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Chapter 2: Persons Subject to Tax and Exemptions

One of the most important steps in determining if a business is subject to franchise and excise tax is determining if the business operates as a taxable entity. Some businesses, such as those that operate as a sole proprietor, are not subject to franchise and excise tax. While other businesses, such as those that operate as a corporation, are generally subject to franchise and excise tax. This chapter provides an overview of the most common entity types and exemptions that apply to otherwise taxable entities.

Entities Not Subject to Franchise and Excise Tax

1. Sole Proprietorships

Sole proprietorships are not subject to franchise and excise tax because they do not provide their owners limited liability protection. Sole proprietorships report their business activity on federal Form 1040, Schedules C, E, or F.

2. General Partnerships

General partnership ("GP") is defined by Tenn. Code Ann. § 67-4-2004(19) as a "partnership in which all partners, as defined by state law, are fully liable for the debts of, or the claims against, the partnership." GPs are not subject to franchise and excise tax because they do not provide their owners limited liability protection. GPs file on federal Form 1065. A GP can usually be identified by its name (the GP's name would not include "LP" or "LLC") and it would identify as a GP on Form 1065, Schedule B.

While GPs are not taxable entities, if a taxable entity is a partner in a GP, then the activities of the GP that pass through to that GP partner on federal Schedule K-1 are taxable to that GP partner for franchise and excise tax purposes.¹

3. Not-for-Profits

Not-for-profit is defined in Tenn. Code Ann. § 67-4-2004(34) and refers to numerous federal classifications of exemptions, the most common being an entity described in Internal Revenue Code § 501. Not-for-profits are generally not subject to franchise and excise tax. They file an information return, Form 990, for federal income tax purposes. However, a not-for-profit entity that has earnings from activities outside the scope of the activities that give it its exempt status is subject to federal and franchise and excise taxes. The not-for-profit's unrelated business taxable income is reported on federal Form 990-T² and is subject to the excise tax. A not-for-

profit entity is also subject to the franchise tax on the greater of its net worth or real and tangible property owned or used in the state that is attributable to any activities that are unrelated to, and outside the scope of, the activities that give the not-for-profit its exempt status.

4. SMLLC Owned by Pension Trust

If a single-member limited liability company ("SMLLC") is wholly-owned by a pension trust, which is a not-for-profit entity, the SMLLC is disregarded to the pension trust for federal income tax purposes. The SMLLC is also disregarded for franchise and excise tax purposes, and its earnings are considered to be net earnings of the pension trust. The combined net earnings of the pension trust and the SMLLC are not subject to franchise and excise tax unless the earnings constitute unrelated business taxable income.³

Entity Exemptions

1. Franchise and Excise Tax Exemptions

There are 17 types of exemptions available to entities that would otherwise be subject to franchise and excise tax. The following exemptions apply to both the franchise and excise taxes. If a taxpayer fails to meet the requirements for the exemption at any time during the taxable period, the taxpayer loses the exemption for the entire taxable period. The complete list of franchise and excise tax exemptions and requirements can be found in Tenn. Code Ann. § 67-4-2008. The exemptions are as follows:

- Industrial development corporations
- Masonic lodges and similar lodges
- Regulated investment companies whose investments consist of at least 75% U.S., state or local bonds
- Federal and state credit unions
- Venture capital funds*
- Farming or the holding of a personal residence*
- LLCs, LLPs, LPs, or business trusts that acquire receivables from an affiliate which report the income in Tennessee*

- LPs or LLCs that provide affordable housing and receive low-income housing credits^{4*}
- Obligated member entities*
- Partnerships, trusts, REMICs, and FASITs that have asset-backed securities of debt obligations^{5*}
- Family-owned noncorporate entities*
- Diversified investing funds*
- Tennessee historic property preservation entities
- Insurance companies
- TNInvestco entities that receive investment credits under the Tennessee Small Business Investment Company Credit Act⁶
- Any entity that is owned, in whole or in part, by the United States armed forces and derives more than 50% of its gross income from operating facilities which are located on property owned or leased by the federal government and operated primarily for the benefit of members of the United States armed forces*
- Qualified low-income community historic structure owners or lessees*

* An entity claiming this exemption must file an Application for Exemption/Annual Exemption Renewal (Form FAE183) for the initial and subsequent taxable periods for which the entity is claiming the exemption. This form is due on or before the 15th day of the fourth month following the close of the entity's taxable period. The Department will grant an extension of time of six months in which to file the form if the entity makes a valid extension request.⁷ While failure to timely file the form will not preclude the entity from qualifying for the exemption, the Department may assess the entity a penalty of \$200, per occurrence, for late filing.

