line 6*.
[20] A complete list of all the codes (and associated meanings) used on Schedule K-1 can be found on page 2 of the federal Schedule K-1. See https://www.irs.gov/pub/irs-pdf/f1065sk1.pdf In-depth explanations of the codes can be found in the instructions to Form 1065. See https://www.irs.gov/pub/irs-pdf/i1065.pdf
[21] Tenn. Code Ann. § 67-4-2006(b)(2)(K)
[22] See Tenn. Code Ann. § 67-4-2006(b)(1)(I) and the manual section on Schedule J additions.
[23] Tenn. Code Ann. § 67-4-2006(a)(7)
[24] Tenn. Code Ann. § 67-4-2006(a)(2)
[25] Tenn. Code Ann. § 67-4-2006(b)(2)(K)
[26] Tenn. Code Ann. § 67-4-2006(a)(8)
[27] Tenn. Code Ann. § 67-4-2006(b)(L)
[28] This adjustment generally does not apply to S-Corporations, entities filing as partnerships, or SMLLCs owned by individuals.
[29] Tenn. Code Ann. §§ 67-4-2006(b)(1)(D), 67-4-2006(b)(2)(D)
[30] The Coronavirus Aid, Relief and Economic Security Act (CARES Act) increased the charitable contribution deduction limit to 25% for the 2020 tax year.
[31] The form instructions state: A negative amount may be reported on line 21, columns (b), (c), and (d), as applicable, the excess of charitable contributions made during the tax year over the amount of the charitable contribution limitation amount. If a contribution carryforward is utilized in the current tax year, the carryforward utilized is reported as a positive amount on columns (b), (c), and (d), as applicable.
[32] Tenn. Code Ann. § 67-4-2006(b)(1)(E)
[33] *Id*.
[34] The carryback is reported on federal Form 1139 or 1120X.
[35] This line reads "Deductions on this return not charged against book income this year."
[36] Tenn. Code Ann. § 67-4-2006(b)(1)(E)
[37] Tenn. Code Ann. § 67-4-2004(26)
[38] Tenn. Code Ann. § 67-4-2004(24)
[39] Tenn. Code Ann. § 67-4-2004(1)
[40] Tenn. Code Ann. § 67-1-804(b)(2)
[41] The add-back for depreciation does not apply to the election to expense certain property under IRC Section 179.
[42] Under the Tax Cuts and Jobs Act of 2017 bonus depreciation may apply to used assets. The definition of property eligible for 100 percent bonus depreciation was expanded to include used

qualified property acquired and placed in service after Sept. 27, 2017, if certain requirements are met.

[43] State depreciation expense means depreciation computed using the same depreciation method and class lives as the federal income tax return, only without previous or current use of "bonus depreciation."

[44] If an asset is disposed of before the end of its life, the income statement account "gain or loss on disposal of asset" will be different for federal and state tax purposes. The difference is reported on Schedule J, Line 16.

[45] The instructions to Line 3 state "Enter any depreciation under the provisions of IRC Section 168 not permitted for excise tax purposes due to Tennessee permanently decoupling from federal bonus depreciation"

[46] If the asset being disposed of was partially purchased with a trade-in that was not fully depreciated and had taken bonus depreciation, there would be a difference in the federal and state gain/loss on disposal.

[47] Tenn. Code Ann. § 67-4-2006(b)(1)(I)

[48] Tenn. Code Ann. § 67-4-2007(f)

[49] Effective June 30, 2008, subsection (C) was added to include obligated member entities.

[50] Tenn. Code Ann. § 67-4-2007(f); *See* Important Notice #08-06

[51] When an otherwise nontaxable entity or individual is required to report the gain, they must file Form FAE 170 and complete Schedules B and C and Schedule J, Line 4. The entity or individual should include on the front page of the tax return its taxable year, FEIN or SSN, name and address. The entity or individual should indicate in an attachment to the return that they are filing the return due to the provision at Tenn. Code Ann. § 67-4-2007(f). The tax return and payment are due on the 15th day of the fourth month following the close of the entity's or individual's taxable year. The excise tax due is 6.5% of the gain on the sale of the asset.

[52] Tenn. Code Ann. § 67-4-2007(f)(1)(A).

[53] Tenn. Code Ann. § 67-4-2007(f)(1)(B)

[54] Tenn. Code Ann. § 67-4-2007(f)(1)(C)

[55] Tenn. Code Ann. § 67-4-2007(f)(1)(D)

[56] Tenn. Code Ann. § 67-4-2006(b)(1)(I)

[57] Tenn. Code Ann. § 67-4-2006(b)(1)(A)

[58] Tenn. Code Ann. §§ 67-4-2109(c), 67-4-2009(1), and 56-4-217

[59] Tenn. Code Ann. § 67-4-2006(b)(1).

[60] Tenn. Code Ann. § 67-4-2006(b)(1)(B)

[61] See IRS Publication 550 http://www.irs.gov/pub/irs-pdf/p550.pdf

[62] See Bank Qualified Bonds http://www.irs.gov/pub/irs-tege/13%20Phase%20I%20Lesson%2013%20-%20Bank%20Qualified%20Bonds%20-%20Section%20265.pdf

[63] Tenn. Code Ann. § 67-4-2006(b)(1)(C)

[64] *Id*.

