

## Contents

Chapter 4: Identifying the Proper Franchise and Excise Taxpayer .....	60
Separate Single-Entity Reporting.....	60
1. Exceptions to Separate Single-Entity Reporting .....	61
2. Tax Implications of Single Filer Returns vs. Consolidated Return .....	61
3. Direct Taxation of Pass-Through Entities .....	61
Disregarded Entities.....	62
1. Corporations Formed Under State Law.....	63
2. Default Classification.....	63
3. Election to be Taxed as a Corporation.....	63
Organizational Structure – Role in an Audit .....	64
1. Pre-Audit Evaluation.....	64
2. Organizational Chart Symbols .....	65
Special Circumstances .....	66
1. Multimember LLC .....	66
2. Series LLCs .....	68
Disregarded Entities – Federal vs. State Rules .....	69
Additional Examples of Complex Disregarded Business Structures.....	72
1. Scenario One .....	72
2. Scenario Two .....	72
3. Revenue Ruling 11-46 – Disregarded Entities and Filing Requirements .....	74
4. Revenue Ruling 11-53 - Disregarded Entities and Filing Requirements.....	77

## Chapter 4: Identifying the Proper Franchise and Excise Taxpayer

### Separate Single-Entity Reporting

Tennessee is known as a separate single entity reporting state. Each taxpayer is considered a separate and single business entity and should file its franchise and excise tax return reflecting only its own business activities.

- Consolidated returns are *not* allowed for franchise and excise tax purposes.
- Each separate entity must file a separate franchise and excise tax return annually.<sup>1</sup>

**⚠ This reporting method is unique from other states that require consolidated or combined franchise and excise/corporate income tax reporting. This unique requirement illustrates why determining the taxpayer is an important first step before filing a franchise and excise tax return.**

This separate single-entity reporting requirement also applies to corporate subsidiaries and qualified S-corporation subsidiaries (“Q-Subs”) that do not file separate federal returns. If consolidated returns are filed federally, including S-corporations and Q-Subs, the taxpayer must provide the Department with a pro-forma federal return reflecting only the activities of each separate single-entity franchise and excise taxpayer.

**⚠ Audit Tip**  
**In an S-corporation audit, the auditor will likely ask whether there are any qualified S-corporation subsidiaries because it is often not readily apparent. If such subsidiaries are present, the auditor will request additional information to determine if those subsidiaries have sufficient nexus to be required to file a separate franchise and excise tax return.**

## 1. Exceptions to Separate Single-Entity Reporting

There are two exceptions to the separate single entity reporting requirement.

- First, unitary groups of Financial Institutions and REIT affiliated groups, as defined in Tenn. Code Ann. §§ 67-4-2004(17) and (7), respectively.
  - Financial Institutions and Captive REITs are required to file a combined return, including all affiliated group members, on Form FAE 174.<sup>2</sup>
- Second, LLCs that have a single owner/member (“SMLLC”) that is an entity taxed as a corporation for federal income tax purposes.
  - The SMLLC and corporate owner file a single franchise and excise tax return in the name of the parent/owner. This also applies if the SMLLCs are stacked in an ownership tier, owning each other, if a corporation is the ultimate single-member owner of the top-tier SMLLC.

## 2. Tax Implications of Single Filer Returns vs. Consolidated Return

This separate single entity filing requirement is important to follow, as it has tax liability implications. Many times, two single returns versus a consolidated return will result in different apportionment ratios (see Chapter 14 for more information). Different apportionment ratios will affect different values for the net worth tax base, income subject to excise tax, loss carryovers used, and credits used and available to offset future years. Furthermore, intercompany transactions between affiliated entities will not be eliminated; depending on the profits (or losses) and credits earned by the affiliated entities, the tax computed on a combined basis may be more or less than that computed on a separate-entity basis.

Finally, although Tennessee is a separate single entity reporting state, there is an election available for affiliated groups to compute their individual *net worth* for franchise tax purposes on a consolidated basis. This computation is reported on Form FAE 170, Schedule F2. This election is only a computation method used to calculate separate entity franchise tax; it is not a method of actually filing the franchise and excise tax return.<sup>3</sup> For more information on this election, see Chapter 9 of this manual.

## 3. Direct Taxation of Pass-Through Entities

Tennessee is unique in that it taxes pass-through entities directly. Most states and the Internal

Revenue Service ("IRS") do not directly tax pass-through entities, such as an S-corporations, LPs, and LLCs. Instead, they tax the entity's owners based on their distributive share of the pass-through entity's net income or loss reflected on federal Schedule K-1, which is issued by the pass-through entity to each of its owners. Because Tennessee is unique in taxing pass-through entities directly, out-of-state taxpayers may erroneously submit returns for the Schedule K-1 recipient rather than the pass-through entity itself.

## Disregarded Entities

As stated above, a disregarded SMLLC and its corporate owner are not required to file separate franchise and excise tax returns because the SMLLC is treated as a division (or part) of the corporation. An SMLLC is disregarded for franchise and excise tax purposes when it is:

- disregarded for federal income tax purposes; and
- its single member is a corporation.

In these circumstances, the taxpayer will file one franchise and excise tax return in which the SMLLC's activity is included with the activity of its corporate owner.<sup>4</sup> Treatment as a disregarded entity for franchise and excise tax is not an option or an election.

**⚠ This rule *only* applies to SMLLCs. Other pass-through entities, such as LPs and multi-owned LLCs, that may otherwise be disregarded for federal tax purposes and owned by a corporation, are *not* disregarded for Tennessee franchise and excise tax purposes.**

A corporation, for franchise and excise tax purposes, means any entity that:

- was formed as a corporation under state law; or
- was not formed as a corporation but whose default classification for federal income tax purposes is to be treated as a corporation, such as a pass-through entity owned by a single corporate owner; or
- has made an election on federal Form 8832 to be classified as a corporation for federal income tax purposes and has received IRS approval to be classified as such.

## **1. Corporations Formed Under State Law**

If the entity is chartered and registered with the Tennessee Secretary of State as a corporation, the entity will always be considered a corporation for franchise and excise tax purposes. This applies to entities that may be federally designated as either a C-corporation or elect to be treated as an S-corporation. The separate single entity reporting exception applies in both scenarios, as both entities are “corporations.” Thus, in both cases, the SMLLC is disregarded and the franchise and excise tax return will include the activities of both the SMLLC and its corporate (C-corporation or S-corporation) owner.

