Contents

Chapter 9: Franchise Tax

Overview

1. Who Must File?

The franchise tax is a privilege tax imposed on entities for the privilege of doing business in Tennessee. All entities doing business in Tennessee and having a substantial nexus in Tennessee, except for not-for-profits and other exempt entities, are subject to the franchise tax.[1] This includes corporations, subchapter S corporations, limited liability companies, professional limited liability companies, registered limited liability partnerships, professional registered limited liability partnerships, limited partnerships, cooperatives, joint-stock associations, business trusts, regulated investment companies, REITs, state-chartered or national banks, or state-chartered or federally chartered savings and loan associations.[2]

Public Law 86-272 Not Applicable to Franchise Tax

As previously discussed in Chapter 3 of this manual, taxpayers whose only business activity is the solicitation of orders for tangible personal property, which are approved and delivered from locations outside the state, are exempt from the excise tax. However, such taxpayers are **not** exempt from the franchise tax. In an opinion published in 2004, the Tennessee Attorney General concluded that Public Law 86-272 applies only to taxes measured by net income, and therefore, does not apply to the franchise tax, which is based on a taxpayer's net worth.[3] A taxpayer claiming exemption from the excise tax under Public Law 86-272 should check the applicable box on the first page of the return and complete only the franchise tax portion of the return (Schedules F1 or F2, G).

2. Minimum Franchise Tax

The minimum franchise tax payable each year is $100. A taxpayer that is inactive or that has had its charter or other registration forfeited, revoked, or suspended without having been dissolved or otherwise properly terminated, is **not** relieved from filing a return and paying the minimum franchise tax.[4]

To properly terminate or withdraw a corporation's charter, the taxpayer must do the following:

- File a final franchise and excise tax return;

- Submit a schedule of liquidation, distribution, or disposition of assets with the final return;
- Pay all taxes owed to the Department;
- Obtain a tax clearance certificate from the Department; and
- Provide the tax clearance certificate, along with Articles of Dissolution, to the Tennessee Secretary of State.

When a taxpayer that has dissolved or liquidated owes franchise tax to the Department, and has failed to pay the tax, the Commissioner is authorized to collect the unpaid tax from any officer, stockholder, partner, member, principal, or employee of the taxpayer, who received property that belonged to the taxpayer. Such collection is limited to the value of the property received by any of these individuals.[5]

3. Franchise Tax Base

The franchise tax base is the taxpayer's net worth (reported on Schedule F1 or F2), or the book value of the property owned and the rental value of property used in this state (reported on Schedule G), whichever is greater. The franchise tax rate is $0.25 per $100 (0.25%, or 0.0025) of the franchise tax base.[6]

4. Minimum Measure (Schedule G)

The measure of the franchise tax cannot be less than the book value (cost less accumulated depreciation) of the property owned and the rental value (net annual rental paid) of property used in this state, excluding exempt inventory and exempt required capital investments made by a taxpayer claiming the job tax credit for higher level investments.[7] An in-depth discussion regarding exempt inventory and exempt required capital investments can be found in Chapter 10.

5. Manufacturers' Franchise Tax Base

Manufacturers, whose principal business is fabricating or processing tangible personal property for resale and ultimate use or consumption off the premises, are subject to franchise tax only on the first $2 billion of apportioned net worth or real and tangible personal property owned or used in this state.[8] Thus, a manufacturer's franchise tax base is capped at $2 billion.[9]

6. GAAP Books and Records

The net worth and property values reported on the franchise tax return should originate from the taxpayer's books and records prepared under generally accepted accounting principles (GAAP). However, if the taxpayer does not maintain its books and records in accordance with GAAP, and is not otherwise required to file as a unitary group on a combined basis, the taxpayer may compute and report its net worth and property values in accordance with the accounting method used by the taxpayer for federal tax purposes, so long as the method fairly reflects such values.[10] If the taxpayer maintains both GAAP *and* tax basis books and records, the taxpayer **must** use its GAAP books and records to determine its franchise tax base.

> ⚠ **Audit Tip: Smaller taxpayers may only keep tax basis books and records to track their day-to-day business operations. However, they may also be required to have GAAP financial statements prepared by an independent accountant for various purposes, such as to obtain a loan or for bonding/licensing requirements. In this case, the taxpayer must use the GAAP financial statements to compute its franchise tax base.**

GAAP requires that an entity's financial statements be prepared in accordance with the *liquidation basis of accounting* when liquidation of the entity is imminent.[11] Under this basis of accounting, assets and liabilities are presented at the amount the entity expects to collect or pay during the liquidation. For some assets, this may be fair value instead of book value. Liabilities will include estimated disposal costs and expenses related to the liquidation. It may be to a taxpayer's disadvantage to use liquidation basis financial statements, but the use of such financial statements is required for franchise tax purposes when liquidation of the taxpayer is imminent. In short, the liquidation basis of accounting is a basis of accounting required by GAAP under the circumstances previously mentioned, and if GAAP financial statements are required to be prepared by the taxpayer using this basis of accounting, they **must** be used to compute the taxpayer's franchise tax base.

Non-Consolidated Net Worth – Schedule F1

1. Net Worth

Net worth is reported on Schedule F1, Line 1. Net worth is defined as a taxpayer's total assets less its total liabilities, computed in accordance with GAAP.[12] This method of determining net worth is used for all types of taxpayers. On the following page is an example of a net worth computation.

Assets		
Cash	10,000	
Accounts receivable, net	20,000	
Investment in TN corporation	10,000	
Investment in TN LLC1	(2,000)	
Investment in TN LLC2	5,000	
Property, plant & equipment, net	37,000	
Other assets	20,000	
Total assets		**100,000**
Liabilities		
Accounts payable	(5,000)	
Mortgage payable	(10,000)	
Warranty liability	(5,000)	
Total liabilities		**(20,000)**
Net worth		**80,000**

Many large, multistate taxpayers that have their financial statements prepared by an independent accountant will have their financial statements prepared in accordance with GAAP because GAAP financial statements are required for large, publicly-traded entities and by many creditors, such as banks and other lenders. Smaller taxpayers may not maintain GAAP financial statements, and thus, would be permitted to compute their net worth in accordance with the accounting method used by the taxpayer for federal tax purposes. However, as previously discussed, if the taxpayer maintains both GAAP and tax basis balance sheets, the taxpayer must use its GAAP balance sheet to compute its net worth for franchise tax purposes.

Taxpayers report their *balance sheet per books* on Schedule L of their federal income tax return (Forms 1065, 1120S, 1120). The amounts reported by a taxpayer on the federal return balance sheet generally are derived from the taxpayer's GAAP books and records, and thus are appropriate to use in computing net worth for franchise tax purposes.

⚠ **Audit Tip: Auditors may compare the amounts reported in the taxpayer's audited financial statements prepared by an independent accountant with those reported on the federal return balance sheet (Schedule L). While the net worth computed from both sources should agree, if the amounts differ, the financial statements should be used to compute net worth.**

Appropriations of Retained Earnings

Under GAAP, an entity may appropriate part of its retained earnings as a separate balance sheet account to earmark the funds for a given purpose, such as a future plant expansion. These types of accounts **do not** represent a liability under GAAP but rather a component of the entity's retained earnings (net worth). The appropriation must be shown in the shareholders' equity section of the entity's balance sheet.[13] In addition, an entity may not charge costs or losses to an appropriation of retained earnings.[14] The purpose of appropriated retained earnings is for entities to indicate to their shareholders that certain funds have been earmarked and are not available to be paid out as dividends.

An entity may erroneously include accounts that are similar in nature to appropriations of retained earnings in the liabilities section of their balance sheet. However, because these accounts do not represent a liability under GAAP, they should **not** be deducted from the entity's total assets in computing net worth; this would erroneously reduce the amount of the entity's net worth subject to the franchise tax, as illustrated on the following page.

Correct

Total assets		**240,853,300**
Liabilities and shareholders' equity		
Liabilities		
Accounts payable	24,420,200	
Current portion of long-term debt	12,000,000	
Note payable - bank	108,050,000	
Total liabilities		**144,470,200**
Stockholders' equity		
Preferred stock	1,000	
Common stock	3,300	
Additional paid-in capital	250,000	
Retained earnings appropriated for plant expansion	**18,228,800**	
Retained earnings (unappropriated)	78,000,000	
Less: cost of treasury stock	(100,000)	
Total shareholders' equity (net worth)		**96,383,100**
Total liabilities and shareholders' equity		**240,853,300**

Incorrect

Total assets		**240,853,300**
Liabilities and shareholders' equity		
Liabilities		
Accounts payable	24,420,200	
Current portion of long-term debt	12,000,000	
Note payable - bank	108,050,000	
Other liability - reserve for plant expansion	**18,228,800**	
Total liabilities		**162,699,000**
Stockholders' equity		
Preferred stock	1,000	
Common stock	3,300	
Additional paid-in capital	250,000	
Retained earnings (unappropriated)	78,000,000	
Less: cost of treasury stock	(100,000)	
Total shareholders' equity (net worth)		**78,154,300**
Total liabilities and shareholders' equity		**240,853,300**

⚠ **Audit Tip: Appropriations of retained earnings that are properly classified as part of the taxpayer's equity will not have a corresponding expense or loss journal entry in the taxpayer's books and records. Unless a book expense or loss was incurred by the taxpayer, the appropriated amount may not be deducted as a liability in computing the taxpayer's net worth for franchise tax purposes.**

2. Affiliated Indebtedness

Indebtedness to or guaranteed by a parent corporation or affiliated corporation is reported on Schedule F1, Line 2, and must be added back to the tax calculation if the taxpayer is also a corporation and it is determined that the taxpayer is undercapitalized. This add-back is required to prevent taxpayers from avoiding franchise tax by using excessive affiliated debt, rather than capital, to fund their ongoing business operations. In other words, if a corporation, whose capital stock is inadequate for its business needs, is extended credit by a parent or affiliated corporation, or has debt with a third-party lender and *that* debt is guaranteed by a parent or affiliated corporation, all or a portion of the indebtedness may potentially be added back in computing the corporation's net worth.[15] The indebtedness add-back cannot be a negative amount.