[65] *See* TENN. COMP. R. & REGS. 1320-06-01-.20. *Oak Ridge Land Co. v. Roberts*, No. E2012–00458–COA–R3–CV, 2012 WL 5962002 (Tenn. Ct. App. Nov. 29, 2012) found that Rule 20 does not

conflict with the statute by requiring that only book basis be allowed since the statute does refer to value.

[66] Non-Cash Contributions – GAAP: ASC 720-25

[67] An "affiliate" is any entity with more than 50% ownership interest, as defined at Tenn. Code Ann. § 67-4-2004(1)(A).

[68] Tenn. Code Ann. § 67-4-2006(b)(1)(N)

[69] The FONCE exemption also considers the number of rental units, but the limitation is different.

[70] Tenn. Code Ann. § 67-5-501(4)

[71] Tenn. Code Ann. §§ 67-4-2006(b)(1)(J) and (2)(L); See *Hilloak Realty Co. v. Chumley*, 233 S. W. 3d 816 (Tenn. Ct. App. 2007)

[72] Tenn. Code Ann. §§ 67-4-2006(b)(1)(J) and 67-4-2006(b)(2)(L)

[73] For example, guaranteed payments to partners would be specifically allocated to the partners who receive such payments. Also, amounts subject to self-employment taxes would be distributed only to those partners who are subject to self-employment taxes (e.g., individuals, not corporations).

[74] Tenn. Code Ann. § 67-4-20 06(b)(2)(C)

[75] Tenn. Code Ann. § 67-4-2006(b)(2)(A); TENN. COMP. R. & REGS. 1320-06-01-.21(2)

[76] Tenn. Code Ann. § 67-4-2006(c)(5)

[77] Tenn. Code Ann. § 67-4-2006(b)(2)(M)

[78] Tenn. Code Ann. § 67-4-2006(b)(2)(F)

[79] *See* Tenn. Code Ann. §§ 67-4-2006(b)(1), 67-4-2006(b)(2)(G) and (H).

[80] Tenn. Code Ann. § 67-4-2006(c)(5)

[81] Tenn. Code Ann. § 67-4-2006(b)(2)(O)

[82] Tenn. Code Ann. § 67-4-2006(b)(2)(L)

[83] § 118 of the Internal Revenue Code

[84] Tenn. Code Ann. § 67-4-2006(b)(2)(S)

[85] Taxpayers that are not subject to the federal limitation of IRC 163(j) do not enter amounts on Schedule J, Line 13 or 27.

[86] Line title is "Total current year business interest expense deduction"

[87] Tax article: Are business interest expense carryforwards incurred during the 2018 and 2019 tax years deductible for excise tax purposes? I so, how do I track the carryforwards?

[88] Recall that when a pass-through entity distributes items of income or loss to its owners, these items retain their character; thus, when a pass-through entity reports tax-exempt interest income to a corporate owner via Schedule K-1, such income does not enter into the corporation's federal taxable income; rather, the income is reported on Form 1120 as an information item.

[89] Tax Cuts and Jobs Act of 2017 – Pub. L. No 115-97

[90] P.C. 1011

[91] The federal interest limitation applies to businesses with over $25 million of gross receipts.

[92] 50 percent for 2019-2021 under the federal CARES Act

[93] Tennessee follows IRC §118 as it existed before the TCJA of 2017.

[94] P.C. 306, enacted May 2019

[95] Form FAE 170 Schedule J, Lines 4 and 18; Form FAE 170 Schedule J, Lines 7 and 22, for the adjustments on a 2018 franchise and excise return.
[96] 2018 Form FAE 170 (revised 8/2019) modified Schedule J, Lines 4 and 18, for the reporting of repatriated and GILTI income and deductions. 2020 Form FAE 170 Schedule J, Line 12 is where the 50% GILTI add-back is reported.
[97] The 2019 federal Schedule K, Box 11 was revised and it no longer reports section 951A income; instead it is used to report any positive income effect from section 743(b) adjustments.
[98] An example is the "interest income" on Schedule M-3, Part II, Line 13. Interest income received from obligations of states and their political subdivisions would be reported on this line, column c, as a permanent difference. In addition, this amount would be reported on federal Form 1120, page 4, Line 9 "tax exempt interest received or accrued during the tax year," and on federal Form 8916-A, Part II, Line 6.
[99] The federal effective date was on or after December 31, 2004, for corporations and 2006 for partnerships.
[100] Taxpayers filing federal Forms 1120-REIT, 1120-RIC, 1120-H, and 1120-SF, would use Schedule M-1, rather than Schedule M-3.
[101] The corporate and partnership versions of Schedule M-3 are similar, but different. For example, because of the pass-through nature of the partnership, it does not have lines for charitable contribution limitations and carryovers.
[102] Due to complex book and tax rules, most differences could include both temporary and permanent differences. However, this chart only lists the primary difference type.
[103] IRC §1031(a)(1)
[104] Treas. Reg. §1.1031(a)-1(b)
[105] Personal use property, such as a personal residence, does not qualify for like-kind exchange treatment.
[106] IRC §1031(a)(2)
[107] IRC §1031(h)
[108] Treas. Reg. §1.1031(a)-1(a)(2)
[109] According to IRC §1031(d), an assumption of liabilities by the other party to a like-kind exchange is a form of consideration to the party whose liabilities are assumed; an assumption of liabilities is to be treated as *other property or money* (i.e., non-like-kind property).
[110] Such prerequisites are beyond the scope of this manual.
[111] IRC §1031(b)
[112] IRC §1031(c)
[113] There are several Internal Revenue Code provisions that require a portion (or all) of the gain on the sale of depreciable property to be recaptured as ordinary income. This is because part of the gain is attributed to depreciation for which the taxpayer previously received the benefit of a deduction against ordinary income for federal income tax purposes. This does not change the total amount of the gain to be recognized; rather, it only changes the character of the gain.
[114] For a corporation, the total gain should be traced to Form 1120, Lines 8 and 9 via Schedule D and Form 4797, respectively. For S corporations and entities taxed as partnerships, the gain amounts can be similarly traced, with ordinary gain being reported on page 1 of the federal return and capital gain being reported on Schedule K.

