

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 02-05**

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

Application of the Tennessee excise tax exemption codified at Tenn. Code Ann. § 67-4-2008(a)(10)(A) to certain purportedly family-owned non-corporate entities.

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 revocation of the ruling must inure to the taxpayer's detriment.

FACTS

The [NAME] Family owns several rental real estate properties in [CITY A - TENNESSEE] and [CITY B - TENNESSEE]. These properties are owned by a series of limited liability companies or limited partnerships that are ultimately controlled by the [NAME] family. All of the entities maintain a calendar year end.

[GROUP], LLC is a Tennessee limited liability company. [GROUP], LLC owns real estate properties for the family of [A]. The members of [GROUP], LLC, their relationship, and their respective ownership interests are as follows:

<u>Member</u>	<u>Relationship</u>
(1) [A]	Father
(2) [B], Inc.	[A] 100% S-Corp
(3) [C]	[CHILD OF A]
(4) [D]	[CHILD OF A]
(5) [E]	[CHILD OF A]

The members have been assigned points in the [GROUP], LLC for voting purposes. Voting points are as follows:

[A]	Class A	9,757.70
[B], Inc.	Class A	0.00 (Assigned to [A])
[C]	Class B	80.77
[D]	Class B	80.77
[E]	Class B	<u>80.76</u>
Total		10,000.00

Rental income profits (as defined in the operating agreement) are allocated in accordance with [REFERENCE TO SECTION OF DOCUMENT] of the operating agreement as follows:

1. First, among the members until cumulative profits are equal to cumulative losses for all prior fiscal years;
2. Next, among Class A members until cumulative profits are allocated to Class A members are equal to the preferred return;
3. The balance, 50% to Class A members and 50% to Class B members proportionately based on the number of points held in each class.

The Class A and Class B points are owned as follows:

<u>Class A</u>	<u>Points</u>	<u>Percentage</u>
[A]	8,575.20	87.8819%
[B], Inc.	<u>1,182.50</u>	<u>12.1181%</u>
Total	9,757.70	100.0000%

<u>Class B</u>	<u>Points</u>	<u>Percentage</u>
[C]	80.80	33.34%
[D]	80.80	33.33%
[E]	<u>80.80</u>	<u>33.33%</u>
Total	242.40	100.00%

It is asserted that the members' financial interests in [GROUP], LLC cannot be determined by looking independently at each members' profits or capital interest as shown in the operating agreement for [GROUP], LLC. Nor can they be

determined from the members' Schedule K-1. The financial interest (encompassing both capital and profits) can only be determined by computing a hypothetical sale of [GROUP], LLC's assets followed by liquidation. Such an analysis will reflect the members' financial interests in the net assets of [GROUP], LLC.

Six Entities Owned at Least 95% by [GROUP], LLC

[GROUP], LLC owns at least 95% of the following entities that are doing business in Tennessee:

[F], Ltd.	Owns [RESIDENTIAL PROPERTY] in [CITY A], TN
[G], LLC	Owns [RESIDENTIAL PROPERTY] in [CITY A], TN
[H], LLC	Owns [RESIDENTIAL PROPERTY] in [CITY A], TN
[I], LLC	Owns [RESIDENTIAL PROPERTY] in [CITY A], TN
[J], LLC	Owns [COMMERCIAL PROPERTY] in [CITY C], TN
[K], LP	Owns [RESIDENTIAL PROPERTY] in [CITY B], TN

[GROUP], LLC owns 99.9% of [F],Ltd.; [G], LLC; [H], LLC; [I], LLC; and [J], LLC. [GROUP], LLC owns the remaining 0.1% of these entities through [R], LLC, a [STATE – NOT TENNESSEE] single member limited liability company. These properties have been placed into separate entities for lender financing purposes. These entities are disregarded as separate entities for federal income tax purposes and are treated as directly owned by [GROUP], LLC. Therefore, it is asserted that [GROUP], LLC owns directly 100% of these entities.

[GROUP], LLC owns 99.78% of [K], LP. An unrelated individual owns the remaining .22%.

Four Entities Owned Less Than 95% by [GROUP], LLC

[GROUP], LLC owns less than 95% of the following entities that are doing business in Tennessee:

[L], Ltd.
[M], LLC
[N], Ltd.
[O], LP

The ownership of these entities is described in detail below.

[L], Ltd.

[L], Ltd. is a Tennessee limited partnership which owns the [#1] phase of the [PROPERTY P] in [CITY A], Tennessee, and 99% of [M], LLC (ownership of this entity is described below).