## **2. Default Classification**

Some entities are disregarded to their owner’s return for federal income tax purposes by default. Default means that this is the standard federal tax treatment applied to the entity without any other action taken (e.g., an SMLLC always defaults to its owner for federal income tax purposes). There are three possible federal tax classifications:

- Disregarded entity
- Corporation
- Partnership

Federal classification rules also allow for certain non-corporate entities to be taxed as corporations. These are called “eligible entities” and include:

- Limited liability companies
- Limited liability partnerships
- Limited liability limited partnerships
- Limited partnerships
- General partnerships

Depending on the elections made and the number of owners, the IRS may treat a partnership or LLC as a corporation, partnership, or part of its owner’s return (a disregarded entity). If there is only one owner, the entity is by default disregarded as an entity separate from its single owner (treated as a division of the parent) for federal income tax purposes. The federal default classification is to tax non-corporate entities as partnerships if there are two or more owners.<sup>5</sup>

## **3. Election to be Taxed as a Corporation**

Some entities that do not disregard to their owner by default can “check the box,” (or elect) on

Form 8832 to be disregarded for federal income tax purposes. This form is also used by partnerships and LLCs to elect a corporate classification for federal income tax purposes, rather than be disregarded. If an entity elects to be treated as a corporation and is the single member of an LLC, the SMLLC will be disregarded to its owner. For example:

- An SMLLC is owned by an LP that elects to be treated as a corporation. The SMLLC would be disregarded and included in the LP's franchise and excise tax return.

This election also applies to the SMLLCs themselves. For example:

- An entity organizes as an SMLLC. The SMLLC then elects to be treated as a corporation. In such a case, the SMLLC is not disregarded, even if its single owner is a corporation.

## **Organizational Structure – Role in an Audit**

### **1. Pre-Audit Evaluation**

It is very helpful at the start of an audit for a taxpayer to provide the auditor with an organizational chart to assist the auditor in determining the ownership structure between entities. Many times, an audit will involve an entity that is just one component of an overall business structure. Because business structures can change year-to-year, the auditor will discuss the organizational structure with the taxpayer and confirm its accuracy.

If a chart is unavailable, the auditor will request an explanation of the group's structure. The auditor will analyze the organizational structure to identify disregarded entities that should be included in the franchise and excise tax return of the corporate owner. This is also important because of a requirement, in some cases, to reverse the pass-through income/loss amounts from pass-through entities on Form FAE 170, Schedule J and to include the attributes of pass-through entities in the apportionment factors on Form FAE 170, Schedule N. (See Chapters 11 and 14 for more information on the excise tax and apportionment, respectively).

Because non-corporate entities, such as LPs and LLCs, are not listed on federal Form 851, the auditor will inquire whether there are any of these entities in the business structure. If so, the auditor will inquire whether these entities are disregarded entities or file a federal Form 1065.

Once each separate entity can be identified, the auditor will confirm that entities registered with the Tennessee Secretary of State, or "doing business" in the state, are filing franchise and excise tax returns. The auditor will also identify if an entity is a holding company to determine if the lower-tier entity that it is holding would be the franchise and excise taxpayer. The auditor will

also determine if the lower-tier entity is a general partnership, in which case the entity with the ownership interest in the general partnership is the franchise and excise taxpayer, assuming it is a type of entity that offers limited liability protection to its owners (e.g., corporation, LLC, LP).

## 2. Organizational Chart Symbols

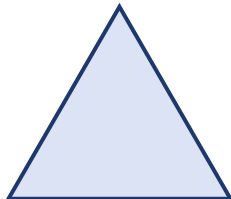
Organizational charts sometimes use various symbols to represent entity types. Symbols make it easier to identify the type of entity in question, especially with large affiliated groups with many levels or tiers of entities. Generally, the chart should also indicate the ownership percentage on the line connecting the entities.

Below are examples of symbols commonly used in organizational charts and preferred for consistent use by the Department.

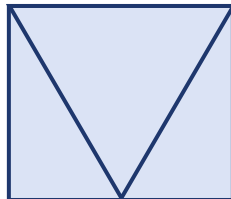
- Corporation
- S-corporation
- Treated as a Corporation



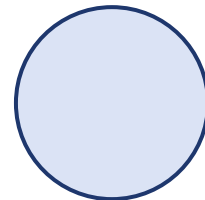
- GP, LP & LLC
- Treated as a Partnership



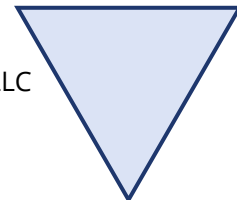
- SMLLC
- taxed as a Corporation



- Individual
- Sole proprietor



- SMLLC
- Partnership or LLC disregarded to owner's return



## Special Circumstances

### 1. Multimember LLC

A multi-member limited liability company may be disregarded for franchise and excise tax purposes in certain situations where, in a “top-down” analysis,<sup>6</sup> it effectively becomes an SMLLC.

See the organization chart on the next page in relation to the following example:

Multi-member LLC (MMLLC) is owned by two disregarded SMLLCs (SMLLC2 and SMLLC3) that are in turn owned by a disregarded SMLLC (SMLLC1) that is itself owned by a single corporation. MMLLC will be disregarded for franchise and excise tax purposes if it is disregarded for federal income tax purposes.