[115] The amount of capital investment in a property for tax purposes; for purchased property, basis is generally the purchase price (cost) of the property.
[116] Cost (or other basis) less allowable depreciation, as well as other basis adjustments permitted, for federal income tax purposes.
[117] IRC §1031(d)
[118] The fair market value of like-kind property received can be found on Form 8824, Line 16; the adjusted basis of like-kind property given up can be found on Form 8824, Line 18; the sum of boot received in the exchange can be found on Form 8824, Line 15.
[119] Although the entity received boot in the example exchange, it *still* takes a substituted basis in the replacement property. The gain it recognized is attributed to the boot received. Boot basis is measured separately from replacement property basis. The basis that an entity takes in boot received in a like-kind exchange is the fair market value of the boot on the date of the exchange.
[120] This is the case for corporations. For S corporations and entities taxed as partnerships, any ordinary gain will be found on page 1 of the federal return and the capital gain will be found on Schedule K.
[121] This example ignores the effect of subsequent depreciation of the replacement property.
[122] Codified at 26 U.S.C.
[123] Tenn. Code Ann. § 67-4-2006(a)
[124] Codified at Tenn. Code Ann. § 67-4-2006(b)-(c)
[125] The property received in a like-kind exchange.
[126] The property given up in a like-kind exchange.
[127] Some states have clawback provisions, which require a taxpayer to track (for state tax purposes) gains or losses deferred through like-kind exchanges where the replacement property is located outside of the state and to report and pay tax to the state on the gain recognized upon the ultimate sale or disposition of the replacement property, even if the taxpayer no longer has nexus with said state. Tennessee excise tax law does not contain such a provision.
[128] Tenn. Code Ann. § 67-4-2015(a)
[129] Except for a taxpayer that is a member of a consolidated net worth affiliated group or captive REIT affiliated group, in which case the taxpayer's property factor is based on GAAP books and records. However, property is still included in the property factor at its "original cost," as defined by franchise and excise tax Rule 28.
[130] TENN. COMP. R. & REGS. 1320-06-01-.28(1)(a)
[131] Recall, the fair market value of the replacement property less any deferred gain, or plus any deferred loss, equals the adjusted (substituted) basis of the replacement property received.
[132] Generally, this will include any amounts reported on Form 8824, Lines 12 and 15, excluding any reduction included on Line 15 for exchange expenses.
[133] Generally, this will include all amounts reported on Form 4797, Line 20.
[134] TENN. COMP. R. & REGS. 1320-06-01-.32(1)(b)
[135] Tenn. Code Ann. § 67-4-2106(a)-(b)
[136] Tenn. Code Ann. § 67-4-2106(b) *does* permit an exception to the use of GAAP in calculating a taxpayer's net worth subject to the franchise tax for taxpayers who do not maintain their books and records in accordance with GAAP.
[137] Tenn. Code Ann. § 67-4-2108(a)(1)

[138] Tenn. Code Ann. § 67-4-2108(a)(3)

[139] Under GAAP, the taxpayer might also employ use of the specialized accounting rules for *nonmonetary transactions* codified at ASC 845.

[140] Other than a taxpayer who is required to file as a unitary group on a combined basis for franchise tax purposes.

[141] So long as the method fairly reflects the property's value.

[142] For additional details regarding this exception, please refer to Chapter 9 (*Franchise Tax*) of this manual and the section entitled *GAAP Books and Records*.

[143] Codified at Tenn. Code Ann. § 67-4-2108(a)(3)

[144] These forms and schedules are not intended to represent a completed federal return. Only the forms and schedules pertinent to the example like-kind exchange in this chapter are presented to illustrate how any gains or losses from the exchange would be traced to the federal return. In practice, gains or losses from a like-kind exchange would be aggregated with all other reportable gains and losses of the taxpayer on the federal return.