2. Exemptions Requiring an Evaluation

Of the 17 exemptions listed above, there are 6 that might require an evaluation by the Audit Division to verify the taxpayer's eligibility. These exemptions include: 1) venture capital fund, 2) farming/holding a personal residence, 3) obligated member entity, 4) family-owned noncorporate entity, 5) diversified investing fund, and 6) entities created for asset-back securitization of debt obligations. The Department may request documents such as federal tax returns (including all forms and schedules), articles of organization, or partnership agreements

(to determine an entity's business purpose) when evaluating an entity's eligibility for exemption. An overview of the requirements for each of these exemptions is listed below.

Venture Capital Fund

- Entity must be an LLC, LLP, LP, or a business trust.
- Entity is operated for the exclusive purpose of buying, holding, and/or selling securities and greater than 50% of securities are in non-publicly traded companies.
- Entity buys, holds, and/or sells securities on its own and not as a broker.
- More than 50% of the entity's capital is from investments neither related to nor affiliated with the fund.

Farming/Holding a Personal Residence⁸

- Entity must be an LLC, LP, or LLP.
- At least 66.67% of the entity's activity is in farming and 66.67% of its assets are used by the owner or the owner's lessee for farming, or at least 66.67% of the entity's activity is the holding of one or more personal residences where one or more of the members/partners reside.
- At least 95% of the voting rights, capital interests, or profits are owned by natural persons who are relatives or by trusts for their benefit.
- Entity must complete a Disclosure of Activity form, which is due with its Application for Exemption and each Annual Exemption Renewal, to inform the Department of the entity's activities relating to the exemption.

⚠ It is imperative that the taxpayer complete the Disclosure of Activity form in its entirety, including all pertinent addresses and the county in which the assets are located.

Obligated Member Entity ("OME")

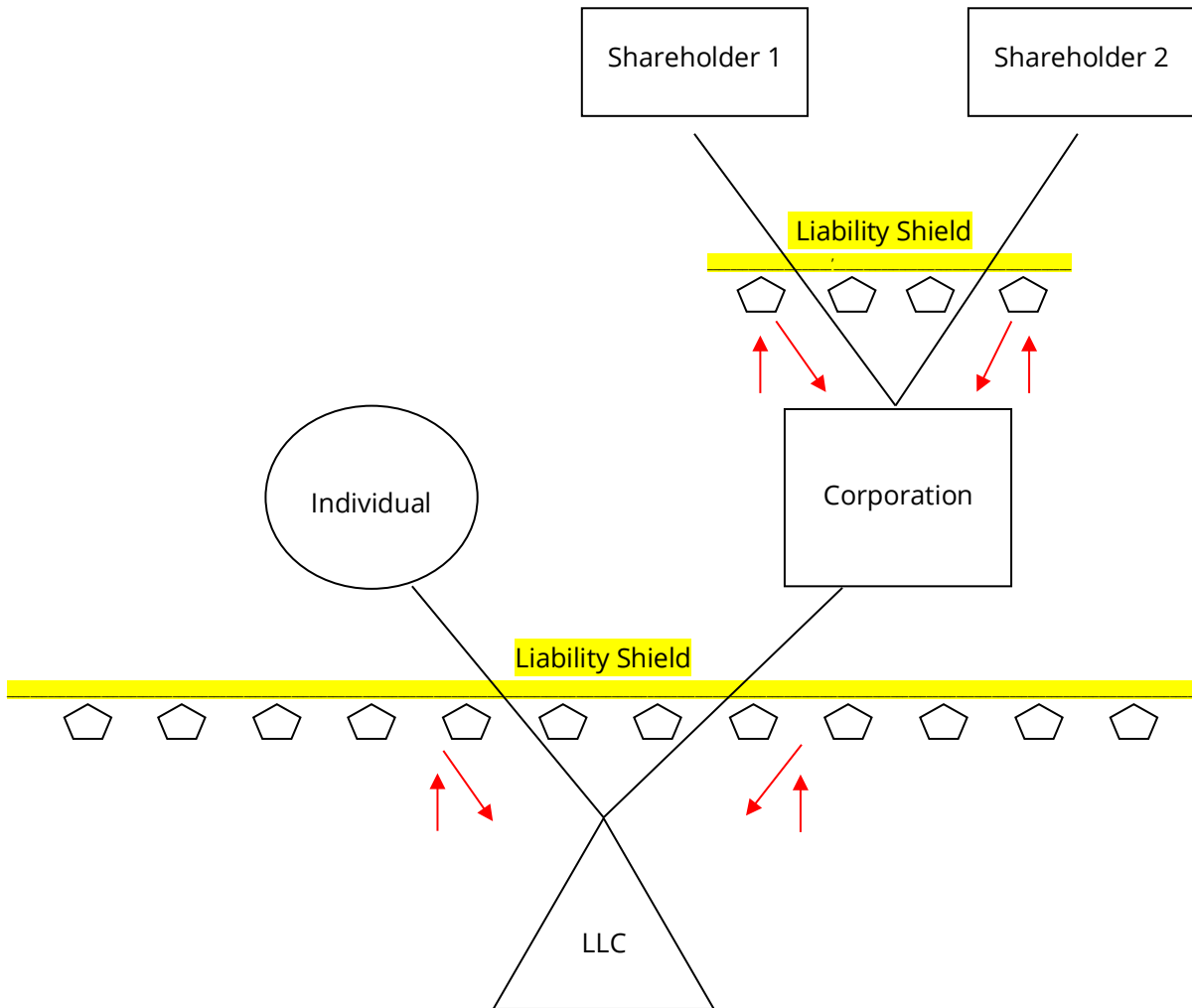
- Entity must be an LP, LLP, or LLC (cannot be an LLC that has elected to be classified as a corporation for federal income tax purposes by filing federal Form 8832).⁹
- All members or partners of the entity make an election to be fully liable for the debts, obligations, and liabilities of the entity.
 - An “Obligated member” is a member or partner of an obligated member entity that is fully liable for the debts, obligations and liabilities of the entity, as provided in Tenn. Code Ann. § 67-4-2008(b)-(d), and that has filed appropriate documentation to that effect with the secretary of state;¹⁰
- An OME is subject to franchise and excise tax to the extent any obligated member, or any owner of an obligated member, provides limited liability protection.¹¹ The information needed to compute the tax is generally found on the OME's federal Schedule(s) K-1. For example:
 - XYZ, LLC (“XYZ”) has two members, A and B. XYZ qualifies as an obligated member entity because A and B have filed documentation with the secretary of state to make them fully liable for the debts, obligations and liabilities of XYZ. The corporate, LP and LLC forms of entity organization generally shield the entity's owners from being subject to the entity's debts, obligations and liabilities; however, in this example, A and B have given up this protection by becoming obligated members. As A and B are both individuals, there are no additional, indirect ownership interests to consider with respect to XYZ. OMEs that are directly and solely owned by individuals do not have indirect ownership interests to consider, and such OMEs will always be fully exempt from the franchise and excise tax.
 - In this example, Member A is an individual and Member B is a corporation with shareholders of its own. As stated above, corporations provide their owners with limited liability protection and generally shield them from liabilities of the corporation. This remains true even though B has agreed to be an obligated member of XYZ. When one of the obligated members of an OME itself confers limited liability protection on its own owners, then the OME is partially exempt from the franchise and excise tax. The tax is computed on the information reported on B's federal Schedule K-1 received from XYZ. More specifically, the values shown on B's Sch. K-1, Part III, Lines 1-13, are reported on Schedule J1 of XYZ's Tennessee excise tax return. Additionally, the equity of XYZ attributable to Member B is subject to the franchise tax. In this example, XYZ's equity (net

