

# PUBLICATION

---

## Spotlight on Tennessee: Significant Excise and Franchise Tax Changes Affecting Lease Arrangements

June 30, 2009

On June 4, 2009, the Tennessee Department of Revenue (Department) released its text of annual amendments and additions to this State's tax laws. Commonly referred to each year as a Technical Corrections Act, this year's Act (2009 Act) includes more than 70 pages of housekeeping changes, technical amendments and substantive modifications to Tennessee's excise/franchise taxes, sales/use taxes, gross receipts taxes, among other tax and economic incentive laws in which the Department is interested. Governor Bredesen signed the 2009 Act into law on June 25, 2009.

Although numerous tax statutes are affected by the 2009 Act, the purpose of this Alert is to focus on certain excise and franchise tax changes made by the 2009 Act that significantly affect lease arrangements.

### FONCE

A FONCE, that is, a family-owned, non-corporate entity as defined by Tennessee Code Annotated Section 67-4-2008 (a)(11), is exempt from Tennessee excise and franchise taxes. The 2009 Act changes the mix of leasing arrangements suitable for a FONCE, effective on July 1, 2009.

By way of background, the phrase "family-owned" means at least 95% of the ownership units of the non-corporate entity must be owned by family members as specified in Section 67-4-2008 (a)(11)(B). Further, pursuant to Section 67-4-2008 (a)(11)(A), "substantially all" of the entity's activity must be either the production of "passive investment income" or a combination of the production of passive investment income and "farming" (as "farming" is defined in Subsection (a)(6) of Section 67-4-2008). The phrase "substantially all" has been interpreted by the Department to mean at least 66.67% of the gross receipts of the non-corporate entity must be from the foregoing sources.

The phrase "passive investment income" includes gross receipts derived from royalties, dividends, interests, annuities, and sales or exchanges of stock or securities to the extent of any gains therefrom. That phrase has also included gross receipts derived from "rents" -- but the 2009 Act has dramatically modified the type of the "rents" that now can qualify for passive investment income. The 2009 Act makes the following modifications:

- *Rents Redefined.* The word "rents" is deleted as an approved source of "passive investment income" and, in its place, the phrase "rents from residential property or farm property" is added as an approved passive investment income source.
- *Residential Property.* This phrase is defined as having the same meaning as in Section 67-5-501, which provides definitions for property tax purposes. That Section states in part that residential property includes all real property that is used, or held for use, for dwelling purposes. The Section 67-5-501 definition for property tax purposes also requires that the residential property not contain more than one rental unit; however, in determining passive investment income for FONCE purposes, the 2009 Act provides that residential property includes any property leased or rented for residential purposes that includes not more than four residential units.
- *Farm Property.* This phrase is also defined as having the same meaning as in Section 67-5-501. That Section states in part that farm property includes all real property that is used, or held for use, in

agriculture, including, but not limited to, growing crops, pastures, orchards, nurseries, plants, trees, timber, raising livestock or poultry, or the production of dairy products. For property tax purposes, the term "farm property" also includes acreage used for recreational purposes by clubs, including golf courses playing hole improvements; but that portion of the "farm property" definition is specifically not included in determining passive investment income for FONCE purposes.

Since residential property and farm property are the only two types of rental property that can generate passive investment income, conspicuously omitted is industrial and commercial property. **As a result, each FONCE receiving rents from industrial and commercial property must immediately begin making calculations so as to determine whether such rents will cause a violation of the "substantially all" test referenced above.** If so, such violation will cause a disqualification of the FONCE's exempt status.

The Department anticipates that significant revenues will be raised as a result of the tax exemption disqualification of those FONCEs leasing industrial and commercial property. In fact, the Bredesen Administration attempted to remove industrial and commercial property from the FONCE exemption during the 2008 Legislative Session, but was unsuccessful. The 2009 Act not only represents the Administration's successful efforts this year to remove industrial and commercial property, but also (as discussed below) represents an effort to further limit the rental amount from certain lease arrangements involving industrial and commercial property.

#### Rental Limitation for Industrial and Commercial Property

The 2009 Act also limits the amount of rent that can be paid by a lessee to an affiliate for industrial and commercial property. In that regard, the 2009 Act modifies Section 67-4-2006 (b)(1) so as to add a new subdivision (N). That new subdivision has the effect of adding back to the net earnings or net losses of a taxpayer "(a)ny amount in excess of reasonable rent that is paid, accrued, or incurred for the rental, leasing, or comparable use of industrial and commercial property owned by an affiliate... ."