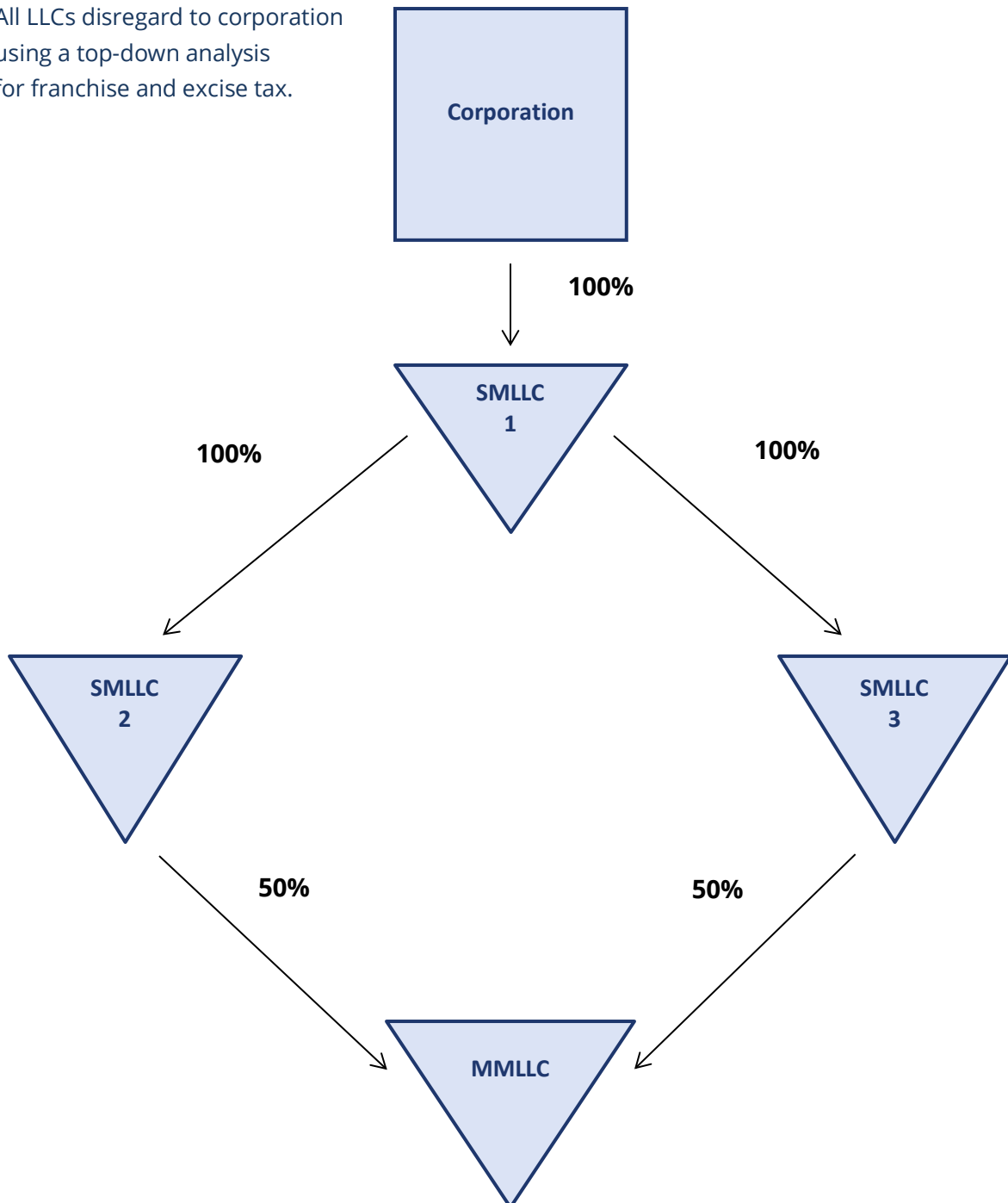
To arrive at this conclusion, a “top-down” analysis is done.

- SMLLC1 is disregarded into the corporation;
- SMLLC2 and SMLLC3 are disregarded into the corporation; and then
- MMLLC is disregarded into the corporation.

A multimember LLC that does not disregard into a single corporation using this “top-down” analysis is not disregarded for franchise and excise tax purposes.



All LLCs disregard to corporation  
using a top-down analysis  
for franchise and excise tax.



## 2. Series LLCs

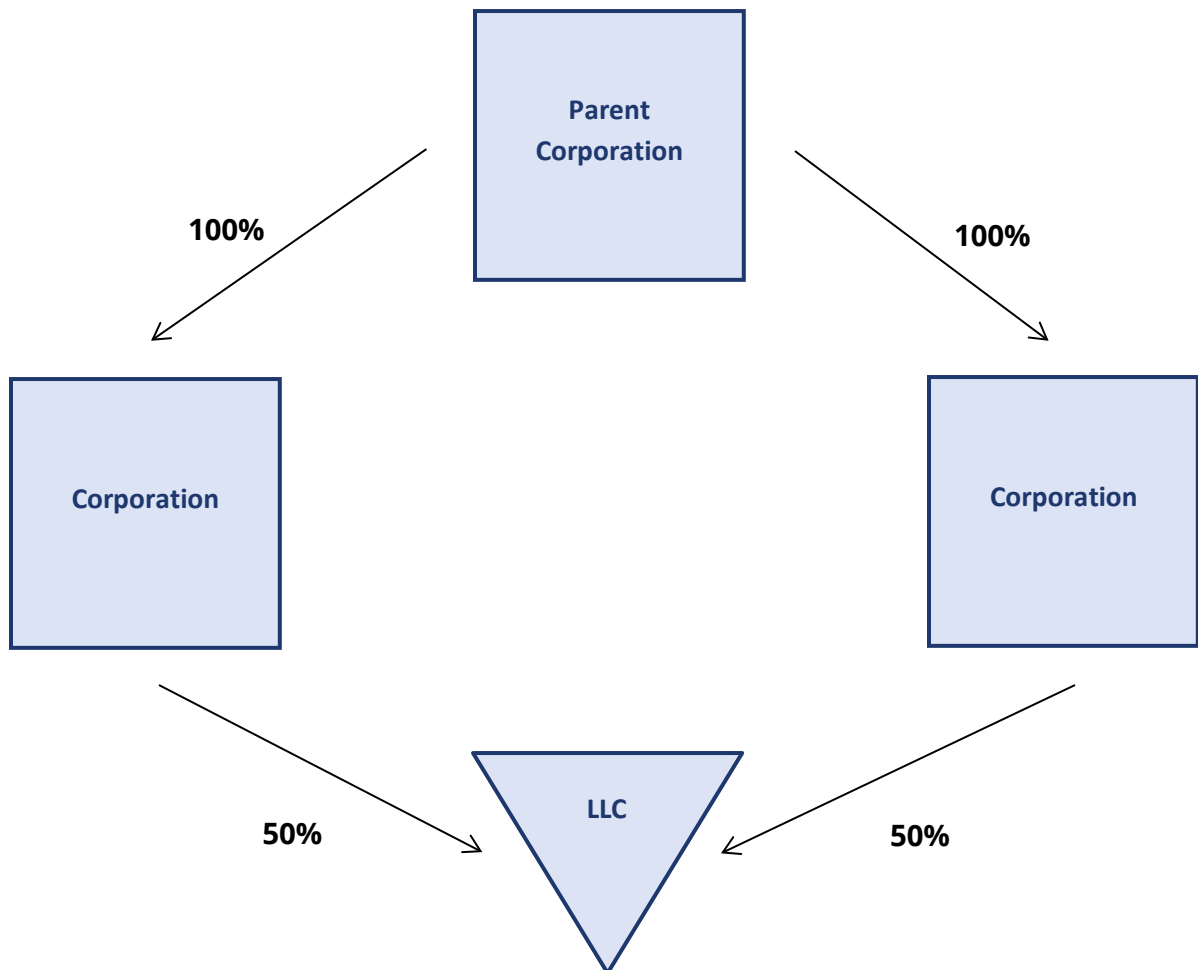
The series limited liability company is a relatively-new entity type that was established in 2006, but it is treated like any other entity in evaluating whether or not it meets the state's requirements to be disregarded.<sup>7</sup> For franchise and excise tax purposes, the Master LLC and each LLC series will generally be classified as a corporation, partnership or other type of business entity, consistent with the way it is classified for federal income tax purposes.