worth), as reported under generally accepted accounting principles, is \$100,000. Member B's ending capital percentage reported on Sch. K-1, Part II, Item J is 50%. (This is the percentage share of the capital that Member B would receive if XYZ was liquidated by the distribution of undivided interests in XYZ's assets and liabilities.) The net worth reported on the franchise tax return Sch. F1, Line 1 is \$50,000 (\$100,000 x 50%).

⚠ An obligated member entity whose members are individuals or entities that do not offer limited liability protection to their owners will be fully exempt from the franchise and excise tax. An obligated member entity with a member that provides limited liability protection to their owners (corporation, LLC, LP, etc.) will be partially exempt.

- Estates, trusts that are not taxpayers, not-for-profit entities, or other entities exempt from franchise and excise tax, are not deemed to provide limited liability protection. They must, however, follow the same procedures renouncing liability protection with the Tennessee Secretary of State for XYZ to qualify as an obligated member entity.
 - A partially exempt OME will file both an Annual Exemption Renewal (Form FAE183) and a franchise and excise tax return (Form FAE170) for the taxable period.
- The entity must file the required documentation, as detailed at Tenn. Code Ann. § 67-4-2008(b)-(d), with the Tennessee Secretary of State to be eligible for this exemption and must provide a copy of such documentation to the Department when applying for this exemption.
 - The OME must file the required documentation on or before the first day of the taxable period for which the exemption applies.
 - If the OME files the required documentation after the first day of the taxable period, the exemption will not become effective until the following taxable period. **The exemption may not be prorated.**
- The following charts show limited liability protection before and after an LLC becomes an OME.