⚠ **Audit Tip: The indebtedness add-back applies only to indebtedness between affiliated corporations. Indebtedness between corporations and partnerships or individual stockholders is not includable in the net worth computation. If the taxpayer is not a corporation, or if a corporate taxpayer's lender/guarantor is not itself a corporation, then this add-back does not apply.**

Affiliated debt includes all loans, notes, payables, etc. owed to or guaranteed by any related corporation, as shown on the balance sheet, but does not include any account or trade payables that are current liabilities. Affiliated indebtedness *does*, however, include any current portion of a long-term affiliated debt that is reported as a current liability on the taxpayer's balance sheet.

The indebtedness add-back is required only if the corporation is inadequately capitalized for its business needs. To determine whether this is the case, two tests are performed; the indebtedness add-back, if any, is the **lesser** of the amount computed under the Rule 15 Method[16] or the 4:1 Debt-to-Equity Method. An in-depth discussion of these two methods follows.

Rule 15 Method

The first test for determining the potential indebtedness add-back is the Rule 15 Method. Two subtests are performed under this method, and the **greater** result from the subtests is used:

- **First Subtest** – *Excess of indebtedness over quick assets.* **Quick assets** include any asset that can be converted to cash within the accounting period, such as cash, receivables, and marketable securities. Inventories are not included in this first test.

- **Second Subtest** – *Excess of book value of capital assets (including inventory) over net worth.*

- **The potential add-back cannot exceed the amount of the total affiliated indebtedness.** If quick assets exceed the affiliated indebtedness and net worth exceeds the book value of capital assets, the taxpayer is adequately capitalized, and no indebtedness add-back is required.

Rule 15 Method - Example

ASSETS		LIABILITIES	
Cash on hand	500	Accounts payable	1,500
Cash in bank	1,500	Accrued liabilities	800
6-mo. Certificate of deposit	5,000	Wages payable	1,300
Accounts receivable	3,000	Note payable - Parent, Inc.	20,000
Allowance for bad debts	(200)		
Inventory	4,800	EQUITY	
Machinery, net	10,000	Capital stock	500
Stock in TN corporation	2,000	Retained earnings	2,500
Total assets	26,600	Total liabilities & equity	26,600

1) First Subtest - Excess of indebtedness over quick assets:

Affiliated indebtedness		20,000
Cash	7,000	
Accounts receivable, net	2,800	
Marketable securities	2,000	
Total quick assets		11,800
Excess of indebtedness over quick assets		8,200

2) Second Subtest - Excess of book value of capital assets over net worth:

Inventory	4,800	
Fixed assets, net	10,000	
Total capital assets		14,800
Capital stock	500	
Retained earnings	2,500	
Total net worth		3,000
Excess of book value of capital assets over net worth		11,800

3) Compare results from two subtests:

1. First subtest	8,200	
2. Second subtest	11,800	
3. Greater of two subtests	11,800	
4. Total affiliated indebtedness	20,000	
5. Lesser of # 3 or 4 above*	**11,800**	**Result from Rule 15 Method**

***Compare with the result from the <u>4:1 Debt-to-Equity Method</u> and use the lesser amount.**

4:1 Debt-to-Equity Method

The following steps are used to compute the potential indebtedness add-back under the 4:1 Debt-to-Equity Method:

- Determine if the taxpayer has any affiliated or intercompany debt. Affiliated debt includes all loans, notes, payables, etc. owed to or guaranteed by any related corporation, as shown on the balance sheet, but does <u>not</u> include any account or trade payables that are current liabilities. Affiliated indebtedness *does*, however, include any current portion of a long-term affiliated debt that is reported as a current liability on the taxpayer's balance sheet.

- Net the affiliated indebtedness against corresponding receivables on long-term debt between the taxpayer and the same affiliated entity that issued the original debt.

    - It is important to note that a receivable can be netted against affiliated indebtedness **only** if it meets the same criteria for inclusion as the indebtedness. In other words, any account or trade receivables classified as current assets on the balance sheet from the same affiliated entity **cannot** be netted against

affiliated indebtedness, but the current portion of a loan or note receivable that is reported as a current asset on the affiliated entity's balance sheet *can* be netted against affiliated indebtedness.

- Determine the taxpayer's overall debt-to-equity ratio.

  - **Adequately Capitalized:** If the debt-to-equity ratio is 4:1 or less, the taxpayer is considered adequately capitalized, and no amount of affiliated indebtedness will be required to be added back in determining the taxpayer's net worth.

  - **Inadequately Capitalized:** If the taxpayer's debt-to-equity ratio is more than 4:1, the taxpayer is deemed to be inadequately capitalized, and the excess amount of affiliated indebtedness may potentially be added back in determining the taxpayer's net worth.

- Determine the actual amount of affiliated indebtedness that must be added back in determining the taxpayer's net worth, based on the results from both the Rule 15 and 4:1 Debt-to-Equity Methods. The amount of affiliated indebtedness that should be added back on Schedule F1, Line 2 equals the **lesser** result from these two tests. However, the affiliated indebtedness add-back **cannot** exceed the total amount of the affiliated indebtedness itself (net of any corresponding receivables, as discussed in the second step above).

On the following page are four independent examples of the potential affiliated indebtedness add-back computation under the 4:1 Debt-to-Equity Method. These are the definitions of the terms that are used in the examples that follow:

- *Assets* = All assets from the balance sheet

- *Liabilities* = All liabilities from the balance sheet

- *Equity* = *Assets* – *Liabilities* (may be a negative number)

- *Ratio* = 4

- *Value of Equity* = *Equity* x *Ratio* (may be a negative number)

- *Debt* = Total liabilities, excluding current liabilities except for any current portion of long-term affiliated indebtedness included in the current liabilities reported on the balance sheet (in other words, long-term affiliated debt plus the current portion of such debt).

- *Potential Add-Back = Debt – Value of Equity*

[Example on following page]

4:1 Debt-to-Equity Method - Examples

Example 1

Intercompany indebtedness =		30,000		
Assets =	100,000			
Liabilities =	90,000	(including	15,000	current liability)
Assets		100,000		
Less: Liabilities		(90,000)		
Equity		10,000		
Ratio		4		
Value of Equity		40,000		
Debt		75,000		
Less: Value of Equity		(40,000)		
Potential add-back		35,000		
Result from 4:1				
Debt-to-Equity Method		**30,000**	*****	

***Intercompany indebtedness is less**

Example 2

Intercompany indebtedness =		30,000		
Assets =	100,000			
Liabilities =	70,000	(including	40,000	current liability)
Assets		100,000		
Less: Liabilities		(70,000)		
Equity		30,000		
Ratio		4		
Value of Equity		120,000		
Debt		30,000		
Less: Value of Equity		(120,000)		
Potential add-back		(90,000)		
Result from 4:1				
Debt-to-Equity Method		**0**	*****	

***Equity exceeds total debt**

Example 3

Intercompany indebtedness =		60,000		
Assets =	50,000			
Liabilities =	90,000	(including	20,000	current liability)
Assets		50,000		
Less: Liabilities		(90,000)		
Equity		(40,000)		
Ratio		4		
Value of Equity		(160,000)		
Debt		70,000		
Less: Value of Equity		160,000		
Potential add-back		230,000		
Result from 4:1				
Debt-to-Equity Method		**60,000**	*****	

***Intercompany indebtedness is less**

Example 4

Intercompany indebtedness =		30,000		
Assets =	100,000			
Liabilities =	85,000	(including	40,000	current liability)
Assets		100,000		
Less: Liabilities		(85,000)		
Equity		15,000		
Ratio		4		
Value of Equity		60,000		
Debt		45,000		
Less: Value of Equity		(60,000)		
Potential add-back		(15,000)		
Result from 4:1				
Debt-to-Equity Method		**0**	*****	

***Equity exceeds total debt**

3. Net Worth Apportionment

The net worth (including any required indebtedness add-back) of a taxpayer that is doing business only in this state will be 100% subject to the franchise tax. However, when a taxpayer does business both within and outside the state, the taxpayer will apportion its net worth (including any required indebtedness add-back) to this state based on its franchise tax apportionment ratio computed on the appropriate apportionment schedule[17] of the franchise and excise tax return.[18] The franchise tax apportionment ratio is reported on Schedule F1, Line 4. In-depth discussions regarding a taxpayer's right to apportion and the mechanics of apportionment can be found in Chapter 14 of this manual.

Consolidated Net Worth – Schedule F2

1. Overview

A taxpayer may elect to compute its net worth on a consolidated basis **only** if it is a member of an affiliated group[19] that has made a group election to compute their net worth on a consolidated basis ("CNW election"). To make the CNW election, the affiliated group must file a Consolidated Net Worth Election Registration Application with the Department on or before the due date (including extensions) of the franchise and excise tax return covering the period for which the CNW election is to take effect. In addition, there is a checkbox on the first page of the franchise and excise tax return (Form FAE170/174) for each affiliated group member to check to indicate that it has made the CNW election.

The CNW election is binding for a minimum of five years, and it applies to each member of the affiliated group. All affiliated group members included in the CNW election **must** complete Schedule F2 of their separate returns; under this election, the taxpayer **does not** have the option of computing its net worth on both a consolidated *and* non-consolidated basis for a given tax year and using the lesser amount as its net worth franchise tax base.