A Master LLC, or a series, that is wholly-owned by a corporation and is disregarded for federal income tax purposes will be disregarded for Tennessee franchise and excise tax purposes. All other federally disregarded Master LLCs or series are treated as separate entities for franchise and excise tax purposes.

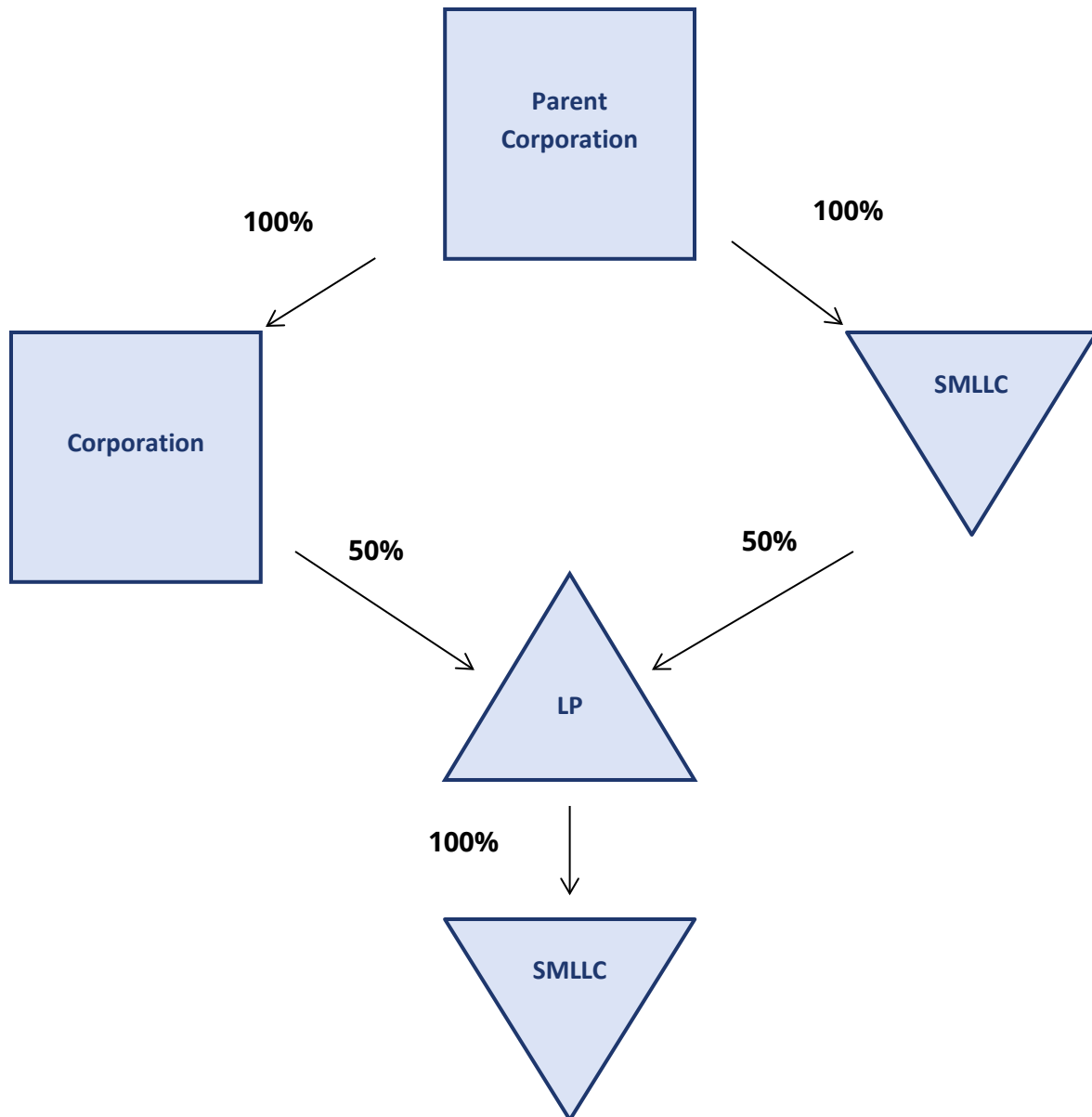
## Disregarded Entities – Federal vs. State Rules

The following example emphasizes the differing federal and state rules for disregarded entities. An LLC is owned by two affiliated corporations (50% each) who are included in the same consolidated Form 1120 federal tax return. The LLC is disregarded and its financials are reported on its owners' Forms 1120.<sup>8</sup>

