TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 06-34

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Whether a limited liability company qualifies as an exempt family-owned non-corporate entity under Tenn. Code Ann. § 67-4-2008(a)(11).

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

(A) The taxpayer must not have misstated or omitted material facts involved in the transaction;

(B) Facts that develop later must not be materially different from the facts upon which the ruling was based;

(C) The applicable law must not have been changed or amended;

(D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and

(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

FACTS

[TAXPAYER] is a Tennessee limited liability company. The Taxpayer is engaged in the business of providing intellectual property services and licenses to other businesses. The Taxpayer is 100% owned by [SEVEN RELATED INDIVIDUALS].

Pursuant to the sample Intellectual Property Services and License Agreement provided by the Taxpayer (the "Agreement"), the licensee pays the Taxpayer a royalty fee in exchange for a

license to use the Taxpayer's intellectual property. The intellectual property includes [TYPES OF INTELLECTUAL PROPERTY]. Additionally, the Taxpayer is required pursuant to the Agreement to provide a number of services to the licensees, either directly or through its agents. Such services include [ACTIVE SERVICES RELATED TO THE INTELLECTUAL PROPERTY].

QUESTION

Is the Taxpayer exempt as a family-owned non-corporate entity from the payment of Tennessee excise tax under Tenn. Code Ann. § 67-4-2008(a)(11) and from the payment of Tennessee franchise tax under Tenn. Code Ann. § 67-4-2105(a)?

RULING

No. The Taxpayer is not exempt from the payment of the Tennessee franchise and excise taxes under Tenn. Code Ann. §§ 67-4-2008(a)(11) and 67-4-2105(a) unless it demonstrates that at least 66.67% of its gross receipts with respect to the current taxable year are derived from royalties or other passive investment income.

ANALYSIS

Tenn. Code Ann. § 67-4-2008(a)(11)(A) exempts from the Tennessee excise tax any family-owned non-corporate entity where substantially all the activity of the entity is the production of passive investment income. Tenn. Code Ann. § 67-4-2105(a) provides an exemption from the Tennessee franchise tax for any entity exempt from the excise tax under the provisions of Tenn. Code Ann. § 67-4-2008.

1. <u>The "family-owned" requirement</u>.

The Taxpayer is "family-owned" for purposes of the exemption under Tenn. Code Ann. § 67-4-2008(a)(11).

As noted above, Tenn. Code Ann. § 67-4-2008(a)(11)(A) exempts from the Tennessee excise tax any "family-owned" non-corporate entity where substantially all the activity of the entity is the production of passive investment income. Tenn. Code Ann. § 67-4-2008(a)(11)(B)(i) defines "family-owned" to mean that at least ninety-five percent (95%) of the ownership units of the entity are owned by "members of the family." Tenn. Code Ann. § 67-4-2008(a)(11)(B)(i)(*c*) defines "members of the family" as the lineal descendents of a particular individual.

As noted in the facts, the Taxpayer is currently owned by seven individuals, namely four brothers and three sisters. Each of these owners is the lineal descendant of a particular individual, *i.e.*, one individual is the parent of all of the owners. The seven owners of the Taxpayer are therefore "family members" for purposes of the exemption. The seven family members hold 100 percent of the ownership interest in the Taxpayer. Because at least 95 percent of the ownership interest in the Taxpayer is owned by members of the family, the Taxpayer qualifies as "family-owned" under Tenn. Code Ann. § 67-4-2008(a)(11)(B)(i).

2. The "substantially all the activity" requirement.

Under the facts presented, it is unclear whether substantially all the Taxpayer's activity is the production of passive investment income for purposes of the exemption under Tenn. Code Ann. § 67-4-2008(a)(11). The Taxpayer may not claim the exemption unless it shows that it meets this requirement.

As noted above, Tenn. Code Ann. § 67-4-2008(a)(11)(A) exempts from the Tennessee excise tax any family-owned non-corporate entity where "substantially all the activity" of the entity is the production of "passive investment income." The Department of Revenue interprets "substantially all the activity" to mean that at least 66.67% of the gross receipts of the entity must be derived from passive investment income.[1] Tenn. Code Ann. § 67-4-2008(a)(11)(B)(ii) defines "passive investment income" as "gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities to the extent of any gains therefrom." Gross receipts include all receipts, from whatever sources, before deductions.

The Taxpayer's gross receipts in the current taxable year include royalty income from the licensing of its intellectual property. Royalty income comes within the definition of "passive investment income" under Tenn. Code Ann. § 67-4-2008(a)(11)(B)(ii). Because royalty payments are the only form of consideration provided for in the Agreement, it would initially appear that 100% of the Taxpayer's gross receipts qualify as passive investment income.

However, the Agreement also requires the Taxpayer to provide a number of active services to the licensee. Such services include [LANGUAGE REDACTED].

The Agreement is silent with respect to the consideration that the Taxpayer receives in exchange for such services. Because a party to a transaction such as the one embodied in the Agreement is unlikely to provide such extensive and costly services for no consideration, a portion of the royalty fee presumably compensates the Taxpayer for the services. Notably, the United States Tax Court has stated that the contemporaneous existence of obligations under an agreement may indicate that some or all of the receipts received pursuant to the agreement cannot properly be characterized as "royalties." *Sierra Club, Inc. v. C.I.R.*, T.C. Memo 1999-86 (Tax Ct. 1999).