The CNW election remains in effect until the affiliated group revokes it; the affiliated group may revoke its CNW election after the minimum required five-year period by filing another Consolidated Net Worth Election Registration Application with the Department on or before the due date (including extensions) of the tax return for the period during which such election is to be revoked, and checking the "revoke election" box on the first page of the application. The Commissioner is authorized to accept a late election, a late revocation of an election, or to permit an early revocation of an election to compute net worth on a consolidated basis, if the

Commissioner determines that there is a good and reasonable cause for such action;[20] the taxpayer must submit such petitions to the Commissioner in writing.

> ⚠ **The CNW election is an alternative method used to compute the net worth franchise tax base. <u>It is NOT an election to file a consolidated franchise and excise tax return.</u> Each affiliated group member subject to franchise and excise tax will continue to file separate returns, but the consolidated net worth amount reported on Schedule F2, Line 1 will be the same for all affiliated group members.**

An affiliated group will **not** be allowed to compute its net worth on a consolidated basis **unless** all members of the affiliated group close their taxable year on the same date. If an affiliated group member exits the group during a tax year due to a change in ownership, merger, or liquidation, the member exiting the group will be excluded from the affiliated group, and it must compute its net worth on a non-consolidated basis on Schedule F1 of the return. In addition, if an affiliated group member is in final return status,[21] it will **not** be permitted to compute its net worth on a consolidated basis **unless** the entire affiliated group is in final return status during the same tax period.[22, 23]

Consolidated net worth is defined as the difference between the total assets less the total liabilities of the affiliated group at the close of business on the last day of the tax year, as shown by a pro forma consolidated balance sheet including all members of the group. The pro forma consolidated balance sheet is to be prepared in accordance with generally accepted accounting principles wherein transactions and holdings between members of the group and holdings in non-domestic persons[24] have been eliminated.[25]

2. Affiliated Group Members

Entity Type and Nexus

In general, with respect to a taxpayer that is subject to the Tennessee franchise tax on a standalone basis, affiliated group members can be any type of domestic person[26] (entity):

- in which the taxpayer, directly or indirectly, has more than 50% ownership interest;
- that, directly or indirectly, has more than 50% ownership interest in the taxpayer; and

- in which a person described in the bullet point above, directly or indirectly, has more than 50% ownership interest, **regardless of whether such persons do business in Tennessee**.[27]

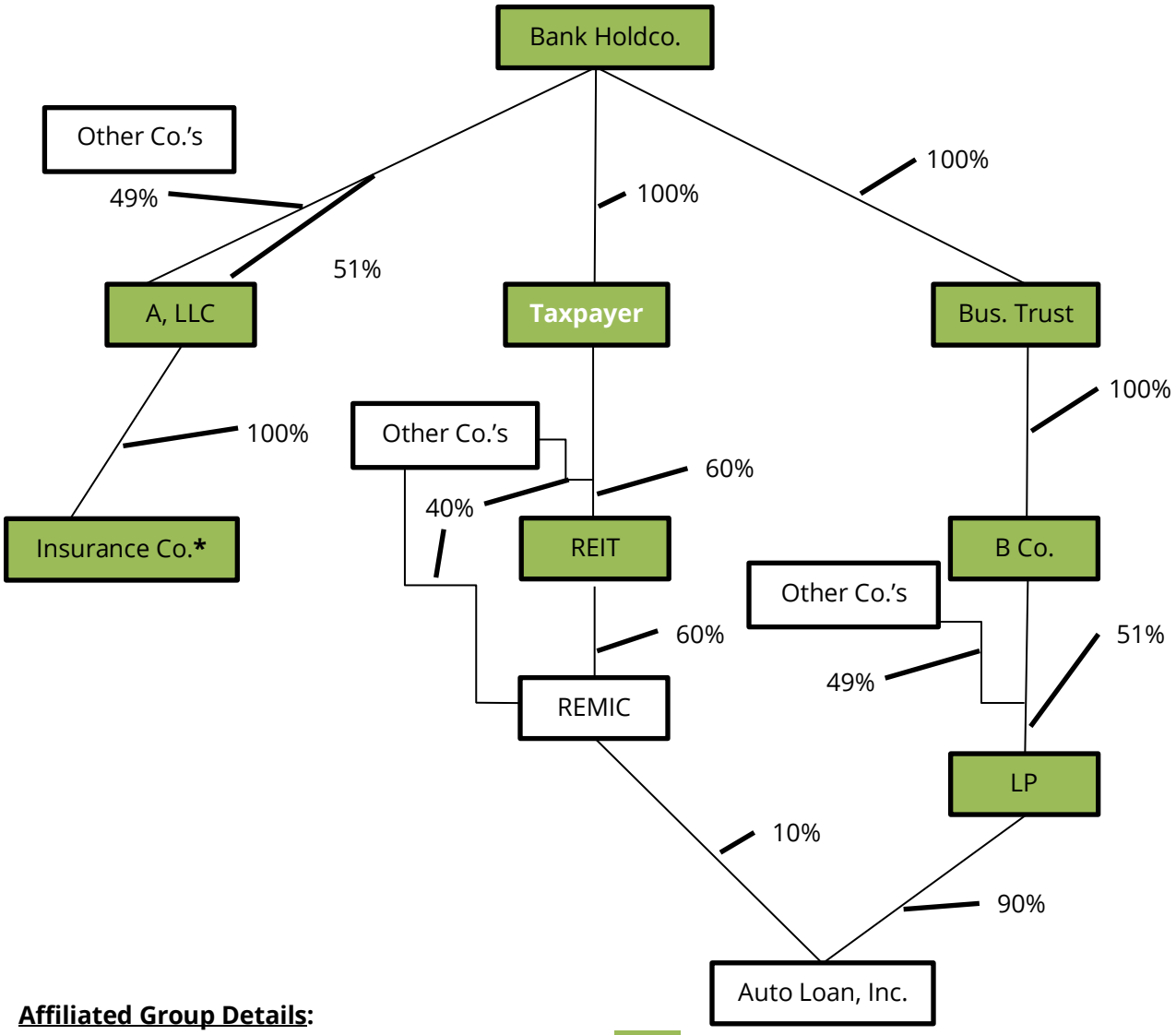
Affiliated group members can be a combination of: corporations, subchapter S corporations, LLCs, PLLCs, RLLPs, PRLLPs, LPs, cooperatives, joint-stock associations, business trusts, regulated investment companies, REITs, state-chartered or national banks, or state-chartered or federally chartered savings and loan associations. Basically, affiliated group members may include any entity that meets the definition of a "person" or "taxpayer,[28]" **regardless of whether the entity does business in Tennessee**. The Consolidated Net Worth Election Registration Application lists affiliated group members that include both financial institutions and non-financial institutions. In addition, it lists affiliated group members that have nexus with the state as well as those that do not. The affiliated group members subject to franchise and excise tax are listed under Part 1 of the application, and those not subject to the tax are listed under Part 2. Note that the inclusion of affiliated group members not having nexus with the state on this application does **not** subject them to franchise and excise tax, although the net worth of such entities *is* included in the affiliated group's consolidated net worth computation.

All affiliated group members are required to be listed on the Consolidated Net Worth Election Registration Application, regardless of their entity type or whether they have nexus with the state. If an entity meets the definition of an affiliated group member, it must be listed on the application. Only non-domestic persons are omitted from the application because, by definition, they are not affiliated group members.

Greater-than-50% Ownership Interest

Essentially, if there is a greater-than-50% ownership interest between entities (one of which is subject to the Tennessee franchise tax on a standalone basis), then both entities are affiliated group members. The greater-than-50% ownership interest requirement ensures that an entity can only be included in one affiliated group. Greater-than-50% owned subsidiaries of a parent company would be affiliates of one another, even if their only connection was their common parent.[29] On the following page is an example organization chart of an affiliated group reflecting includable affiliated group members.

Example Affiliated Group Organization Chart



Affiliated Group Details:

- Affiliated group members are highlighted in green.
- All affiliates are domestic persons.
- All affiliates have the same year end.
- All affiliates have a greater-than-50% ownership interest among one another.

***** Although this entity is exempt from franchise and excise tax, it is *still* included in the affiliated group; however, it would not be included in the consolidated net worth computation. See the Other Issues section in this chapter for more information.

Domestic Person

Affiliated group members must be *domestic persons*. Domestic person means any person with more than 20% of its property, payroll, and sales factors in the United States, as compared to those attributes worldwide. The apportionment provisions at Tenn. Code Ann. § 67-4-2111 are to be used for this computation. In the following example, the entity is a domestic person because more than 20% of its property, payroll, and sales are in the United States.

	United States	Worldwide	U.S./WW %
Property	100	5,000	2.00%
Payroll	0	2,500	0.00%
Sales[30]	321,000	600,000	53.50%
Sales	321,000	600,000	53.50%
Sales	321,000	600,000	53.50%
Total			162.50%
Factors			5
Average			32.50%

It is important to understand the difference between the federal meaning of *foreign* and *domestic* and the state's meaning of these terms. For federal tax purposes, *foreign corporation* means a corporation chartered in a foreign nation, whereas *domestic corporation* means a corporation chartered in the United States. For franchise and excise tax purposes, *foreign corporation* means a corporation chartered outside of Tennessee, whereas a *domestic corporation* means a corporation chartered in Tennessee.

The United States generally taxes domestic corporations on their worldwide income, without regard to whether the income arose from a transaction outside of the United States. Foreign corporations are also taxed, but only on income that is either 1) *effectively connected*[31] with a trade or business conducted in the United States or 2) *fixed, determinable, annual, or periodical*[32] from U.S. sources. A domestic corporation's worldwide income is reported on Form 1120 and a foreign corporation's income subject to U.S. income tax is reported on Form 1120-F. A foreign corporation filing on Form 1120-F may be an affiliated group member if it meets both the greater-than-50% ownership test and is a domestic person.