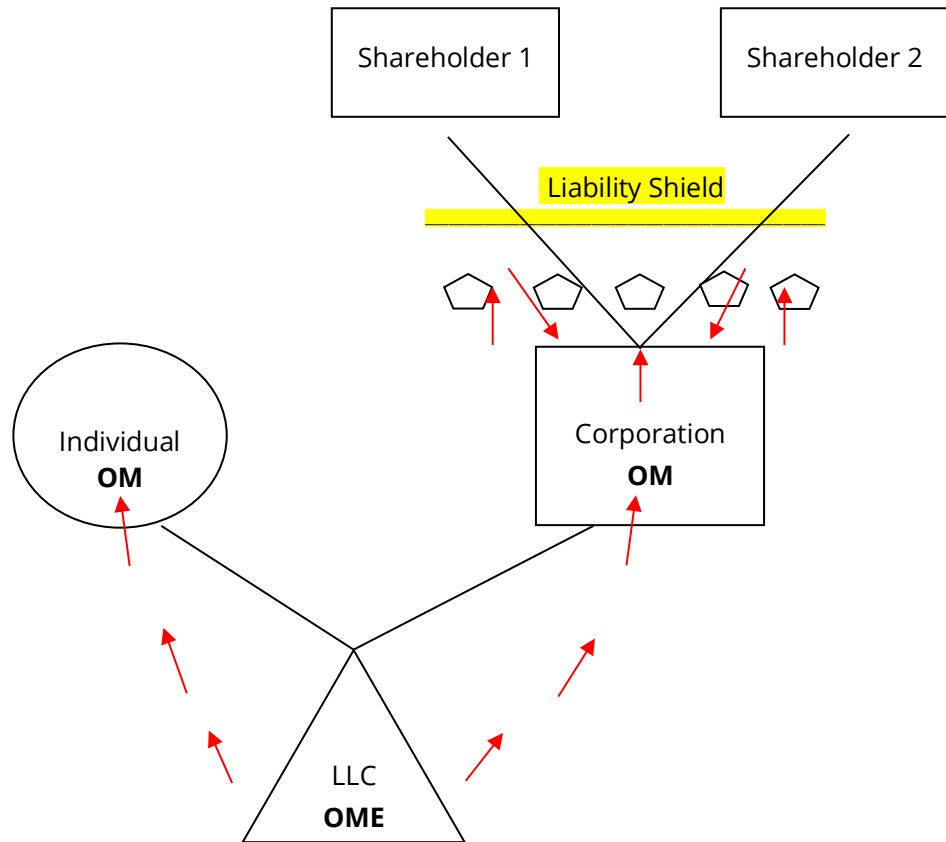
Liability Limitations Before LLC Becomes an OME



The LLC form of organization provides limited liability protection to the entity's owners. The red arrows shown above represent the liabilities, debts, and obligations of the LLC. The yellow line shows that direct and indirect owners of the LLC are not required to satisfy the liabilities, debts and obligations of the LLC.

The LLC would be required to file a franchise and excise tax return if they are doing business and have substantial nexus in Tennessee.

Liability Limitations After LLC Becomes an OME



The individual and corporate owners of the LLC have agreed to be obligated members and forego the liability protection normally afforded to LLC owners. Note, the yellow shield shown in the previous chart has been removed to show that the owners of the LLC may have to satisfy the debts, obligations and liabilities of the LLC. Because the corporate member is the type of entity that confers limited liability protection to its owners, the OME is only partially exempt. The OME would prepare a franchise and excise tax return based on information found on the Sch. K-1 it issued to the corporate OM. The OME would also file form FAE 183 Application for Exemption/Annual Exemption Renewal to report its partial exemption.

Asset-Backed Securitization

- Entity is classified as a partnership or trust;

- Elects to be treated as a real estate mortgage investment conduit ("REMIC") under I.R.C. 860D;
- Elects to be treated as a financial asset securitization investment trust ("FASIT") under I.R.C. 860L; or
- Is a business trust, as defined in Tenn. Code Ann. § 48-101-202(a), or is classified as a business trust under state law and is disregarded for federal income tax purposes.
- The sole purpose of the entity must be the asset-backed securitization of debt obligations, including mortgages and trade receivables.

Family-Owned Noncorporate Entity ("FONCE")

- Entity must be an LLC, LP, or LLP.
 - An SMLLC owned by an individual also qualifies.
 - The exemption is not available to corporate entities, including S corporations.
 - The exemption is not available to noncorporate entities that make an election to be classified as a corporation for federal income tax purposes (e.g., Form 8832).
- At least 95% of the ownership units of the entity are owned by members of the family or the estate or trust of a deceased individual who, while living, was a member of the family (e.g., a testamentary trust). Members of the family means, with respect to an individual,¹²
 - An ancestor of such individual;
 - The spouse or former spouse of such individual;
 - A lineal descendent of such individual, of such individual's spouse or former spouse, or of a parent of such individual; or
 - The spouse of a former spouse of any lineal descendent described in the preceding bullet point.
- At least 66.67% of the entity's activity is either 1) the production of passive investment income, or 2) the combination of passive investment income and farming.