[L], Ltd. is owned as follows: (Please see Exhibit C for a diagram)

[GROUP], LLC	10.00%GP
[GROUP], LLC	33.33%LP
Trust A	56.67%LP

Trust A is a Tennessee trust that was formed to hold certain assets including the ownership interest of [L], Ltd. Trust A is not a business trust nor a real estate investment trust and is not subject to Tennessee franchise and excise tax. Beneficiaries of Trust A are as follows:

[GROUP], LLC	75.5232%
Unrelated third party	24.4768%

Therefore, [GROUP], LLC's total direct and indirect ownership in [L], Ltd. is:

Direct ownership	43.33%
Indirect ownership through Trust A 56.67% x 75.5232%	42.80%
Total ownership	86.13%

[M], LLC

[M], LLC is a Tennessee limited liability company that owns the [#2], [#3], and [#4] phases of [PROPERTY P] in [CITY A], Tennessee. The lender required this separate entity to be formed for financing reasons.

[M], LLC is owned as follows: (Please see Exhibit C for a diagram)

[L], Ltd.	99.00%
[Q], Inc.	1.00%

[Q], Inc. is a Tennessee S-corporation owned 100% by [A] and was formed because Tennessee did not allow single member LLCs at the time. [Q], Inc. is subject to Tennessee franchise and excise tax and is not relevant to this discussion.

Therefore, [GROUP], LLC's total direct and indirect ownership in [M], LLC is:

Direct ownership	0.00%
Indirect ownership through [L], Ltd. 99% x 86.13%	85.27%
Total ownership	85.27%

In addition, [A]'s ownership of [M], LLC exclusive of ownership of [M], LLC through [GROUP], LLC is:

Indirect ownership through S corporation	1.00% x 100%	1.00%
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[N], Ltd.

[N], Ltd. is a Tennessee limited partnership that owns the [PROPERTY S] in [CITY B], Tennessee. [N], Ltd. is currently owned as follows: (Please see Exhibit D for a diagram)

[GROUP], LLC	42.50%GP
[O], LP	57.50%LP

[O], LP

[O], LP is a Tennessee limited partnership that owns an interest in [N], Ltd. and is owned as follows: (Please see exhibit D for a diagram)

[GROUP], LLC	4.34%GP
[GROUP], LLC	69.57%LP
Total [GROUP], LLC	73.91%
Unrelated third party ownership	26.09%LP

Therefore, [GROUP], LLC's total direct and indirect ownership in [N], Ltd. is:

Direct ownership	42.50%
Indirect ownership through [O], LP 57.50% x 73.91%	42.50%
Total	85.00%

The principal business conducted by [GROUP], LLC, the six entities owned at least 95% by [GROUP], LLC, and the four entities owned less than 95% by [GROUP], LLC, is the rental of residential [REAL ESTATE] to the public. For the calendar year 2000, each entity derived more than 90% of its total gross receipts from rental real estate activities. The net rental income earned by each entity is reported on IRS Form 1065, U.S. Return of Partnership Income, Schedule K, line 2 as "Net income (loss) from rental real estate activities."

QUESTIONS

1. Is [GROUP], LLC exempt from franchise and excise tax as a family-owned non-corporate entity pursuant to Tenn. Code Ann. §§ 67-4-2008(a)(10)(A) and 67-4-2105(a)?
 - a. If the answer to question 1 is no, and it is because the Department believes that [GROUP], LLC has not met the "passive investment income" requirement, then please provide the Department's interpretation of this requirement as it relates to gross receipts derived from rents, including the Department's interpretation of the "substantially all" requirement. Also, please describe the types of

evidence that [GROUP], LLC must provide to meet the “passive investment income” requirement.

- b. If the answer to question 1 is no, and it’s because the assignment of [B], Inc.’s voting rights in [GROUP], LLC to [A] does not satisfy the “family owned” requirement, then please provide the Department’s interpretation of the term “ownership units”, including the exact combination of voting, capital, or profit interests that must be owned by family members to qualify for the exemption.

Please explain the difference between the Department’s interpretation of the term “ownership units” as contained in Tenn. Code Ann. § 67-4-2008(a)(10)(A) and the ownership language contained in Tenn. Code Ann. § 67-4-2008(a)(6)(B), which allows an exemption for a family owned entity when 95% or more of the voting rights, capital interest, or profits of the entity are owned either by natural persons who are relatives of one another or by trusts for their benefit.

- c. If the answer to question 1 is no, then please assume that [B], Inc.’s ownership in [GROUP], LLC is reduced below 5% in accordance with the Department’s response to question 2.b. so that the family members own at least 95% of [GROUP], LLC, and that [GROUP], LLC meets the passive investment income requirement. Will [GROUP], LLC be exempt from franchise and excise tax as a family-owned non-corporate entity? If not, please describe the additional requirements that must be met.