3. Consolidated Net Worth Computation

Consolidated net worth for the affiliated group is computed as the affiliated group's total assets less its total liabilities as of the last day of the tax year, as shown by a pro forma consolidated balance sheet including all members of the group, prepared in accordance with GAAP, wherein

transactions and holdings between members of the group and holdings in non-domestic persons have been eliminated. The consolidated net worth amount reported on Schedule F2, Line 1 will be the same for all affiliated group members that are required to file a franchise and excise tax return.

The consolidated net worth amount is based on 100% of all the affiliated group members' net worth amounts, even when the ownership between affiliated group members is less than 100%. For example, a parent affiliate that has a 75% share in a subsidiary affiliate will include in this affiliated group's consolidated net worth computation 100% of the subsidiary affiliate's assets and liabilities, rather than the parent affiliate's 75% share of the subsidiary affiliate's assets and liabilities.

Once an affiliate meets the definition of an affiliated group member, its assets and liabilities are included in the consolidated net worth computation in their entirety. There is never a reduction in includable assets and liabilities due to a less-than-100% ownership interest between a parent and subsidiary affiliate. It is important to note that, due to the elimination of transactions and holdings between affiliated group members in the consolidation process, the consolidated net worth of an affiliated group will not be overstated, regardless of the percentage of holdings between affiliated group members. See the Verifying Affiliated Group Members section in this chapter for additional information regarding the consolidation process.

An example of a consolidated balance sheet, including eliminations, is shown on the following page. This consolidated balance sheet is similar to the level of detail that taxpayers usually provide in the attachments to their consolidated federal income tax returns, reflecting the balance sheet attributes of each entity included in the consolidated return, a single eliminations column, and a column for the consolidated totals that are ultimately reflected on the return.

Consolidated Balance Sheet Example						
Balance Sheet	Parent	ABC Inc.	DEF Inc.	XYZ Inc.	Eliminations	Consolidated Totals
ASSETS:						
Cash	70,000	75,000	50,000	50,000		245,000
Accounts receivable, net	-	25,000	150,000	25,000		200,000
Intercompany note receivable	160,000	-	-	-	(160,000)	-
Investment in ABC Inc.	260,000	-	-	-	(260,000)	-
Investment in DEF Inc.	100,000	-	-	-	(100,000)	-
Investment in XYZ Inc.	(90,000)	-	-	-	90,000	-
Inventory	-	100,000	175,000	75,000		350,000
Fixed assets, net	-	200,000	225,000	50,000		475,000
TOTAL ASSETS	500,000	400,000	600,000	200,000	(430,000)	1,270,000
LIABILITIES:						
Accounts payable	-	90,000	150,000	40,000		280,000
Intercompany note payable	-	40,000	60,000	60,000	(160,000)	-
Note payable - bank	100,000	-	240,000	140,000		480,000
Other liabilities	50,000	10,000	50,000	50,000		160,000
TOTAL LIABILITIES	150,000	140,000	500,000	290,000	(160,000)	920,000
EQUITY:						
Capital stock	10,000	1,000	1,000	1,000	(3,000)	10,000
Additional paid-in capital	40,000	9,000	9,000	9,000	(27,000)	40,000
Retained earnings	300,000	250,000	90,000	(100,000)	(240,000)	300,000
TOTAL EQUITY	350,000	260,000	100,000	(90,000)	(270,000)	350,000
TOTAL LIABILITIES & EQUITY	500,000	400,000	600,000	200,000	(430,000)	1,270,000

Taxpayers generally begin the franchise tax consolidated net worth computation with either the consolidated federal return Schedule L balance sheet or with the consolidated balance sheet included with the taxpayer's audited financial statements. Both methods may require adjustments to ensure that all affiliated group members are included in (and non-affiliated group members excluded from) the consolidated net worth computation. See the Verifying Affiliated Group Members section in this chapter for examples of adjustments that would need to be made, using these two methods, to arrive at the correct affiliated group composition.

4. Apportionment of Consolidated Net Worth

Affiliated group members that are subject to the franchise tax will multiply the consolidated net worth amount (Schedule F2, Line 1) by an apportionment ratio (Schedule F2, Line 2) to arrive at their share of the affiliated group's consolidated net worth subject to franchise tax. Each member computes its share by multiplying the consolidated net worth amount by a fraction, the numerator of which is the individual affiliated group member's Tennessee attributes (property, payroll, and sales) and the denominator of which is the affiliated group's total attributes everywhere. The attribute amounts included in the denominators of the affiliated group's apportionment factors should be the same for all affiliated group members subject to franchise tax.

Similar to the consolidated net worth computation, the consolidated net worth apportionment factors are calculated based on pro forma consolidated financial statements prepared in accordance with generally accepted accounting principles wherein transactions and holdings between members of the affiliated group and holdings in non-domestic persons have been eliminated.[33] Pursuant to GAAP, the consolidated balance sheet and income statement includes 100% of the assets, liabilities, revenues, expenses, etc. of less-than-100% owned affiliates. Therefore, even in the case of a less-than-100% owned subsidiary, 100% of the subsidiary's apportionment attributes will be included in the apportionment factors (after the elimination of intercompany transactions and holdings, and holdings in non-domestic persons).

- For example, an affiliated group consists of a parent entity and a 60% owned subsidiary. The subsidiary owns $300,000 of real and tangible property, none of which is located in the state. The subsidiary has $600,000 in payroll, of which 20% is sourced to the state. The subsidiary has $750,000 in sales, $400,000 of which are sales of inventory made to the subsidiary's parent and $350,000 of which are sales made to non-affiliated customers—of which 80% are sourced to the state. The 60% owned subsidiary's apportionment factors (to be combined with the parent entity's) are as follows:

  - **Property factor:** $0 in Tennessee / $300,000 total everywhere
  - **Payroll factor:** $120,000 in Tennessee / $600,000 total everywhere
  - **Sales factor:** $280,000***** in Tennessee / $350,000****** total everywhere

    ***** ($750,000 - $400,000) x 80%; intercompany sales are excluded

    ****** $750,000 - $400,000; intercompany sales are excluded

Application of CNW Apportionment

The computation of the consolidated net worth apportionment ratio (Schedules 170NC, 170SF, 174SC, 174NC) may seem similar to that of the excise tax apportionment ratio (Schedule N); however, the following are notable differences between the two apportionment ratios:

- The excise tax apportionment ratio is based on tax basis books and records, whereas the consolidated net worth apportionment ratio is based on GAAP books and records in which transactions and holdings between affiliated group members and holdings in non-domestic persons are eliminated.

    - Property owned by the taxpayer should be reported on both Schedules N and 170NC at its original cost.[34] However, intercompany transfers of property between affiliated group members should be excluded from Schedule 170NC; this applies to intercompany transfers of inventory, land, and depreciable assets.

    - For example, an affiliated group consists of a parent entity and a 100% owned subsidiary. Both the parent and the subsidiary operate solely within the state. At the end of the tax year, the parent reports on its separate entity balance sheet (prior to consolidation) $500,000 in inventory and the subsidiary reports $250,000 in inventory. During the tax year, the subsidiary sold 200 units of inventory (at a total cost of $100,000 to the subsidiary) to its parent for $125,000. The parent has not sold any of this inventory to non-affiliated customers as of the end of the tax year. Because the parent records the inventory received via the intercompany transfer on its separate entity (pre-consolidation) balance sheet at the transfer price of $125,000, in consolidation, the intercompany inventory amount must be reduced by $25,000 to properly state the inventory at its original cost (i.e., cost to the subsidiary) of $100,000. The parent and subsidiary inventory balances will appear on Schedules N and 170NC as follows:

        - **Parent (Sch. N)** – Prop. factor: $500,000 in TN / $500,000 everywhere
        - **Parent (Sch. 170NC)** – Prop. factor: $475,000***** single / $725,000****** cons.
        - **Sub. (Sch. N)** – Prop. factor: $250,000 in TN / $250,000 everywhere
        - **Sub. (Sch. 170NC)** – Prop. factor: $250,000 single / $725,000****** cons.

            ***** $500,000 parent inventory balance - $25,000 I/C elimination

            ****** $500,000 parent inventory balance + $250,000 subsidiary inventory balance - $25,000 I/C elimination

- Assume the same facts as in the immediately preceding example, except that prior to the end of the tax year, the parent sells 75% of the inventory that it purchased from its wholly-owned subsidiary to non-affiliated customers. From a consolidated perspective, the markup on the 25% of intercompany inventory remaining on the parent's separate entity balance sheet must be eliminated, in consolidation, to properly state the remaining inventory at its original cost. First, the subsidiary's **gross profit percentage** must be determined as follows: ($125,000 inventory transfer price - $100,000 cost of inventory to the subsidiary) / $125,000 inventory transfer price = **20%**. The gross profit percentage (GPP) is then applied to the remaining intercompany (I/C) inventory balance as follows: $125,000 inventory transfer price x 25% (percentage of I/C inventory remaining) x 20% GPP = **$6,250 markup** that must be eliminated in consolidation. The parent and subsidiary inventory balances will appear on Schedules N and 170NC as follows:

    - **Parent (Sch. N)** – Prop. factor: $406,250***** in TN / $406,250***** everywhere
    - **Parent (Sch. 170NC)** – Prop. factor: $400,000****** single / $650,000******* cons.
    - **Sub. (Sch. N)** – Prop. factor: $250,000 in TN / $250,000 everywhere
    - **Sub. (Sch. 170NC)** – Prop. factor: $250,000 single / $650,000******* cons.

        ***** $500,000 parent inventory balance from preceding example less $93,750 inventory balance sold to non-affiliated customers ($125,000 transfer price x 75% inventory sold = $93,750)

        ****** $406,250 parent inventory balance - $6,250 I/C elimination

        ******* $406,250 parent inventory balance + $250,000 subsidiary inventory balance - $6,250 I/C elimination

- All intercompany transactions and holdings between affiliated group members and holdings in non-domestic persons are excluded from the consolidated net worth apportionment ratio but are included in the excise tax apportionment ratio.