- **Passive investment income** means gross receipts derived from royalties, rents from residential property or farm property, dividends, interest, annuities, and gains (not gross sales proceeds) from sales or exchanges of stocks or securities.¹³
 - Rents from industrial and commercial real estate are not considered passive investment income for the purpose of the FONCE exemption.
 - Residential property, for the purpose of the FONCE exemption, cannot have more than **four** residential units per separately deeded property.¹⁴ For example:
 - A condominium with *four* separately deeded units would qualify as residential property.
 - A family-owned noncorporate entity that owns *ten* condominiums, each of which is under a separate master deed and has *four* units per condominium, would qualify for the exemption.
 - A family-owned noncorporate entity owns *two* condominiums, each of which is under a separate master deed and has *eight* units per condominium. The condominiums do **not** qualify as residential property.
 - A five-unit apartment building would **not** qualify as residential property.
 - There is no requirement that a FONCE own four or fewer separately deeded properties in order to qualify for the exemption. A single FONCE may own more than four separately deeded properties and qualify for the exemption, so long as the FONCE meets the family ownership and passive income requirements.
 - Ownership of commercial and industrial property does not automatically disqualify a noncorporate entity from claiming the FONCE exemption. The entity must take into consideration its total gross receipts from all sources (passive and non-passive) for the tax period; assuming that the noncorporate entity meets the FONCE ownership requirements, and as long as 66.67% or more of the entity's gross receipts for the tax period

consist of passive investment income, the entity will qualify for the FONCE exemption. For example:

- A non-corporate entity is equally owned by two spouses. The entity owns several real estate properties from which it derives rents. The following is a schedule of the annual rents derived from the entity's real estate properties, broken down by property:

Residential home	\$ 9,000
Residential home	\$ 9,900
Condominium (four units)	\$ 34,200
Condominium (four units)	\$ 37,620
Condominium (six units)	<u>\$ 45,000</u>
	<u>\$ 135,720</u>

All of the above properties qualify as residential property except for the six-unit condominium. The entity's passive investment income from all the other properties totals \$90,720. Because **66.84%** ($\$90,720 / \$135,720$) of the entity's gross receipts consist of passive investment income, the entity qualifies as a FONCE.

- Rents from a tenant in common interest in commercial property in which there is no active participation is not considered passive income. Active participation is not a determining factor of passive investment income for the FONCE exemption; because the property in which the entity has an ownership interest is not residential property, the rents do not qualify as passive investment income.
- Only gains from the sale or exchange of stocks or securities qualify as passive investment income. Gains from the sale or disposition of real, tangible, or intangible property do not qualify.
- An entity will meet the passive investment income test for the purpose of the FONCE exemption if it does not have any income derived from any source for the taxable period.
- Entity must complete a Disclosure of Activity form which is due with its Application for Exemption and each Annual Exemption Renewal, to inform the Department of the entity's activities relating to the exemption.

⚠ It is imperative that the taxpayer complete the Disclosure of Activity Form in its entirety, including all pertinent addresses and the county in which the assets are located.

Diversified Investing Fund

- Entity must be an LLC, LLP, LP, or a business trust.
- At least 90% of the cost of the entity's total assets consists of qualifying investment securities, bank deposits, and office space and equipment.
- At least 90% of the entity's gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities.
- The entity's primary purpose is buying, holding, and selling qualified securities on its own behalf and not as a broker.
- The entity's capital is primarily derived from investments by entities or individuals not affiliated with the fund.

Taxable Entities

1. Types of Taxable Entities

Prior to 1999, only C corporations and S corporations were subject to franchise and excise tax. However, in 1999, the definition of a taxpayer¹⁵ was expanded to include all the following types of entities:

- Corporation (C corporation)
- Subchapter S corporation (S corporation)
- Limited liability company (LLC)
- Professional limited liability company (PLLC)
- Registered limited liability partnership (RLLP)

- Professional registered limited liability partnership (PRLLP)
- Limited partnership (LP)
- Cooperative
- Joint-stock association
- Business trust
- Regulated investment company
- Real Estate Investment Trust (REIT)
- State-chartered or national bank
- State-chartered or federally-chartered savings and loan association

Of the above entities, the most common ones subject to franchise and excise tax are C corporations, S corporations, LLCs, and LPs.

The 1999 tax reform also expanded the franchise and excise tax base to include several non-corporate pass-through entities. A *pass-through entity* that offers limited liability protection to its owners is subject to the tax. A pass-through entity can be an S corporation, an entity treated as a partnership for federal income tax purposes, an entity treated as a trust for federal income tax purposes, or a business entity that has a single owner and that is disregarded as an entity separate from its owner for federal income tax purposes¹⁶ (disregarded entities will generally be treated as separate taxpaying entities for franchise and excise tax purposes).

The mechanics of federal tax law provide that pass-through entities such as S corporations, LPs, and LLCs do not pay federal income tax at the entity level, but instead distribute their income or loss to their owners, which in turn report and pay the tax on their respective income tax returns, hence the term *pass-through entity*. This distribution is reported by the pass-through entity to its owner(s) on federal Schedule K-1. For example, owners that are individuals report the pass-through income or loss on their Individual Income Tax Returns (Form 1040) along with their individual activities. Tennessee is unique in its taxation of pass-through entities in that it taxes these entities *directly* at the entity level, rather than taxing the owners to which the pass-through entity makes distributions of its income or loss.