2. Assuming that [GROUP], LLC is exempt from franchise, excise tax as a family-owned non-corporate entity, are the six entities owned at least 95% by [GROUP], LLC exempt from franchise and excise tax as family-owned non-corporate entities pursuant to Tenn. Code Ann. §§67-4-2008(a)(10)(A) and 67-4-2105(a)?

- a. If the answer to question 1 is no, and it is because the Department believes that [GROUP], LLC has not met the “passive investment income” requirement, then please provide the Department’s interpretation of this requirement as it relates to gross receipts derived from rents, including the Department’s interpretation of the “substantially all” requirement. Also, please describe the types of evidence that [GROUP], LLC must provide to meet the “passive investment income” requirement.
- b. If the answer to question 2 is no, will the entities be exempt if [A] is granted 95% of the voting rights for each entity, but the capital and profits interests of each entity remain the same?

(1) If the answer to question 2.b. is no, then please provide the Department's interpretation of the term "ownership units", including the exact combination of voting, capital, or profit interests that must be owned by the family members to qualify for the exemption.

Please explain the difference between the Department's interpretation of the term "ownership units" as contained in Tenn. Code Ann. § 67-4-2008(a)(10)(A) and the ownership language contained in Tenn. Code Ann. § 67-4-2008(a)(6)(B), which allows an exemption for a family owned entity when 95% or more of the voting rights, capital interest, or profits of the entity are owned either by natural persons who are relatives of one another or by trusts for their benefit.

Please advise whether the ownership units must be owned directly by the family members or may the ownership units be owned indirectly through another entity such as [GROUP], LLC (i.e., tiered entities). If the ownership units must be owned directly by family members, please explain why tiered entities that meet the ownership requirement are subject to taxation but entities owned directly by family members are not.

3. Are the four entities owned less than 95% by [GROUP], LLC partially exempt from franchise and excise tax to the extent of [GROUP], LLC's direct and indirect ownership interest?
 - a. If the answer to question 1 is no, and it is because the Department believes that [GROUP], LLC has not met the "passive investment income" requirement, then please provide the Department's interpretation of this requirement as it relates to gross receipts derived from rents, including the Department's interpretation of the "substantially all" requirement. Also, please describe the types of evidence that [GROUP], LLC must provide to meet the "passive investment income" requirement.
 - b. If the answer to question 3 is no, will the entities be exempt if [A] is granted 95% of the voting rights for each entity, but the capital and profit interests of each entity remain the same?
 - (1) If the answer to question 3.b. is no, then please provide the Department's interpretation of the term "ownership units", including the exact combination of voting, capital, or profit interests that must be owned by the family members to qualify for the exemption.

Please explain the difference between the Department's interpretation of the term "ownership units" as contained in Tenn. Code Ann. § 67-4-2008(a)(10)(A) and the ownership

language contained in Tenn. Code Ann. § 67-4-2008(a)(6)(B), which allows an exemption for a family owned entity when 95% or more of the voting rights, capital interest, or profits of the entity are owned either by natural persons who are relatives of one another or by trusts for their benefit.

Please advise whether the ownership units must be owned directly by the family members or may the ownership units be owned indirectly through another entity such as [GROUP], LLC (i.e., tiered entities). If the ownership units must be owned directly by family members, please explain why tiered entities that meet the ownership requirement are subject to taxation but entities owned directly by family members are not.

- c. If the answer to question 3 is no, please assume that the unrelated third party ownership in the four entities is reduced below 5% in accordance with the Department's response to question 3.b. so that [GROUP], LLC owns at least 95% of these entities, and that each entity meets the passive investment income requirement. Will these four entities be exempt from franchise and excise tax as family-owned non-corporate entities? If not, please describe the additional requirements that must be met.

RULINGS

1. Yes. [GROUP], LLC will be treated as an exempt family-owned non-corporate entity as long as all the requirements of Tenn. Code Ann. § 67-4-2008(a)(10) remain satisfied.

- a. Not applicable
- b. Not applicable.
- c. Not applicable.

2. No, because the six entities do not satisfy the 95% family-owned requirement of Tenn. Code Ann. § 67-4-2008(a)(10).

- a. Not applicable
- b. No.

3. No. Tenn. Code Ann. § 67-4-2008(a)(10) does not provide for partial exemptions.

- a. Not applicable.

b. No.

c. No.

ANALYSIS

1. Tenn. Code Ann. § 67-4-2008(a)(10) exempts from the payment of the excise tax certain family-owned non-corporate entities as follows:

(a) There shall be exempt from the payment of the excise tax levied under this part the following:

(10)(A) Any family-owned non-corporate entity where substantially all of the activity of the entity is the production of passive investment income.