    - The intercompany eliminations required to arrive at the consolidated net worth apportionment ratio are the same as the intercompany eliminations that are required to arrive at the consolidated net worth amount; this applies to all items of revenue, expense, gain, and loss incurred between affiliated group members, as well as intercompany transfers of property and intercompany holdings.

- For example, a parent entity owns a building located in the state that the parent purchased several years ago for $500,000. During the current tax year, the parent sells this building to its wholly-owned subsidiary for $260,000; at the time of the sale, the building's book value (cost less accumulated depreciation) to the parent was $200,000. From a consolidated perspective, this intercompany transaction is not recognized. To determine the affiliated group's consolidated net worth amount, the building will be included in the affiliated group's consolidated GAAP balance sheet at the parent's book value of $200,000 and it will be included in the group's property factor denominator (on Schedule 170NC) at the original cost to the parent of $500,000—this amount will also be included in the *subsidiary's* property factor numerator (on Schedule 170NC). In addition, the parent's $60,000 gain on the sale of the building will be eliminated from the group's retained earnings on the consolidated GAAP balance sheet and the $260,000 gross proceeds from the sale of the building will be excluded from the group's sales factor numerator and denominator (on Schedule 170NC).

- Intercompany rental expense included in the property factor and the corresponding intercompany rental income that is included in the sales factor must be eliminated from the consolidated net worth apportionment ratio.

- Dividends received from affiliated group members are included in the sales factor of the excise tax apportionment ratio if they are from less-than-80% owned affiliates. All intercompany dividends are excluded from the sales factor of the consolidated net worth apportionment ratio.

Single Sales Factor Election

Manufacturers[35] may elect to apportion their net worth subject to franchise tax using a single sales factor apportionment ratio computed on Form FAE 170, Schedule S. In addition, the electing manufacturer may also be part of an affiliated group that has made the consolidated net worth election. In this case, the manufacturer will apportion its share of the affiliated group's consolidated net worth by multiplying the amount by a fraction, the numerator of which is the individual manufacturer's Tennessee sales and the denominator of which is the affiliated group's total sales everywhere, computed on Form FAE 170, Schedule 170SC.

⚠ **The single sales factor election applies <u>only</u> to the manufacturer making the election. It does <u>not</u> apply to the entire affiliated group.**

Affiliated group members that are not electing manufacturers will continue to use the apportionment ratio that they have traditionally used to apportion consolidated net worth. The property, payroll, and sales of all affiliated group members will continue to be included in the denominator of the affiliated group's consolidated net worth apportionment ratio. In other words, the computation of an affiliated group's consolidated net worth apportionment ratio remains unchanged, even when a member of the affiliated group has individually elected to use a single sales factor apportionment ratio, in which case the electing affiliate will use the single sales factor apportionment ratio (rather than the group's "standard" consolidated net worth apportionment ratio) to apportion its share of the affiliated group's consolidated net worth.

Financial Institutions and Mixed Affiliated Groups

Generally, a financial institution's franchise and excise tax apportionment ratio is based on a single receipts factor, where Tennessee receipts are divided by everywhere receipts.[36] All other taxpayers, except for common carriers,[37] compute their apportionment ratio by using a standard UDITPA[38] three-factor formula based on property, payroll, and triple-weighted sales. However, a mixed affiliated group problem arises when an affiliated group includes both financial institutions and non-financial institutions.

Under these circumstances, and absent any guidance to the contrary, the affiliated group members would not be using the same apportionment methods, and the apportionment ratio computation would be dissimilar (i.e., some affiliated group members would be using the single receipts factor (FIs) while others would be using the standard UDITPA formula (non-FIs)). To remedy this problem, the mixed affiliated group must determine whether the group is predominately a financial institution affiliated group or a non-financial institution affiliated group; this determination controls which apportionment method *all* affiliated group members (FIs and non-FIs, alike) must use to apportion consolidated net worth.[39]

If it is determined that a mixed affiliated group is a **financial institution affiliated group**, the **single receipts factor** should be used by all affiliated group members to apportion consolidated net worth. A financial institution affiliated group[40] is any affiliated group in which more than 50% of the group's aggregate gross income, excluding dividends and receipts resulting from transactions between members, is derived from conducting the business of a financial institution.[41] For the purpose of this determination, the computation of gross income of an affiliated group member does not include income from nonrecurring, extraordinary transactions.

If it is determined that a mixed affiliated group is a **non-financial institution affiliated group**, the **standard UDITPA three-factor formula** based on property, payroll, and triple-weighted sales should be used by all affiliated group members to apportion consolidated net worth.

Financial Institution Affiliated Groups and CNW Election Application

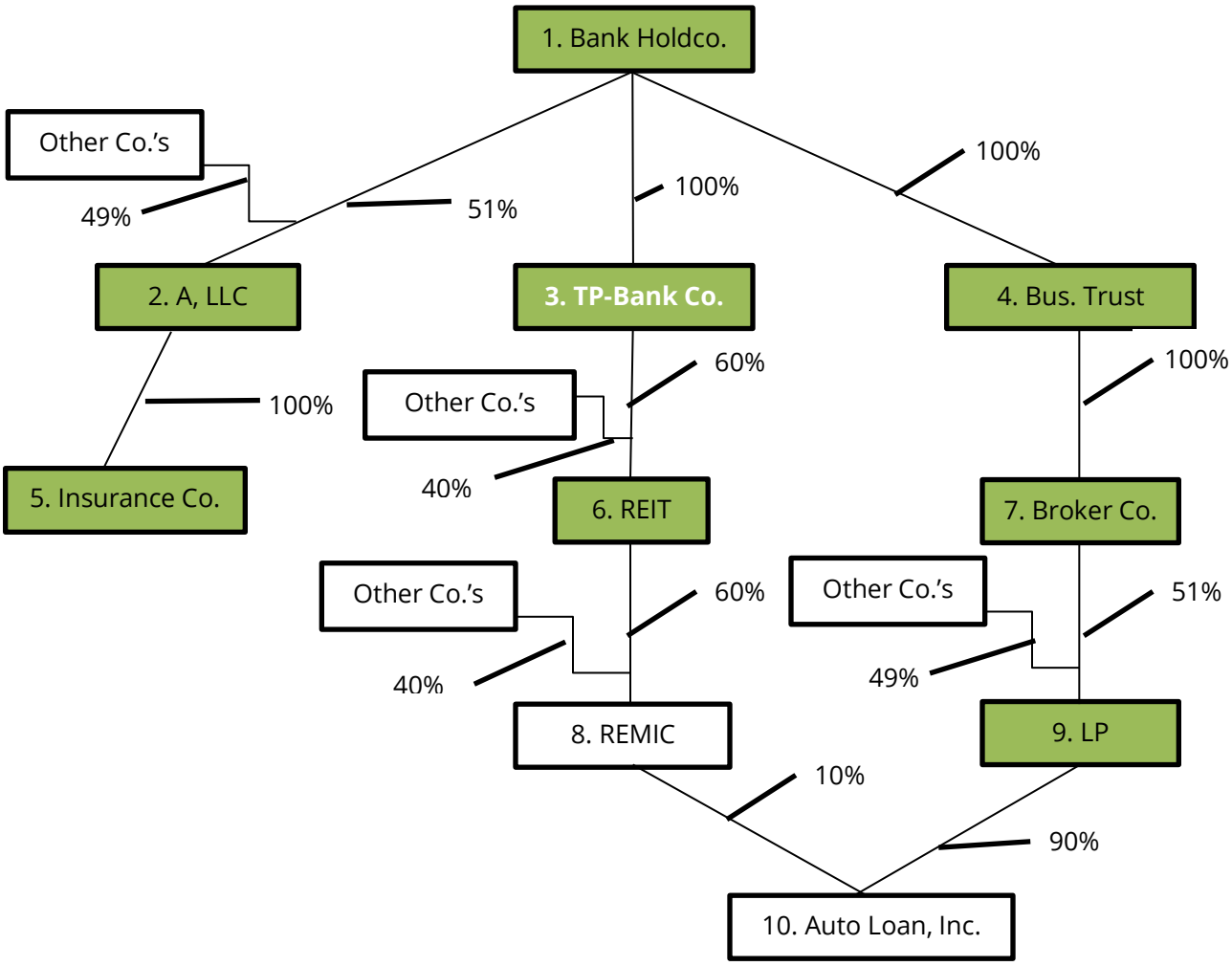
Designation as a financial institution affiliated group does not change the manner in which the CNW election application is completed by the affiliated group. All affiliated group members are listed on the application, including both financial and non-financial institution affiliated group members. Financial institution affiliated groups may erroneously think that *only* affiliates that are themselves financial institutions should be listed on the CNW election application. For example, a bank that owns a brokerage company (which is not an FI) should include the brokerage company on the CNW election application. Because the CNW election application has a checkbox that states "check if application is for a financial institution affiliated group," banks sometimes erroneously think that they should only list entities that, individually, are financial institutions. Rather, by checking this box, the bank is implicitly stating that they have performed an analysis of gross receipts from all affiliated group members and determined that a majority of the gross receipts (after eliminations) from all affiliated group members were derived from conducting the business of a financial institution; as such, regardless of whether, individually, an affiliated group member is a financial institution, all financial institution affiliated group members are listed on the bank's CNW election application.

Form Selection for Consolidated Net Worth Apportionment

The designation of an affiliated group as either a *financial institution affiliated group* or a *standard (non-FI) affiliated group* is important in selecting the correct consolidated net worth apportionment schedule. There are four consolidated net worth apportionment schedules (Schedules 170NC, 170SF, 174SC, 174NC), but only one will be correct for any single taxpayer. A taxpayer cannot select the correct apportionment schedule until it determines if its affiliated group is either a financial institution affiliated group or a standard affiliated group. On the following page is a chart that will help you identify which of the four schedules should be used by the taxpayer.