2. Attributes of Taxable Entities

Corporation (C Corporation)

- Incorporates, or charters, under the provisions of *Tennessee Code Annotated* Title 48 with the Tennessee Secretary of State.
 - Out-of-state corporations may obtain a certificate of authority from the Tennessee Secretary of State to conduct business in Tennessee.
- Files a federal income tax return on Form 1120 or other variant of this form such as 1120-REIT (real estate investment trust), 1120-RIC (regulated investment company), 1120-C (cooperative association), 1120-F (foreign corporation chartered outside the U.S.), 1120-FSC (foreign sales corporation), 1120-H (homeowners association), or 1120-IC-DISC (interest charge domestic international sales corporation).
- May file federally as a single entity or may elect to file on a consolidated basis with affiliates. Federal Form 851 lists the affiliated group members.
- LLCs may file Form 1120 and be taxed as a corporation if the LLC makes this election on federal Form 8832.
- Business trusts file as a corporation on federal Form 1120.

Subchapter S Corporation (S corporation)

- Files a federal income tax return on Form 1120S. The income or loss is distributed to the owners on Schedule K-1, and the owners report and pay the tax due on their individual returns. S corporations do not pay federal income tax at the entity level.
- Stockholders of a C corporation may make an election on Form 2553 to be treated as an S corporation as long as the stockholders are individual persons (not corporations).
- May have wholly-owned subsidiaries known as qualified subchapter S subsidiaries (“QSub”) that, upon election, are included in the federal Form 1120S of the parent S corporation.
 - The parent S corporation files federal Form 8869 to make the QSub election.

- The election results in a deemed liquidation of the QSub into the parent S corporation.
- Following the deemed liquidation, the QSub is treated as a division of the parent S corporation, and all of its assets, liabilities, items of income, deduction, and credits are treated as those of the parent.
- If the QSub was a separate corporation prior to the deemed liquidation, it may have to file a final federal return.
 - A final return is not required if the QSub election was made pursuant to a tax-free reorganization under IRC §368(a)(1)(F).

Limited Liability Company (LLC)

- Formed by filing articles of organization with the Tennessee Secretary of State, pursuant to *Tennessee Code Annotated* Title 48.
- LLC owners are called *members*; LLC members can be corporations, partnerships, individuals, or other entities.
- Files federal Form 1065 as a partnership if it has more than one owner.
 - If the LLC has only one member, it is treated as a single-member limited liability company (“SMLLC”) for federal income tax purposes, and its income or loss is generally included in the return of its owner.
 - An SMLLC is not disregarded for franchise and excise tax purposes unless its single-member is a corporation.
- The income or loss reported by an LLC on Form 1065 is distributed to its members on Schedule K-1, and each member reports and pays tax on their distributive share of the LLC’s income or loss on their individual returns.

Professional Limited Liability Company (PLLC)

- Files federal Form 1065 as a partnership.
- Members are engaged in providing a professional service (e.g., doctors, attorneys, accountants, etc.).

- Organized pursuant to *Tennessee Code Annotated* Title 48.

Registered Limited Liability Partnership (RLLP)

- Limits an individual partner's liability for acts committed by other partners of the RLLP or employees of the RLLP, but not for the individual partner's own actions.¹⁷
- Files federal Form 1065 as a partnership.

Professional Registered Limited Liability Partnership (PRLLP)¹⁸

- Files federal Form 1065 as a partnership.
- Members are engaged in providing a professional service (e.g., doctors, attorneys, accountants, etc.).

Limited Partnership (LP)

- Formed by filing a certificate of limited partnership with the Tennessee Secretary of State, pursuant to *Tennessee Code Annotated* Title 61.
- Must have more than one partner.
- Must have at least one general partner.
- Limited partners are only liable to the extent of their investment in the LP.
- The partners of an LP can be any combination of corporations, partnerships, individuals, or other entities.
- Files federal Form 1065 as a partnership or Form 1065-B for electing large partnerships with over 100 partners.

Series Limited Liability Companies (SLLC)/Master LLC

In 2006, Tennessee's LLC laws were expanded to allow the creation of one or more *series limited liability companies* within an LLC commonly referred to as a *master LLC*. Each SLLC is treated as a separate entity with respect to its debts, liabilities, obligations, and expenses.¹⁹ The master LLC is separate from the SLLCs.

- An SLLC will designate a series of LLCs within the SLLC's formation. Each series (LLC) is treated as a separate entity for franchise and excise tax purposes.²⁰
- A common use of the SLLC is to hold separate pieces of real estate for development purposes.
- Each LLC in the series can segregate the risk of the property, loan, and legal liability from other properties held in each SLLC.
- Only the master LLC is required to file with the Tennessee Secretary of State.
- The master LLC and each SLLC must register with the Department and set up separate franchise and excise tax accounts. Each LLC must file separate returns unless they meet the criteria to be disregarded.