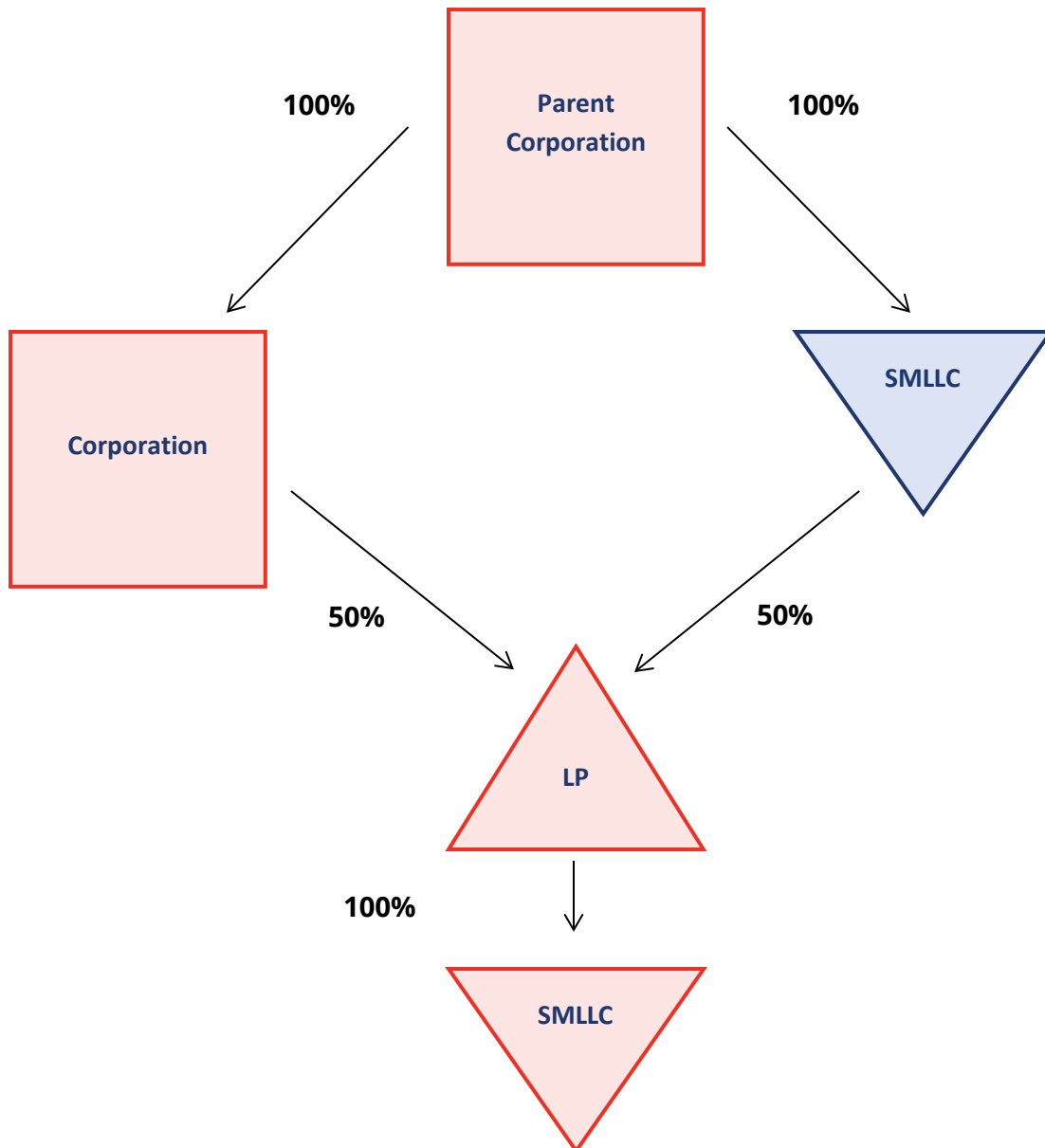
However, the LLC is a separate stand-alone taxpayer for franchise and excise tax purposes and must file its own franchise and excise tax return. Additionally, the two corporations must file their own franchise and excise tax returns as well.



In the following example, one *federal* return would be filed. All entities would be disregarded to the parent for federal income tax purposes, but not for Tennessee franchise and excise tax purposes. See the next page for the state's treatment.



This is the same organizational structure as previously shown. The entities highlighted in red are separate single-entity franchise and excise taxpayers. The SMLLC highlighted in blue would disregard to its parent and would not file a separate franchise and excise tax return.



## Additional Examples of Complex Disregarded Business Structures

### 1. Scenario One

Corporation A is the single-member owner of AA, LLC. Corporation A also has one subsidiary: Corporation B. Corporation B is the single-member owner of BB, LLC, who in turn is the single-member owner of CC, LLC. For federal income tax purposes, all of the LLCs are disregarded; AA, LLC disregards to Corporation A, BB, LLC and CC, LLC disregard to Corporation B. Corporation A files a consolidated Form 1120 with its wholly-owned subsidiary, Corporation B. All five of these entities file on one federal Form 1120 filed by Corporation A.

However, the Tennessee filing requirements differ:

- Corporation A must file a franchise and excise tax return.
- Corporation B must file a franchise and excise tax return.
- AA, LLC is disregarded to Corporation A and its activities are included in Corporation A's franchise and excise tax return.
- BB, LLC is disregarded to Corporation B and its activities are included in Corporation B's franchise and excise tax return.
- CC, LLC is also disregarded to Corporation B because its single-member, BB, LLC, is an SMLLC whose single-member is Corporation B; the activities of CC, LLC will be included in Corporation B's franchise and excise tax return. This is an example of the "top-down" analysis found in TENN. COMP. R. & REGS. 1320-06-01-.40.

### 2. Scenario Two

QQ, LLC; RR, LLC; and SS, LLC are all SMLLCs and are all disregarded to their single-member owner TT, LLC for federal income tax purposes. TT, LLC is a multi-member LLC that is 90% owned by UV Corporation and 10% owned by XY Corporation, which are both unrelated corporations that each file their own Form 1120. TT, LLC files a Form 1065 because it is a multi-member entity (a partnership) that has not elected to file as a corporation. All these entities except SS, LLC do business in Tennessee.

Again, the LLCs' Tennessee filing requirements differ from their federal filing requirements:

- UV Corporation and XY Corporation each file their own franchise and excise tax and federal returns.
- TT, LLC must file a separate franchise and excise tax return.
- QQ, LLC and RR, LLC must file separate franchise and excise tax returns. They are not disregarded because their single-member owner is not a corporation or an SMLLC whose single-member is a corporation.
- Pro forma returns will need to be created from the federal Form 1065 of TT, LLC to report the activities of TT, LLC; QQ, LLC; and RR, LLC each on a separate-entity basis.
- SS, LLC is not required to file a franchise and excise tax return because it does not do business in Tennessee and is not disregarded to another entity's return.

If TT, LLC had made the election on federal Form 8832 to be taxed as a corporation, the Tennessee filing requirements would be as follows:

- No change in the filing requirements for UV Corporation and XY Corporation.
- TT, LLC would be required to file a franchise and excise tax return that includes the activities of its disregarded SMLLCs (QQ, LLC; RR, LLC; and SS, LLC). Note that even though SS, LLC does not do business in the state and would not be taxed as a separate entity, it is included in the franchise and excise tax return of TT, LLC because it is disregarded and treated as a division of this corporate taxpayer.
- The excise tax portion of TT, LLC's return would be based on its federal Form 1120 and would produce a single taxable income or loss, since intercompany transactions between it and its SMLLCs would offset or be eliminated.