CNW APPORTIONMENT SCHEDULE SELECTION		
Individual taxpayer is:	**Taxpayer is a member of a:**	**Use CNW apportionment schedule:**
FI – files Form FAE174	Standard affiliated group	174NC
FI – files Form FAE174	FI affiliated group	174SC
Not an FI – files Form FAE170	Standard affiliated group	170NC
Not an FI – files Form FAE170	FI affiliated group	170SF

Next is an example evaluation of an affiliated group for the purpose of determining whether the affiliated group is a financial institution or standard affiliated group, and to determine the proper consolidated net worth apportionment schedule that should be used by each affiliated group member. Note that entities number 1, 3, and 10, individually, are financial institutions. However, the affiliated group as a whole is a standard affiliated group because less than 50% of the group's gross receipts (excluding dividends and receipts resulting from transactions between members, and receipts from nonrecurring, extraordinary transactions) were derived from conducting the business of a financial institution. Also, note that entity number 5 is an insurance company. The insurance company is an affiliated group member; however, because insurance companies are exempt from franchise and excise tax, the insurance company does not file a return and its gross receipts are not included in the greater-than-50% test for determining whether the affiliated group is a financial institution affiliated group.



Entity	Taxpayer is Financial Institution?	Affiliated Group Member	Entity Gross Receipts	Entity Gross Receipts from FI*	FI Affiliated Group Member	CNW Apportionment Schedule
1.	**Yes**	Yes	$ 1,000	$ 900	No	174 NC
2.	No	Yes	2,000	0	No	170 NC
3.	**Yes**	Yes	3,000	2,100	No	174 NC
4.	No	Yes	4,000	0	No	170 NC
5.	No	Yes	N/A	N/A	N/A	N/A
6.	No	Yes	6,000	0	No	170 NC
7.	No	Yes	7,000	0	No	170 NC
8.	No	No	N/A	N/A	N/A	N/A
9.	No	Yes	9,000	3,000	No	170 NC
10.	**Yes**	No	N/A	N/A	N/A	N/A
Total			**$ 32,000**	**$ 6,000**	**18.75% receipts from FI activity**	

***** Receipts from conducting the business of a financial institution, after elimination of dividends and receipts from transactions between affiliated group members and nonrecurring, extraordinary transactions

5. Verifying Affiliated Group Members

Verification of affiliated group members is, perhaps, the most important step in determining consolidated net worth for franchise tax purposes, and it is often the step where most errors tend to occur. Because taxpayers sometimes apply the federal or GAAP definitions of an affiliate when determining the consolidated net worth affiliated group, it is helpful to understand the similarities and differences between the federal, GAAP, and state definitions[42] of an affiliate. From a state tax perspective, it is also important to understand the differences in the federal and GAAP definitions, because documents from these outside sources are often used to verify the affiliated group and consolidated net worth computation.

The following documents provide some degree of relevant information with respect to verifying affiliated group members:

- Organization chart, including ownership percentages
- Audited, consolidated financial statements and accompanying footnotes
- Federal Form 851 – Affiliations Schedule

However, none of the above documents, when examined alone, are sufficient in verifying affiliated group members.

Organization/Ownership Chart

An organization chart visually displays entities owned directly and indirectly by a parent company. Organization charts are an easy way to see the big picture of the ownership structure and can be very helpful in quickly identifying potential affiliated group members. Several levels of organization charts may be needed if the organization has gone through any type of restructuring.

However, these charts generally do not show if an entity is a *domestic person,*[43] as defined by the state. Also, unless the chart is embedded in another document (such as an annual report), it is not as authoritative as the federal Form 851 (included in federal return that is signed by the taxpayer and filed with the IRS) or audited financial statements (audited by an independent accountant).

Audited Financial Statements with Footnotes

Audited, consolidated financial statements, accompanying footnotes, and supporting consolidation workpapers can be used to verify the accuracy and completeness of the affiliates listed on the CNW election application and the net worth computation. In order to better understand the information from these sources, it is helpful to obtain a general understanding of the GAAP guidance on consolidation, equity method investments, and equity securities.

In general, a full consolidation occurs when the parent's ownership in a subsidiary is greater than 50% of the subsidiary's voting stock. The equity method is used to account for an investment in which the ownership interest is between 20% and 50%, and an investment in which the ownership interest is less than 20% would simply be shown as an investment on the balance sheet at fair value.

Consolidation (>50% Ownership) – GAAP

Under GAAP, consolidated financial statements are required to be prepared for external financial accounting purposes by a parent and its majority-owned subsidiaries (>50% voting stock owned). The parent and each of its majority-owned subsidiaries still maintain a separate legal existence and keep their own separate books and records for internal financial accounting purposes. In consolidated financial statements, the attributes of all majority-owned subsidiaries are combined with those of the parent (with all intercompany transactions and holdings eliminated) to present the financial statements from the perspective of a single economic entity. However, there are exceptions to this general rule.

Some subsidiaries may meet the greater-than-50% ownership test but are excluded from the consolidation, while other entities may not meet this threshold but are included in the consolidation. This is because GAAP also permits consolidation when the parent has a less-than-50% ownership interest in the subsidiary but *controls* the subsidiary through contractual or other means; however, the state definition of affiliate considers only the greater-than-50% test. Also, a majority-owned subsidiary is generally included in consolidated financial statements even if it has a different fiscal year end, but it is not consolidated if it is in legal reorganization or bankruptcy. In contrast, for franchise tax consolidated net worth purposes, all affiliates are required to close their taxable year on the same date,[44] but an affiliate *could* be in bankruptcy and continue to be in the affiliated group.

As previously mentioned, under GAAP, *control* is the primary criterion for determining whether to consolidate a subsidiary. Generally, control exists when the parent owns (directly or indirectly)

over 50% of the voting stock of an affiliate. However, control could also exist if a company has a major economic impact on an affiliate and its business decisions, even if the parent owns only a minor voting interest in the subsidiary. If there is significant doubt concerning the parent's ability to exercise control over the subsidiary, the subsidiary will not be included in the consolidation. Usually, one of the first footnotes to an entity's audited financial statements will describe the principles of consolidation and the entity's reporting for investments in unconsolidated affiliates. The following is an example of such footnote:

> The company's consolidated financial statements include the accounts of Parent Co. and its subsidiaries as of and for the fiscal years ended December 31, 20X3, 20X2, and 20X1. Intercompany accounts and transactions have been eliminated in consolidation. Investments for which Parent Co. exercises significant influence, but does not have control, are accounted for under the equity method.

When reading consolidated financial statements, another concept that is important to understand is the concept of a *noncontrolling interest*. GAAP requires that controlled subsidiaries be consolidated, since the parent and its majority-owned subsidiaries are viewed as a single economic entity. Furthermore, GAAP requires that 100% of the controlled subsidiary be consolidated, regardless of the parent's ownership percentage (i.e., even if the parent owns less than 100% of the subsidiary). Thus, a *noncontrolling interest* represents the ownership interests in the subsidiary that are held by owners other than the parent.[45]

For example, if a parent company owns (directly or indirectly) 80% of a subsidiary, the 20% owned by others is the noncontrolling interest. In this case, the consolidated income statement will include 100% of the results of operations of both the parent and the subsidiary, even though the parent's ownership of the subsidiary is only 80%. The net income line will reflect 100% of the parent's and subsidiary's net income (excluding intercompany transactions). In addition, the consolidated income statement will break out the amount of consolidated net income attributable to the noncontrolling interest and to the parent. The net income attributable to the noncontrolling interest is presented as a subtraction from total consolidated net income to arrive at the consolidated net income attributable to the parent. The following is an example of a consolidated income statement with a noncontrolling interest presented:

Parent Co. Consolidated Income Statement Year Ended December 31, 20X3	
Revenues	$395,000
Expenses	(330,000)
Income from continuing operations, before tax	65,000
Income tax expense	(26,000)
Income from continuing operations, net of tax	39,000
Discontinued operations, net of tax	-
Net income	39,000
Less: Net income attributable to the noncontrolling interest	(7,800)
Net income attributable to Parent Co. shareholders	$ 31,200

On the consolidated balance sheet, GAAP requires that noncontrolling interests be reported as part of the equity of the consolidated group.[46] The equity section of the balance sheet will report the total equity of the consolidated group (including that of both the parent and the noncontrolling interest). Note, unlike the consolidated income statement, where the consolidated net income attributable to the noncontrolling interest is presented as a subtraction in arriving at consolidated net income attributable to the parent, on the consolidated balance sheet, the noncontrolling interest remains part of total consolidated equity (net worth). It is important to note that, for franchise tax purposes, the consolidated net worth computation will include any noncontrolling interests attributable to consolidated affiliated group members in which the parent owns less than 100% of the affiliate. On the following page is an example of a consolidated balance sheet with a noncontrolling interest presented:

Parent Co. Consolidated Balance Sheet As of December 31, 20X3	
Assets:	
Cash	$ 570,000
Accounts receivable	125,000
Available-for-sale securities	125,000
Plant and equipment	220,000
Total assets	$ 1,040,000
Liabilities:	
Total liabilities	$ 555,000
Equity:	
Parent Co. shareholders' equity:	
Common stock, $1 par	200,000
Paid-in capital	42,000
Retained earnings	123,500
Accumulated other comprehensive income	22,500
Total Parent Co. shareholders' equity	388,000
Noncontrolling interest	97,000
Total equity	485,000
Total liabilities and equity	$ 1,040,000

The chart below highlights some of the differences between the rules for GAAP consolidation and franchise tax net worth consolidation. Taxpayers will almost always have to make some adjustments to their GAAP consolidated financial statements to arrive at the correct franchise tax affiliated group and consolidated net worth amount due to the differences between the GAAP and franchise tax rules for consolidation. Thus, it is very important to be aware of these differences and to recognize that there is an increased likelihood for error in this area.