Trusts

- Business trusts generally file a federal income tax return on Form 1120 and are taxable entities for franchise and excise tax purposes.
- Estates and trusts file a federal income tax return on federal Form 1041 and are not subject to franchise and excise tax.²¹
- Real Estate Investment Trusts (REIT) are corporations that file federal Form 1120-REIT and are subject to franchise and excise tax. An in-depth explanation of REITs can be found in Chapter 17 of this manual.

Entity Formation

An entity providing limited liability protection for its owners is incorporated or organized through the Tennessee Secretary of State's office ("SOS"). Any corporate entity formed with the SOS by filing articles of incorporation, or articles of organization/certificate of limited partnership for LLCs/LPs, respectively, will have established franchise and excise tax nexus with the state and is considered a *domestic entity*. Entities that are formed out-of-state may qualify their charter or other registration with the SOS and receive a certificate of authority to do business in Tennessee. Out-of-state entities are considered *foreign entities* (meaning, formed in another state). Entities that are registered with the SOS are required to file an annual report and remit a filing fee with the SOS.

Information regarding business entities (both domestic and foreign) registered with the SOS can be accessed through the Business Information Search on the SOS website at www.tn.gov/sos (the direct link to this search engine is <https://tnbear.tn.gov/Ecommerce/FilingSearch.aspx>). Accessible information includes the official name of the business entity, state in which it was formed, initial filing date, fiscal year, location of its principal office, number of members (if applicable), whether the entity is an obligated member entity, and its status (such as active, administratively dissolved or revoked, etc.).

Occasionally, small, individually-owned businesses operate in the state and claim corporate, LLC, or LP status, even though they have not submitted articles of incorporation or organization to the SOS, or received a certificate of authority from the SOS to do business in Tennessee. In this case, the business will be subject to franchise and excise tax since the owners are operating and using a business name indicating corporate, LLC, or LP status. The use of such business name may include, but is not limited to, advertising, the store front, business cards, customer invoices, bank accounts or loans, business documents and contracts, or any other type of documentation of the business. For example:

A taxpayer, within 15 days of becoming subject to franchise and excise tax, must complete and submit an Application for Registration to the Department.²² The taxpayer can file the form online through TNTAP at <https://tntap.tn.gov/eservices> or mail/hand deliver the application to any Taxpayer Services Division office. The purpose of the form is to ensure the Department has the taxpayer's correct information, including address, federal employer identification number (FEIN), Secretary of State control number, reporting or filing period, etc. This helps make certain that the taxpayer is properly registered for all applicable taxes.

A taxpayer doing business in Tennessee, regardless of whether it is registered with the SOS, must file a franchise and excise tax return. This filing requirement applies to both taxpayers that have not registered with a secretary of state in any state as well as taxpayers that have not qualified their out-of-state registration with the Tennessee SOS. Any taxpayer doing business in Tennessee who is registered with the SOS, but whose charter or other registration becomes inactive, administratively dissolved or revoked, is still required to file a franchise and excise tax return.²³ A taxpayer with delinquent returns will be required to file up-to-date returns to reinstate with the SOS.

Entity Classification

1. Classification for Franchise and Excise Tax Purposes

Businesses are classified for franchise and excise tax purposes as corporations, partnerships, or other types of business entities, consistent with the way they are classified for federal income tax purposes.²⁴ Taxpayers indicate their entity type when registering their business with the Department. Generally, an entity will be treated the same for both federal and Tennessee franchise and excise tax purposes. For example, a non-corporate entity that would normally file a Form 1065 partnership return may elect to be treated as a corporation and file Form 1120 for federal income tax purposes. In this case, the Department will accept the taxpayer's federal entity classification election and will treat the taxpayer as a corporation for franchise and excise tax purposes.

If a business that is normally a non-taxable entity, such as a sole proprietorship, holds itself out to the public as a type of entity that would be subject to franchise and excise tax (e.g., a corporation, LLC, or LP) then the business will be subject to franchise and excise tax.

2. Federal Default Classification

Depending on whether a pass-through entity and its owners makes an election to change the entity's federal default classification, the Internal Revenue Service may treat a partnership or LLC as either 1) a corporation, 2) a partnership, or 3) part of the owner's return (a disregarded entity). Federal regulations dictate how an entity files for federal income tax purposes. If the entity does not make any election or other action regarding its federal entity classification, the following is the standard federal income tax treatment that will be applied to the entity:

- If a pass-through entity has only one owner, the entity is *disregarded* as an entity separate from its owner and is treated as a division of its owner for federal income tax purposes. For example, an SMLLC is disregarded as a separate taxpayer, and its activities are included in its owner's (single-member) return.
- Non-corporate entities (such as LLCs and LPs) are taxed as partnerships if the entity has two or more owners. For example, a joint venture (a business arrangement without an actual partnership or corporate formation) would file as a partnership on federal Form 1065.

Under federal default classification rules, an entity that is the owner (single-member) of an SMLLC will include the SMLLC's activities with those of its own on a single federal return filed by the owner.