Simply examining a copy of the completed federal income tax return or Tennessee franchise and excise tax return of a single-member owner may not reveal that the activities of one or more SMLLCs are included in its return. Therefore, the auditor may request and examine the taxpayer's workpapers, any available pro forma returns, federal elections, consolidation schedules, or other records deemed necessary to ascertain the validity of the entities included in the tax returns. A preliminary audit analysis or inquiry of the organizational structure should alert the auditor that there are SMLLCs present within the structure. Once the federal filing

status of any SMLLCs or other disregarded entities is determined, the franchise and excise tax filing status can be properly determined.

### 3. Revenue Ruling 11-46 – Disregarded Entities and Filing Requirements

Revenue Ruling 11-46 addresses the changes in Tennessee filing requirements for the potential reorganization of a group of related companies. The parent is a corporation that wholly owns a group of SMLLCs and LPs. For federal income tax purposes, all of the SMLLCs and LPs are disregarded under the default rules to the parent's corporate return.

**Chart A** on the next page shows an organizational chart detailing how the entities are structured in this Ruling. Federally, the whole group files as one taxpayer under the name of the parent corporation. LP1 and LP2 are disregarded entities, since their partners are disregarded to the same entity.

There are *potentially* five franchise and excise taxpayers: **1)** Parent Corporation, including disregarded LLC A, LLC A1, and LLC A2, **2)** LP1, **3)** LP 2, **4)** LLC A3 and **5)** LLC A4.

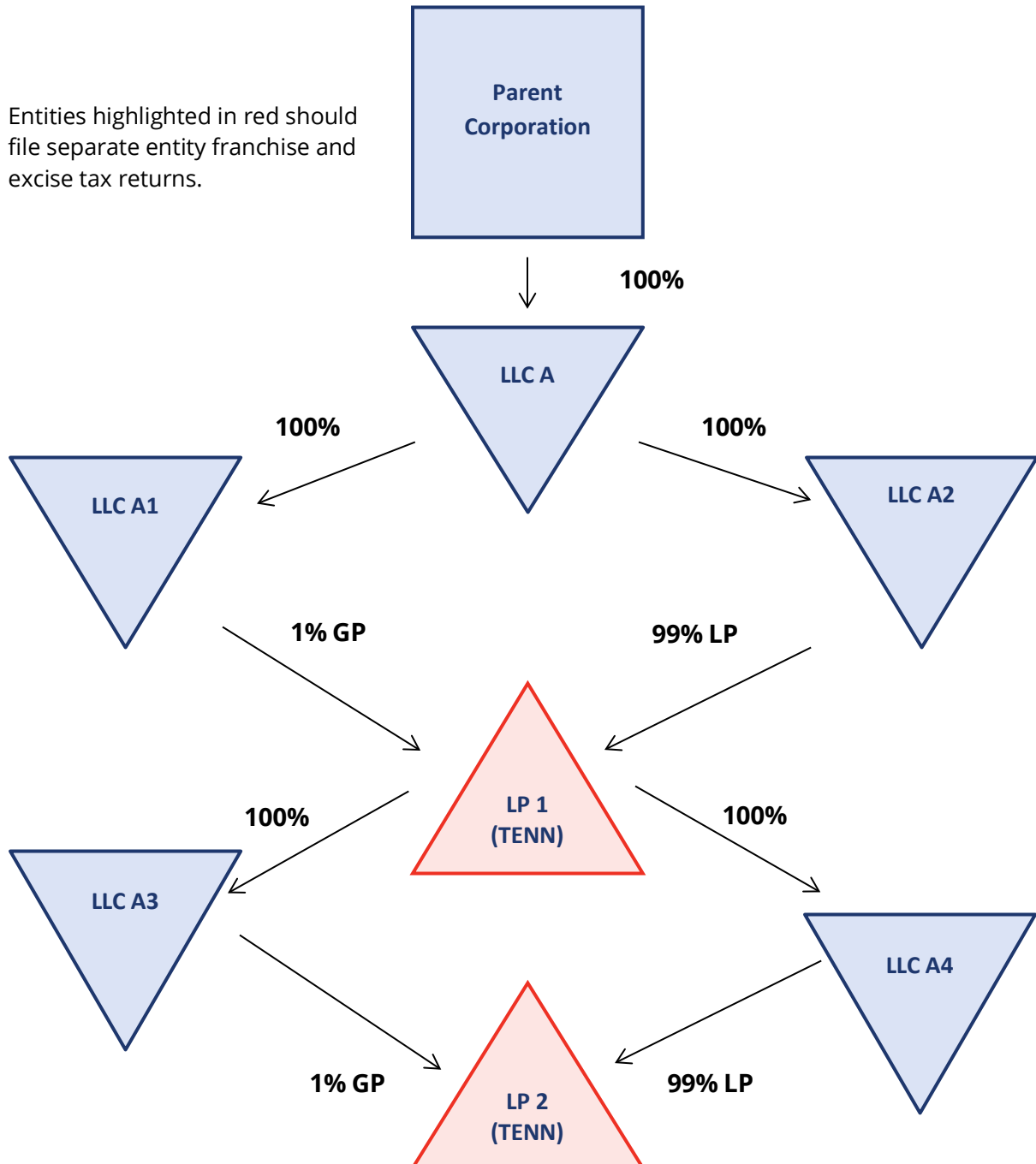
In this Ruling Parent Corporation, LLC A, LLC A1, and LLC A2 are not doing business and do not have substantial nexus in the state; there is no franchise and excise tax filing requirement. Also, LLC A3 and LLC A4 are not subject to the state tax because they are not disregarded and do not have nexus with Tennessee. However, for franchise and excise tax purposes, LP1 and LP2 are both separate-entity taxpayers that should file their own returns. In this scenario, auditors would need to request pro forma returns for LP 1 and LP2.

Note that under the “top-down” analysis discussed earlier, LLC A disregards into the parent corporation, then LLC A1 and LLC A2 disregard into the parent corporation. Any one of these four entities may create a franchise and excise tax filing requirement for the group.