Consolidation Criteria	GAAP	Franchise Tax CNW
Consolidate entities in which parent/affiliate has >50% direct/indirect stock ownership	**Yes**	**Yes**
Only *domestic entities*[47] are included in the consolidation	**No**	**Yes**
Majority-owned *foreign subsidiary* is consolidated	**Yes, unless parent does not have *control***	**Depends if foreign subsidiary is a domestic entity[48] (if so, Yes)**
Consolidated affiliates can have different year ends	**Yes**	**No**
Consolidated entities can be in legal reorganization or bankruptcy	**No**	**Yes**
Consolidate entities in which parent/affiliate has <50% direct/indirect stock ownership, if *control* exists	**Yes**	**No**
Exclude from consolidation entities in which parent/affiliate has >50% direct/indirect stock ownership, if *control* does **not** exist	**Yes**	**No**

Equity Method (20-50% Ownership) – GAAP

Under GAAP, the *equity method* of accounting is used by an entity (the investor) to account for its direct or indirect investment in the common stock of another entity (the investee). The general rule is that stock ownership between 20% and 50% in the investee requires use of the equity method; however, the underlying criteria for use of the equity method is whether the investor has the ability to exercise *significant influence* over the operating and financial policies of the investee.[49] Under the equity method of accounting, the investor records its initial equity method investment in the investee by debiting a balance sheet account called *Investment in [Investee]* for the purchase price (fair value) of its share of the investee's common stock, and by crediting its cash account for the amount paid. For example, on January 5, 20X3, Parent Co. purchases a 25% share of Investee Co.'s common stock. On that date, the fair value of Investee Co.'s total common stock was $500,000. Parent Co. will record its investment by making the following journal entry in its books:

Investment in Investee Co.	125,000	
Cash		125,000

Over time, the investment account is adjusted to reflect the investor's share of any increase or decrease in the value of its investment in the investee as of each balance sheet reporting date. The investor increases the investment account to reflect its share of the investee's net income when it is earned by the investee (or decreases the investment account for its share of the investee's losses), and the investor decreases the investment account for its share of dividends declared by the investee. For example, during the year, Investee Co. reports net income of $750,000 for the reporting period and declares total dividends to all stockholders of record of $20,000. To account for its share of these items and to appropriately adjust the investment account, Parent Co. will record the following journal entries in its books:

Investment in Investee Co.	187,500	
Equity earnings in Investee Co.		187,500
Dividends receivable	5,000	
Investment in Investee Co.		5,000

Continuing the above example, at the balance sheet reporting date, Parent Co. will report a balance in its Investment in Investee Co. account of $307,500. In addition, Parent Co.'s share of the equity earnings (net income) from Investee Co. will ultimately flow into Parent Co.'s retained earnings account and be included in Parent Co.'s shareholders' equity.

If Parent Co. owned a majority share (>50%) of Investee Co.'s common stock and obtained control of Investee Co., Parent Co. would be required to consolidate Investee Co. in its consolidated financial statements for external financial reporting purposes. For internal financial reporting purposes, however, Parent Co. would continue to use the equity method of accounting to account for this investment (the investment account and all intercompany transactions between the two entities would be eliminated in consolidation). If Parent Co. does not take control of Investee Co. and maintains its 25% ownership interest in this entity, then the investment account will not be eliminated in consolidation and will be reported as an asset on Parent Co.'s consolidated balance sheet.

Fair Value and Cost Methods (<20% Ownership) – GAAP

Under GAAP, when an entity acquires a relatively small ownership interest (<20%) in another entity, it usually accounts for this investment on its balance sheet at fair value. Under the fair value method, the investor recognizes its share of income from the investment when dividends

are declared by the investee, and the investor also recognizes its share of net income from the change in the fair value of the investment during the reporting period. The investor adjusts the investment account to fair value at each balance sheet reporting date.

Alternatively, if the investor cannot readily determine the fair value of its investment, it may simply maintain the investment on its balance sheet at historical cost. In this case, the investor recognizes income from its investment only from its share of dividends declared by the investee. The investor generally would *not* adjust the investment to fair value at the balance sheet reporting date.[50]

Federal Form 851 – Affiliations Schedule

Form 851 identifies the common corporate parent and members of a federal affiliated group. As mentioned previously, the federal definition of affiliated group is different from the state definition. For federal income tax purposes, an affiliated group is one or more chains of includable corporations connected through stock ownership with a common parent corporation. An includable corporation is a corporation other than an IRC §501 exempt corporation, an insurance company, a foreign corporation, a regulated investment company (RIC), a REIT, or an S corporation. In addition to stock ownership, the percentage of voting power is also a consideration for federal purposes.[51] Part II of the form lists the common parent, subsidiaries, ownership relationships, and related percentages.

Federal Form 851 is helpful in that it identifies *some* affiliates that would meet the state's definition of an affiliated group member—those in which there is an 80%-or-more ownership interest. However, non-corporate affiliates and corporations in which the common parent corporation has an ownership interest of 50% or more, but less than 80%, are **not** identified on this form. On the following page is a reference chart that reconciles the differences between the federal affiliated group members that would be reflected on Form 851 and those that would be includable in a franchise tax consolidated net worth affiliated group.

Common Parent Ownership Percentage/Type	Include in Federal Affiliated Group (Form 851)	Include in CNW Affiliated Group
Stock ownership: 80% or more	Yes	Yes
Stock ownership: 1 - 50%	No	No
Stock ownership: 51 - 79%	No	Yes
Non-corporate entities	No	Yes
Foreign corporations, insurance companies, S corporations, or REITs	No	Yes[52]
Non-domestic person, per TN definition	Yes	No

6. Other Issues

Changes in Affiliated Group

The affiliated group is required to notify the Department annually of any changes to the affiliated group. There are checkboxes at the top of the Consolidated Net Worth Election Registration Application ("CNW application") for *amending the election to add or remove group members* and for *revoking the election*. In addition, there are also checkboxes for each affiliate to indicate *new member* or *remove member* along with a blank in which to list an *effective date* for such action. It is important for taxpayers to notify the Department of these changes because the Department maintains this information to determine when affiliated group members were added to or removed from the affiliated group. Affiliates disposed of before year end will be excluded from the affiliated group.[53] However, affiliates acquired during the year and held at year end will be bound by the group's election and will be included in the affiliated group.[54] When an affiliated group files an amended CNW application with the Department to add or remove group members, it need only list the parent of the affiliated group and list **only** the information of the affiliated group members that need to be added or removed from the affiliated group, check the appropriate checkbox (*new member* or *remove member*), and provide the effective date of this action for each affiliate listed.

Indebtedness and Non-Domestic Entities

Due to the elimination of all intercompany accounts between affiliated group members in consolidation, any indebtedness between the affiliated group members generally would not exist. However, there may be instances in which the affiliated group has indebtedness owed to or guaranteed by non-domestic entities. Because non-domestic entities cannot be affiliated

group members, indebtedness owed to or guaranteed by non-domestic entities is **not** eliminated in the consolidated net worth computation.

Exempt Entity Affiliates

The consolidated net worth election is a group election that is binding on all affiliated group members. However, it is likely that some entities that meet the definition of an affiliate might also happen to be an entity that is exempt from franchise and excise tax. In this case, the exempt entity would still be listed as an affiliated group member on the CNW application, but its net worth and apportionment factors would be **excluded** from the affiliated group's consolidated net worth computation and apportionment ratio, respectively.[55]

For example, an insurance company meets the definition of an affiliate for consolidated net worth purposes, but it is also exempt from franchise and excise tax. As such, it should be listed on the CNW application, but because the insurance company is exempt from franchise and excise tax, its net worth and apportionment factors are excluded from the affiliated group's consolidated net worth computation and apportionment ratio, respectively.

7. Audit Procedures

The following list, while not comprehensive, provides a general overview of the audit procedures that a consolidated net worth audit entails. Modifications may be made to these audit procedures due to the particular facts and circumstances of a given audit, at the auditor's discretion.

Review Taxpayer's CNW Application

- Obtain a copy of the taxpayer's original or amended CNW application.
- Verify that the taxpayer's CNW application was timely filed.
- The auditor may not revoke a CNW election.

Identify Affiliated Group Members

- Request the consolidation workpapers used by the taxpayer in computing the consolidated net worth amount. Generally, a worksheet listing account balances with a column for each affiliate, an eliminations column, and a column reflecting the consolidated totals of the affiliated group will be sufficient.

- Request a list of the names and FEINs of the affiliated group members if this information is not readily or easily identifiable on the taxpayer's workpapers.

- Compare the affiliated group members included in the consolidation workpapers with those listed on the CNW application, and inquire about any differences between the two with the taxpayer.

- Determine that all affiliated group members have the same year end. If they do not, then the affiliated group cannot make the CNW election.

Search for Entities Included or Omitted in Error

- To determine whether entities have been included in, or excluded from, the affiliated group in error, request the following documents from the taxpayer for the audit period(s) under review:

    - Organization chart, including ownership percentages
    - Audited, consolidated financial statements and accompanying footnotes
    - Federal Form 851 – Affiliations Schedule

- Review the organization chart, financial statements, and Form 851 to determine whether the affiliated group members meet the greater-than-50% ownership test.

    - Each of these source documents, when reviewed separately, is typically inadequate for the purpose of determining whether this requirement is met. These documents should be reviewed together to reconcile the includable affiliated group members.

- Request a schedule detailing each affiliated group member's property, payroll, and sales in the United States and worldwide, to determine if all affiliated group members that meet the greater-than-50% test also meet the 20% domestic person test.