This "reasonable rent" limitation, **which applies whether or not the affiliate is subject to the excise tax**, mandates the following:

- *Reasonable Rent.* The 2009 Act defines reasonable rent to mean such rent "that does not exceed two percent (2%) per month of the appraised value of the property under" the property tax laws found at Chapter 5 of Title 67.
- *Industrial and Commercial Property.* This phrase is defined as having the same meaning as in Section 67-5-501, which includes all property of every kind used, directly or indirectly, or held for use, for any commercial, mining, industrial, manufacturing, trade, professional, club whether public or private, nonexempt lodge, business, or similar purpose, whether conducted for profit or not.
- *Excess Rent.* If "reasonable rent" is exceeded, the 2009 Act appears to require an adjustment being made by the lessee and the affiliate lessor. The new subdivision (N) provides that when any person fails to make the required adjustment to net earnings or net losses, there shall be imposed a penalty equal to 50% of the amount of the required adjustment where such failure is determined by the Commissioner of Revenue to be due to negligence. The Commissioner is authorized to waive such penalty, in whole or in part, for good and reasonable cause under the waiver of penalty provisions found at Section 67-1-803.
- *Effective Date.* The effective date of the 2009 Act's imposition of the "reasonable rent" limitation is on July 1, 2009.

#### Possible Planning Opportunities for Anticipated Non-Compliant FONCES

As indicated above, this reasonable rent limitation applies regardless of whether or not the affiliate receiving the rent is subject to the excise tax. However, if such affiliate happens to be exempt from excise and franchise taxes as a FONCE, a separate analysis must be made on a continuing basis to determine whether gross receipts derived from such lease arrangement will, in addition to possibly exceeding the "reasonable rent" limitation, disqualify the FONCE's exempt status because of a violation of the "substantially all" requirement referenced earlier in the Alert.

Other planning opportunities may exist where there is a reasonable likelihood in such situation that the FONCE will no longer be able to satisfy the "substantially all" test. Each set of facts and circumstances requires unique attention and counsel from your Tennessee tax advisor as to possible planning opportunities. Some possible opportunities are as follows:

- *Obligated Member Entity.* An "obligated member entity" defined in Section 67-4-2008 (a)(9) is exempt from excise and franchise taxes. The 2009 Act specifically allows for a limited liability company, limited partnership or registered limited liability partnership to elect "obligated member entity" status, with such election being for tax years beginning on or after July 1, 2008 but before October 1, 2009, provided that the appropriate documentation required by Section 67-4-2008 (b) through (d) is filed on or before October 1, 2009 with the Tennessee Secretary of State. Thus, for example, an LLC that is currently exempt as a FONCE but anticipating a violation of the "substantially all" requirement through the continued receipt of rentals from industrial and commercial property, may wish to consider filing the appropriate documentation with the Tennessee Secretary of State on or before October 1, 2009, so as to continue to be exempt as an obligated member entity. The continuation of exempt status under the obligated member entity provisions will not, however, eliminate the "reasonable rent" limitation of the 2009 Act if the lessor is an affiliate of the lessee.
- *Remove I&C Property.* A FONCE receiving rents from industrial and commercial property and also receiving other types of passive investment income (such as, for example, royalties, dividends, and interests), may wish to transfer all or part of the industrial and commercial property from the FONCE so that the continuing gross receipts of the entity will satisfy the "substantially all" requirement for the FONCE exemption. If some industrial and commercial property is allowed to remain in the FONCE because the "substantially all" requirement will not be violated by the receipt of such rents, those rents will nevertheless still be subject to the "reasonable rent" requirement of the 2009 Act.
- *Termination/Conversion.* Where a FONCE anticipates a violation of the "substantially all" requirement, consideration may also be given to dissolving and terminating the FONCE in appropriate circumstances where owners are individuals, or converting the FONCE to a general partnership. Neither an individual nor a general partnership is subject to the standard excise tax or the franchise tax; however, the "reasonable rent" limitation may still be applicable. The special excise tax, found at Section 67-4-2007(f), should also be considered.

Other planning opportunities may also exist depending upon the specific facts and circumstances. Again, you should discuss any planning opportunities with your Tennessee tax advisor.

### Summary

The 2009 Act imposes many new requirements under the excise and franchise tax laws that significantly affect lease arrangements. Should you wish to discuss these Tennessee developments in more details, please contact any of the attorneys in the Firm's Tax Department.