**Chart B**, located below after Chart A, shows a proposed reorganization. The reorganization would convert LP1 and LP2 to LLC B and LLC C, and would eliminate LLCs A1-A4. Under Chart B, for both state and federal purposes, a single return would be filed that includes the activities of Parent Corporation, LLC A, LLC B, and LLC C. After the restructuring the parent owns three LLCs in a tiered structure. All three SMLLCs will be disregarded to the parent's corporate return for both state and federal income tax filing purposes. One franchise and excise tax return is filed to report the activities of all four entities. This determination is based on the ownership and type of entity, rather than whether the entities are “doing business” in the state.

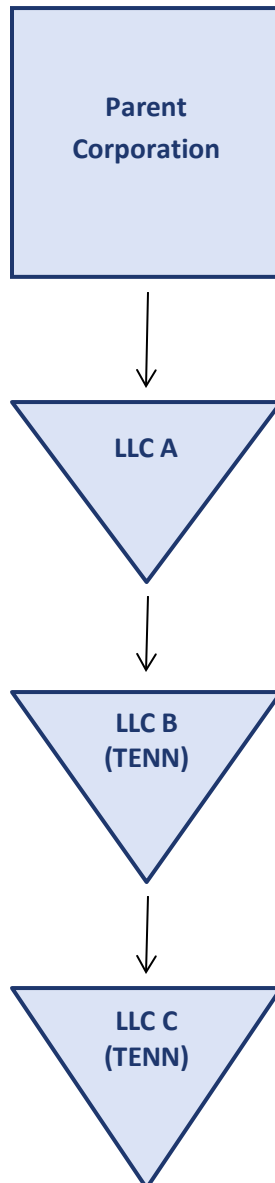


Chart A



### Chart B

This chart shows the reorganization of the structure shown in Chart A, described earlier. Note the conversion of LP 1 and LP 2 (see Chart A) to LLC B and LLC C. Also, note the elimination of LLCs A1, A2, A3 and A4. One state and federal return would be filed including all four entities.



#### 4. Revenue Ruling 11-53 - Disregarded Entities and Filing Requirements

The following discussion, based on Ruling 11-53, addresses the franchise and excise tax filing requirements of individual members within a group. The parent is a foreign company, located outside of the United States, and Corp I is a foreign subsidiary of the foreign parent. Corp C is the U.S. subsidiary of Corp I.

##### In **Chart C**:

- *Federal return filing* – Corp I would file on Form 1120F to report its 50% share of its Schedule K-1 distribution from LLC D. Corp C would file a standard Form 1120 to report its 50% share of its Schedule K-1 distribution from LLC D. LLC D would file a Form 1065 partnership return and issue Schedule K-1s to its two owners. It is not disregarded since the Schedule K-1s are issued to entities that report on different federal returns. All the SMLLCs owned by LLC D are tiered in a 100% ownership stack and would be disregarded to LLC D for federal income tax purposes.
- *Tennessee return filing* – Multi-member LLC D would be a taxpayer because it has activity in the state and is not disregarded. Auditors will request that LLC D provide a pro forma Form 1065, reflecting only the activities of LLC D. Because LLC F and LLC G have Tennessee activities, they would each file individually. Even though they are owned by LLC D, they would not be disregarded to it, since LLC D is not a corporation but a multi-member LLC filing on Form 1065.

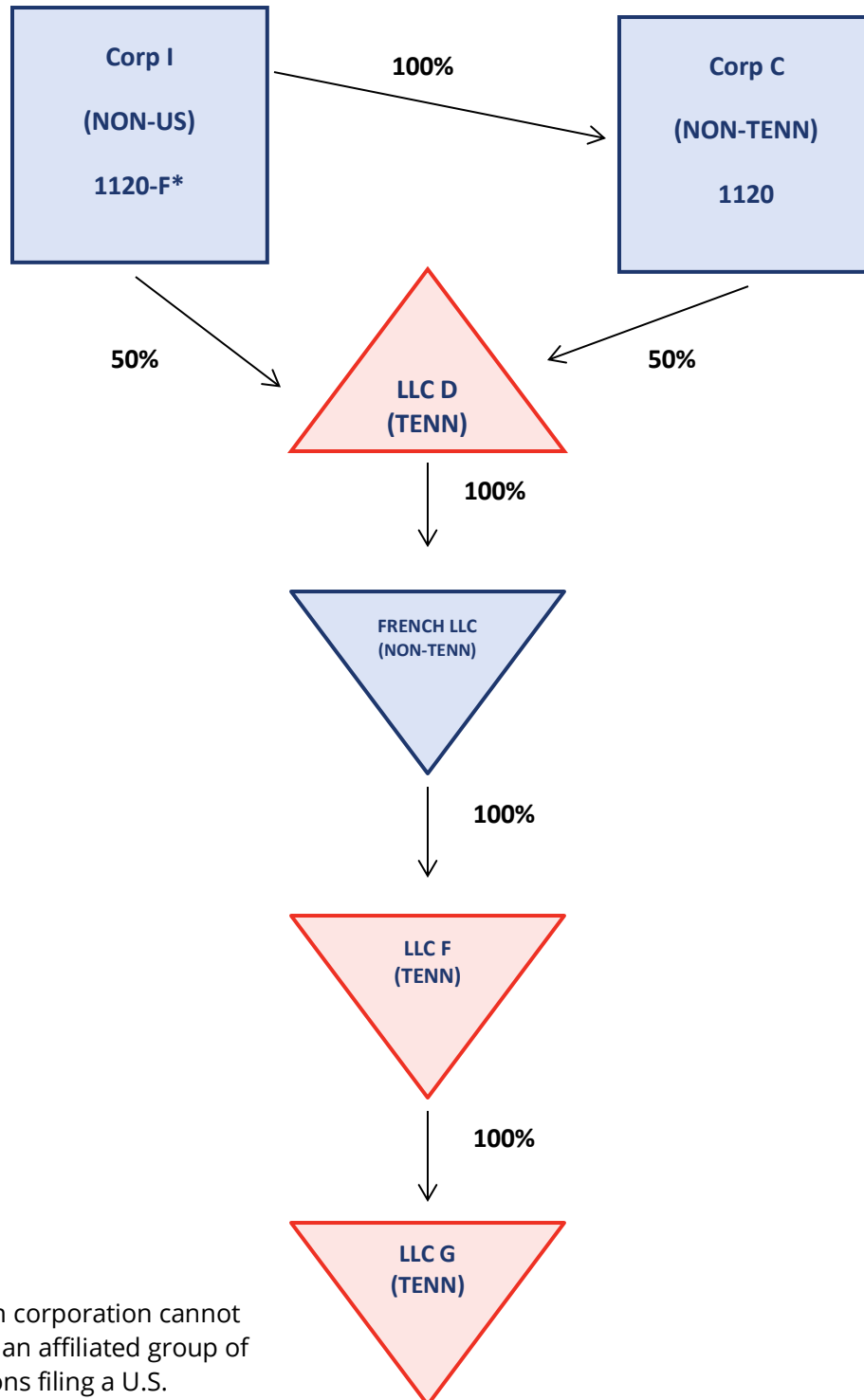
##### In **Chart D**:

The scenario exhibited in Chart D shows that a corporation with no business activity in the state and no business registration with the Secretary of State may be subject to the state's franchise and excise tax if it is the sole owner of an SMLLC that has nexus in the state. Chart D reflects a reorganization of the Chart C structure. Corp. I cancels its ownership interest in LLC D, making LLC D an SMLLC solely owned by Corp C.