- Based on the audit work done, per the previous steps, identify entities that are included in, or excluded from, the affiliated group in error. **<u>If adjustments are made to the affiliated group members, please see the sub-step below.</u>**

    - As a preliminary matter, **and before continuing with any further audit work**, inform the taxpayer of your findings regarding the adjusted composition of the

affiliated group, and request any additional information that you may need to make appropriate adjustments to the consolidated net worth amount and apportionment ratio for the newly-included affiliates.

Verify Consolidated Net Worth Amount

- Verify the consolidated net worth amount reported on Schedule F2, Line 1 of the franchise and excise tax return to the consolidation worksheet.

- Review the eliminations column of the consolidation worksheet and request additional information, if necessary, to reach a conclusion as to whether all transactions and holdings between members of the affiliated group, and holdings in non-domestic persons, have been eliminated in arriving at the consolidated net worth amount.

- Using the records at your disposal, independently compute the consolidated net worth amount to ensure that there are no inadvertent mathematical/computational errors and that the consolidated net worth amount is computed in accordance with Tenn. Code Ann. § 67-4-2106(b).

Consolidated Apportionment Schedule Selection

- Request to see the taxpayer's workpapers that detail the taxpayer's analysis of whether the affiliated group, as a whole, is a financial institution affiliated group or a standard affiliated group

    - Compare the entire affiliated group's gross receipts from financial institution business activities[56] with its receipts from all business activities to determine whether more than 50% of the affiliated group's gross receipts result from conducting the business of a financial institution.

    - Confirm that the gross receipts for the purpose of this comparison exclude intercompany transactions and nonrecurring, extraordinary transactions.

- Confirm the affiliated group's status (financial institution or standard) with the taxpayer and verify that the taxpayer is using the correct consolidated net worth apportionment schedule based on this determination.

- See the Form Selection for Consolidated Net Worth Apportionment section in this chapter for more information on determining the proper consolidated apportionment schedule to be used by the taxpayer.

Verify Consolidated Net Worth Apportionment Ratio

- Verify the denominator amounts of the property, payroll, and sales factors in the consolidated net worth apportionment ratio to those reported in the taxpayer's consolidated net worth apportionment ratio workpapers.

- In general, it is appropriate to follow the same audit procedures that are used to verify apportionment ratio factors for excise tax purposes, as detailed in Chapter 14 of this manual. However, remember that there are additional audit procedures that are unique to consolidated net worth that must also be implemented, as detailed below.

- **Audit procedures unique to consolidated net worth (CNW) apportionment:**

  - Verify that the CNW property factor has been computed using GAAP books and records (with intercompany eliminations), as opposed to tax basis books and records. Note, however, that property owned by the taxpayer, regardless, is still valued at its original cost.

  - Verify that all CNW apportionment factors are computed by eliminating transactions and holdings between members of the affiliated group. Remember, non-domestic persons are not affiliated group members, so transactions with them are not eliminated.

  - Understand that the type of apportionment ratio used by the taxpayer for CNW apportionment may differ from the one the taxpayer uses for excise tax apportionment (UDITPA three-factor formula, single receipts factor formula, modified CNW apportionment for common carriers).

  - If the taxpayer is a financial institution unitary group that files a combined franchise and excise tax return on Form FAE 174, the total gross receipts of the taxpayer's CNW affiliated group could exceed those reported on Schedule SE of the combined return because the CNW affiliated group may include affiliates that are non-unitary with the taxpayer.

Review Affiliates Not Currently Under Audit

- Confirm in the Department's records that all affiliated group members that are subject to franchise and excise tax are filing tax returns and are abiding by the group's CNW election, properly completing Schedule F2 (rather than F1) of the return.

- Verify that the consolidated net worth amount reported on Schedule F2, Line 1 is the same for all affiliated group members.

- Verify that the denominator amounts of the CNW apportionment ratio property, payroll, and sales factors reported in the everywhere (consolidated) column of the apportionment schedule are the same for all affiliated group members, regardless of which apportionment schedule is used by the affiliated group.

[1] Tenn. Code Ann. § 67-4-2105(a)
[2] Tenn. Code Ann. § 67-4-2004(38)
[3] Tenn. Op. Atty. Gen. 04-159 (Nov. 8, 2004)
[4] Tenn. Code Ann. § 67-4-2119
[5] Tenn. Code Ann. § 67-4-2117
[6] Tenn. Code Ann. § 67-4-2106(a)
[7] Tenn. Code Ann. §§ 67-4-2108(a), 2108(a)(6)(G), and 2109(b)(2)(B)
[8] The manufacturing activities are not required to occur in Tennessee.
[9] Tenn. Code Ann. § 67-4-2121
[10] Tenn. Code Ann. §§ 67-4-2106(b) and 2108(a)(3)
[11] ASC 205-30: Liquidation Basis of Accounting
[12] Tenn. Code Ann. § 67-4-2106(b)
[13] ASC 505-10-45-3
[14] ASC 505-10-45-4
[15] Tenn. Code Ann. § 67-4-2107(b)
[16] TENN. COMP. R. & REGS. 1320-06-01-.15
[17] Schedules N (standard apportionment), O (common carriers), P (air carriers), R (air express carriers), or S (manufacturers electing to use single sales factor)
[18] Tenn. Code Ann. § 67-4-2111(a)
[19] As defined by Tenn. Code Ann. § 67-4-2004(2)(A) to mean, greater than 50% direct or indirect ownership interests among domestic persons, regardless of whether such persons do business in Tennessee.
[20] Tenn. Code Ann. § 67-4-2103(i)
[21] Tenn. Code Ann. § 67-4-2004(16)
[22] Tenn. Code Ann. § 67-4-2115(b)
[23] A corporate taxpayer that converts to a disregarded LLC is not removed from an affiliated group as long as the conversion does not result in the taxpayer having a short period that ends on a date that differs from the affiliated group's.
[24] Tenn. Code Ann. § 67-4-2004(15) defines domestic person as any person with more than 20% of the average of its property, payroll and receipts factors, as each factor is computed for a separate entity under § 67-4-2111, in the United States. Thus, non-domestic persons are those that do not meet this definition. However, when a member of an affiliated group invests in a foreign disregarded SMLLC that qualifies as a disregarded entity for franchise and excise tax purposes, the net worth of that foreign disregarded SMLLC *will* be included in the consolidated net worth computation (see Letter Ruling # 14-03).
[25] Tenn. Code Ann. § 67-4-2106(b)
[26] Tenn. Code Ann. § 67-4-2004(15)
[27] Tenn. Code Ann. § 67-4-2004(2)(A)
[28] Tenn. Code Ann. § 67-4-2004(38)
[29] An exception to this would be if the parent was a natural person—that is, an individual. The ownership interests between affiliated group members cannot be through natural persons. For

example, a natural person that has a greater-than-50% ownership interest in two otherwise unaffiliated entities would not make those two entities affiliated group members.

[30] For tax years beginning prior to July 1, 2016, the sales (gross receipts) factor would be double-weighted instead of triple-weighted, and the total ratios (property, payroll, and sales) divided by four instead of five.

[31] https://www.irs.gov/individuals/international-taxpayers/effectively-connected-income-eci

[32] https://www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income

[33] Tenn. Code Ann. § 67-4-2111

[34] Although the consolidated net worth apportionment formula is based on GAAP books and records, Tenn. Code Ann. § 67-4-2111(b)(2)(B) still requires that property owned by the taxpayer be valued at its original (GAAP basis) cost (i.e., original cost without deducting accumulated depreciation).

[35] As defined by Tenn. Code Ann. § 67-4-2111(*l*)(2)

[36] Tenn. Code Ann. § 67-4-2118

[37] Common carriers have special apportionment provisions that are based on mileage and gross receipts for franchise and excise tax purposes, codified at Tenn. Code Ann. §§ 67-4-2111 and 67-4-2013, respectively. Regardless of whether the common carrier is part of a financial institution affiliated group or a non-financial institution affiliated group, it will use the provisions codified at Tenn. Code Ann. § 67-4-2111 to determine its apportionment factors for consolidated net worth.

[38] Uniform Division of Income for Tax Purposes Act – Article IV of the Multistate Tax Commission's *Multistate Tax Compact*. Tennessee's standard apportionment methodology for franchise and excise tax purposes is based on the UDITPA model.

[39] Tenn. Code Ann. § 67-4-2103(f)

[40] Tenn. Code Ann. § 67-4-2004(18)

[41] Tenn. Code Ann. § 67-4-2004(5)(A)

[42] With respect to Tennessee, *affiliate* as defined by Tenn. Code Ann. § 67-4-2004(1)(A).

[43] Tenn. Code Ann. § 67-4-2004(15)

[44] Tenn. Code Ann. § 67-4-2103(d)

[45] ASC 810-10-45-15

[46] ASC 810-10-45-16

[47] Tenn. Code Ann. § 67-4-2004(15)

[48] *Id.*

[49] The ability of the investor to exercise significant influence over the investee can be indicated in several ways, including the investor's representation on the investee's board of directors and the investor's participation in the investee's policy-making processes.

[50] GAAP does permit two fair value adjustments to the cost method: 1) impairment losses (adjustments for *impairment* when it is determined that the fair value of the investment has fallen below the investor's carrying amount of the investment), and 2) observable price changes in orderly transactions for identical/similar investments issued by the same investee.

[51] The common parent corporation must directly own at least 80% of both the voting power and total value of all outstanding stock of an includable subsidiary corporation.

[52] With respect to foreign corporations, they are includable only if they meet the definition of a domestic person under Tenn. Code Ann. § 67-4-2004(15).
[53] Tenn. Code Ann. § 67-4-2103(d)
[54] Tenn. Code Ann. § 67-4-2103(e)
[55] Letter Rulings # 17-06 and 17-13
[56] Tenn. Code Ann. § 67-4-2004(5)(A)