Compensation for the provision of active services such as those listed in [LANGUAGE REDACTED] of the Agreement does not come within the definition of "passive investment income" under Tenn. Code Ann. § 67-4-2008(a)(11)(B)(ii); *i.e.*, such income is not derived from "royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities." The term "royalty" is not defined in the Tennessee Code, nor have the Tennessee courts defined the term. The Sixth Circuit Court of Appeals, however, has described a "royalty" as the "cost, consideration, compensation, or price paid or incurred for a license." [Emphasis added.] *Shatterproof Glass Corp. v. Libbey-Owens-Ford Co.*, 482 F.2d 317, 323 (6th Cir. 1973). Importantly, various courts have found that consideration received for services cannot be characterized as a royalty; these courts permitted the recharacterization of purported royalty

[1] The term "substantially all" is not statutorily defined. The Department of Revenue has interpreted the term to mean "at least 66.67%" based on a technical revision to Tenn. Code § 67-4-2008(a)(6)(A), which replaced the term "substantially all" with "at least 66.67%."

income as non-royalty compensation for services. *See, e.g.*, *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526, 1532 (9th Cir. 1996); *Arkansas State Police Ass'n, Inc. v. C.I.R.*, T.C. Memo 2001-38 (Tax Ct. 2001); *Mississippi State Univ. Alumni, Inc. v. Commissioner*, T.C. Memo 1997-397 (Tax Ct. 1997); *Mourad Bros, Inc. v. Dep't of Treasury*, 431 N.W.2d 98 (Mich.Ct.App. 1988).

It is unclear under the facts presented the extent to which the Taxpayer's income may be attributed to compensation for the provision of services. To qualify for the exemption under Tenn. Code Ann. § 67-4-2008(a)(11), the Taxpayer must demonstrate that at least 66.67% of its gross receipts with respect to the current taxable year are derived from the licensing of intellectual property, and not from the provision of services. The Tennessee Supreme Court has stated that "[a]lthough the rule is well-established that taxing legislation should be liberally construed in favor of the taxpayer and strictly construed against the taxing authority, it is an equally important principle of Tennessee tax law that 'exemptions from taxation are construed against the taxpayer who must shoulder the heavy and exacting burden of proving the exemption.'" *American Airlines, Inc. v. Johnson*, 56 S.W.3d 502, 506 (Tenn.Ct.App. 2000) (quoting *Rogers Group, Inc. v. Huddleston*, 900 S.W.2d 34, 36 (Tenn.Ct.App. 1995)). The Tennessee Supreme Court has also stated that the burden is on the taxpayer to establish the exemption, and any well-founded doubt is sufficient to defeat a claimed exemption from taxation. *American Airlines, Inc. v. Johnson*, 56 S.W.3d at 506 (citing *Tibbals Flooring Co. v. Huddleston*, 891 S.W.2d 196, 198 (Tenn. 1994); *United Canners, Inc. v. King*, 696 S.W.2d 525, 527 (Tenn. 1985)).

Accordingly, to claim the exemption under Tenn. Code Ann. § 67-4-2008(a)(11), the Taxpayer must demonstrate that at least 66.67% of its gross receipts with respect to the current taxable year are derived from royalties or other passive investment income, and not from compensation for the provision of services.

3. <u>The "non-corporate" requirement</u>.

As noted above, Tenn. Code Ann. § 67-4-2008(a)(11)(A) exempts from the Tennessee excise tax any family-owned "non-corporate" entity where substantially all the activity of the entity is the production of passive investment income. Thus, in addition to the "family-owned" and "substantially all the activity" requirements discussed above, Taxpayer must be a non-corporate entity in order to qualify for the exemption under Tenn. Code Ann. § 67-4-2008(a)(11).

The Taxpayer is a limited liability company. Based on the facts presented, it is unclear whether the Taxpayer is classified as a corporation or as a partnership for Tennessee franchise and excise tax purposes.[2] For purposes of this ruling, it is assumed that the Taxpayer has elected the default federal partnership classification under Treas. Reg. § 301.7701-2(a). However, if the Taxpayer has instead elected to be taxed as a corporation for federal income tax purposes, the exemption would not be available because the Taxpayer would be classified as a corporation for Tennessee franchise and excise tax purposes.

[2] For Tennessee franchise and excise tax purposes, an entity is classified as a corporation, partnership or other type of business entity consistent with the way the entity is classified for federal income tax purposes. Tenn. Code Ann. §§ 67-4-2007(d); 67-4-2106(c).

4. Conclusion.

The Taxpayer is not exempt from the payment of Tennessee franchise and excise taxes under Tenn. Code Ann. §§ 67-4-2008(a)(11) and 67-4-2105(a) unless it demonstrates that at least 66.67% of its gross receipts with respect to the current taxable year are derived from royalties or other passive investment income. Please note that the Taxpayer must qualify for the exemption under Tenn. Code Ann. § 67-4-2008(a)(11) on an annual basis.[3]

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APPROVED: Loren L. Chumley
Commissioner of Revenue

DATE: 9/22/06

[3] Regardless of whether the Taxpayer is exempt for Tennessee franchise and excise tax purposes, please note that the Taxpayer may nevertheless be subject to the Tennessee business tax pursuant to Tenn. Code Ann. § 67-4-708(3)(C), which specifically makes certain services taxable. For further information about the business tax, please refer to the Department of Revenue's website at http://www.tennessee.gov/revenue/tntaxes/localtaxes/business.htm.