- *Federal return filing* – Only one federal return will be filed for Corp C and all SMLLCs.
- *Tennessee return filing* – One franchise and excise tax return would be filed for Corp C and all LLCs. Corp C and French LLC do not have Tennessee activity on their own but are included in the franchise and excise tax return because all LLCs disregard to Corp C and some have Tennessee nexus. The return would include the activities of Corp C, LLC D, French LLC, LLC F, and LLC G under a “top-down” analysis, as discussed earlier.

Chart C

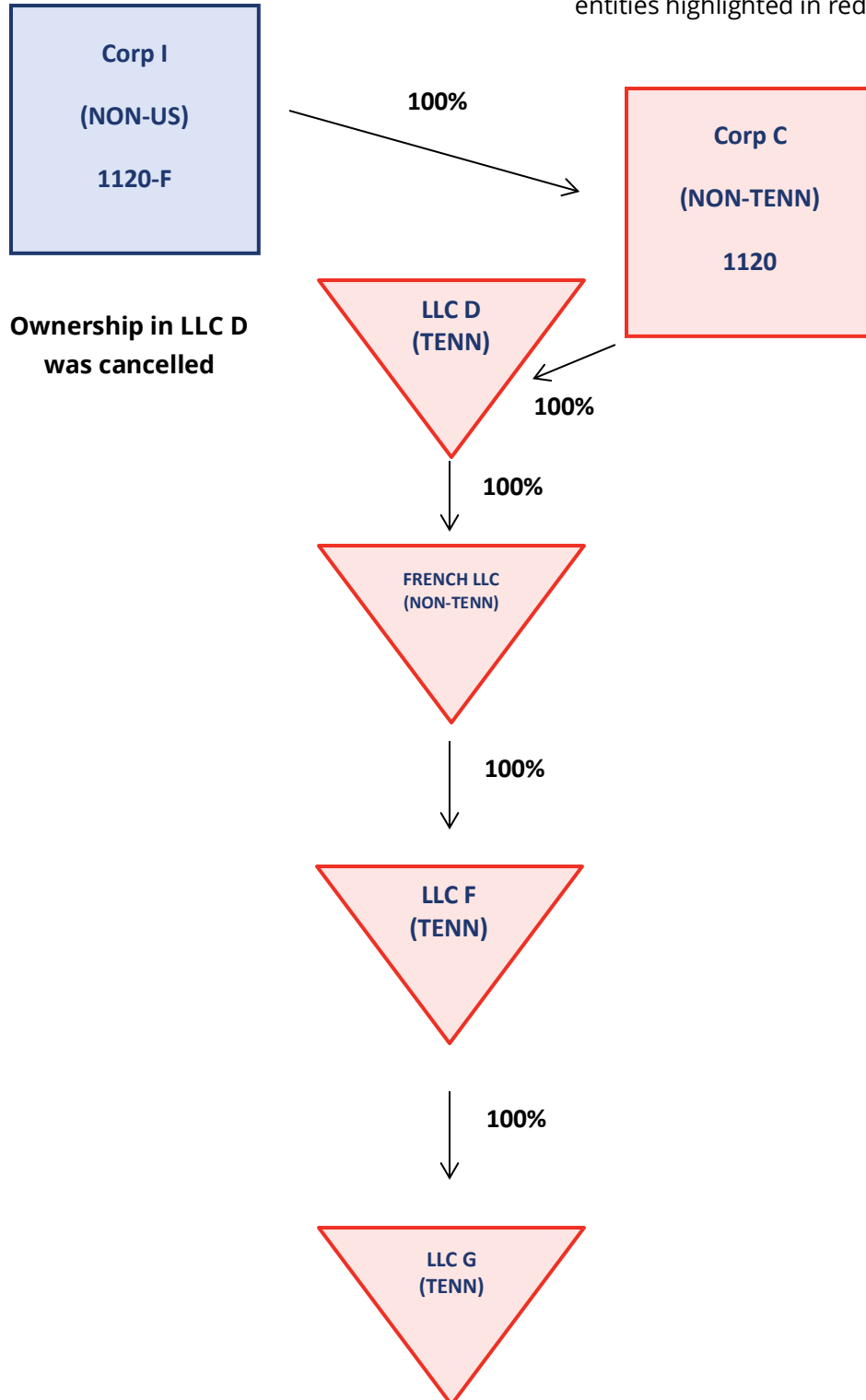
The three state return filers are highlighted in red.



\* A foreign corporation cannot be part of an affiliated group of corporations filing a U.S. consolidated federal return.

Chart D

One state return would be filed for the entities highlighted in red.



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<sup>1</sup> Tenn. Code Ann. §§ 67-4-2007(d), (e)(1), and 67-4-2106(c).

<sup>2</sup> Tenn. Code Ann. § 67-4-2007(e)(1).

<sup>3</sup> Tenn. Code Ann. § 67-4-2103(d).

<sup>4</sup> Tenn. Code Ann. §§ 67-4-2007(d) and 67-4-2106(c).

<sup>5</sup> See IRS Treas. Reg. § 301.7701 for more detailed information regarding federal tax classification.

<sup>6</sup> TENN. COMP. R. & REGS. 1320-06-01-.40.

<sup>7</sup> TENN. COMP. R. & REGS. 1320-06-01-.41.

<sup>8</sup> There is no need to prepare a Form 1065 for the LLC that distributes all its proceeds on Schedule K-1 to two entities that file within the same consolidated Form 1120. While the result is the same either way for federal income tax purposes, it is much simpler for the LLC to be disregarded and included in the consolidated federal return that includes the two corporations that own the LLC.