3. State Classification of SMLLC

If the single-member of a SMLLC is a corporation, the federal tax treatment will conform to franchise and excise tax filing requirements. In addition, a corporation that has no activity of its own in Tennessee is required to register with the Department and file franchise and excise tax returns if it is the single-member of a SMLLC that is doing business in the state (even if the parent corporation's ownership interest in the SMLLC is its only connection to the state). However, if the ultimate owner (single-member) of the SMLLC is any entity other than a corporation, the SMLLC will not be disregarded for franchise and excise tax purposes. In this instance, the federal and state income tax filing requirements of the taxpayer will differ. SMLLCs that do not meet the criteria to be disregarded for franchise and excise tax purposes should maintain separate-entity records or pro forma federal income tax returns to show the separate activity (i.e., items of income, deduction, etc.) of the individual SMLLC for franchise and excise tax purposes. (Please see Chapter 4 for more information on disregarded entities and identifying the Tennessee taxpayer in complex organizational structures.)

⚠ Audit Tip: Federal returns that include disregarded entities do not distinguish between the reported activity of the parent and any disregarded entities included in the return. Therefore, auditors examining SMLLC taxpayers (not corporate owned) may request the SMLLC taxpayer to produce pro forma federal returns showing the SMLLC's activity on a separate-entity basis.

4. Federal Election to be Treated as a Corporation

A non-corporate entity (such as an LLC or LP) may make an election on federal Form 8832 to be classified as a corporation for federal income tax purposes. This is commonly referred to as a "check-the-box" election.²⁵ For example, an LP may make this federal election and file as a corporation on Form 1120 for corporations instead of Form 1065 for partnerships. For franchise and excise tax purposes, the Department recognizes the federal election and will treat the entity as a corporation.²⁶ In addition, a non-corporate entity may make an election on Form 2553 to be an S corporation, in which case it would file a Form 1120S income tax return.

Out-of-State Businesses Responding to State Declared Disaster or Emergency

Out-of-state businesses, who do not otherwise have nexus in Tennessee, who are responding to a state-declared disaster are exempt from franchise and excise taxes for the income generated from performing disaster or emergency related work in the state. This work includes repairing, renovating, installing, building, and rendering services or other business activities that relate to critical infrastructure that has been damaged, impaired, or destroyed during a disaster or emergency and activities conducted in good faith before a potential disaster to prepare for the provision of this work. After a disaster response period, if a responding out-of-state business remains in the state the business loses this exemption and may be subject to the franchise and excise tax from the date that business activities first began in the state. The disaster response period is the period that begins ten days before the date of the earliest event establishing a disaster or emergency and that ends 120 days thereafter, or later if set by the governor or president of the United States.²⁷

¹ [Letter Ruling # 11-63.](#)

² IRS Publication 598 – *Tax on Unrelated Business Income of Exempt Organizations*.

³ [Letter Ruling # 17-07.](#)

⁴ [Important Notice # 04-11.](#)

⁵ See [Letter Ruling # 11-55](#). Entities formed for the purpose of securitizing trust preferred securities are not exempt.

⁶ Tenn. Code Ann. § 4-28-102. See <https://www.tn.gov/ecd/small-business/tninvestco/about-tninvestco.html> for fund names.

⁷ [Important Notice # 09-05.](#)

⁸ [Important Notice # 04-28.](#)

⁹ [Important Notice # 13-16](#) supersedes [Revenue Ruling # 08-20](#) with respect to the franchise and excise tax classification of limited liability companies electing to be classified as a corporation for federal income tax purposes.

¹⁰ Tenn. Code Ann. §§ 67-4-2004(35), 67-4-2008(b), (c), and (d).

¹¹ Tenn. Code Ann. § 67-4-2008(a)(9)(D).

¹² Tenn. Code Ann. § 67-4-2008(11)(B).

¹³ Tenn. Code Ann. § 67-4-2008(a)(11)(B)(iii).

¹⁴ Tenn. Code Ann. § 67-4-2008(a)(11)(B)(iv).

¹⁵ Tenn. Code Ann. § 67-4-2004(38).

¹⁶ Tenn. Code Ann. § 67-4-2004(37).

¹⁷ Tenn. Code Ann. § 61-1-306.

¹⁸ Tenn. Code Ann. § 61-1-1005.

¹⁹ Tenn. Code Ann. § 48-249-309(b).

²⁰ [Important Notice # 13-15.](#)

²¹ [Important Notice – Safe Harbor Established for Trusts and Estates \(1999\).](#)

²² Tenn. Code Ann. § 67-4-2003(c).

²³ Tenn. Code Ann. §§ 67-4-2007(b) and 2105(c).

²⁴ Tenn. Code Ann. §§ 67-4-2007(d) and 2106(c).

²⁵ Treas. Reg. §301.7701-3.

²⁶ [Important Notice # 13-16.](#)

²⁷ Tenn. Code Ann. § 58-2-204(c)(5).