(B) For purposes of this subdivision:

(i) "Family-owned" means that at least ninety-five percent (95%) of

the ownership units of the entity are owned by members of the family, which means, with respect to an individual, only:

(a) An ancestor of such individual;

(b) The spouse or former spouse of such individual;

(c) A lineal descendent of such individual, of such individual's

spouse or former spouse, or of a parent of such individual;

(d) The spouse or former spouse of any lineal descendent described in subdivision (c); or

(e) The estate or trust of a deceased individual who, while living,

was as described in any of the above subdivisions. For purposes of this subdivision, a legally adopted child of an individual shall be treated as the child of such individual by blood.

(ii) "Passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales and exchanges of stock or securities to the extent of any gains therefrom.

Tenn. Code Ann. § 67-4-2008(a)(10).¹

Based on the foregoing, an entity will qualify for the exemption if: 1) the entity is family-owned; (2) the entity is a non-corporate entity; and (3) substantially all of the activity of the entity is the production of passive investment income. As described below, [GROUP], LLC satisfies all of the requirements to qualify for the exemption.

¹ For purposes of the franchise tax, Tenn. Code Ann. § 67-4-2105(a) provides that persons exempt under Tenn. Code Ann. 67-4-2008 are also exempt from the franchise tax.

To be “family-owned,” means that at least 95% of the ownership units of an entity be owned by members of a family. See Tenn. Code Ann. § 67-4-2008(a)(10)(B). The term “ownership units” refers to a member’s capital interest in an entity or that portion of an entities’ asset that would accrue to the member if the entity were to dissolve. Being owned by members of the family means being owned by individuals related by blood or marriage or by certain estates or trusts of deceased individuals. *Id.*

With the exception of [B], Inc.², all of [GROUP], LLC’s members are members of the same family. Thus, as long as the [B], Inc. owns 5% or less of [GROUP], LLC’s ownership units, [GROUP], LLC will meet the family-owned requirement.

According to the information supplied by the taxpayer’s representative, [B], Inc.’s financial interest in [GROUP], LLC cannot be determined by looking independently at [B], Inc.’s profits or capital interests as shown in the operating agreement for [GROUP], LLC. Nor can it be determined from [B], Inc.’s Schedule K-1. Instead, the financial interest (encompassing both capital and profits) can only be determined by computing a hypothetical sale of [GROUP], LLC’s assets followed by a liquidation. The taxpayer has calculated such a hypothetical sale using the net fair market value of [GROUP], LLC’s assets as of October 2001.³ Such an analysis reflects [B], Inc.’s ownership units in the net assets of [GROUP], LLC to be 4.351%. Assuming that for purposes of this ruling the taxpayer’s calculations are correct, [GROUP], LLC would meet the “family-owned” requirement of Tenn. Code Ann. § 67-4-2008(a)(10)(A).

² As an S Corporation, [B], Inc. does not qualify as a family member for purposes of the exemption.

³ The computation is as follows:

Net FMV of [GROUP], LLC assets as of (10/01)		\$41,428,000
First to Unreturned Class A Capital		
[A]	\$17,669,458	
[B], Inc.	<u>418,464</u>	
		(18,087,922)
		23,340,138
Next to Class B Capital		<u>(499,323)</u>
Residual after Original Capital		<u>\$22,840,815</u>
Residual Split		
50% to Class A		\$11,420,408
[A]	\$10,036,471	
[B], LLC	\$ 1,383,936	
50% to Class B		<u>\$11,420,408</u>
Total [B], Inc. share (418,464 + 1,383,936)		<u>\$ 1,802,400</u>
As a % of Net FMV of [GROUP], LLC Assets (1,802,400/41,428,000)		4.351%

For purposes of this hypothetical, [B], Inc.’s Class A capital account was previously reduced by net proceeds from the sale of [GROUP], LLC property. The proceeds from the sale amounted to \$2,018,000 and it was used to reduce the Class A capital amount of [B], Inc. only as agreed to by the [GROUP], LLC members. Thus [B], Inc.’s original Class A capital amount has been reduced from \$2,436,464 to \$418,464.

[GROUP], LLC does business as a limited liability company. Thus, [GROUP], LLC satisfies the non-corporate entity requirement of Tenn. Code Ann. § 67-4-2008(a)(10).

With respect to the passive investment income requirement, Tenn. Code Ann. § 67-4-2008(a)(10)(B)(ii) provides that the term “passive investment income” means gross receipts derived from, among other things, rent. The Department of Revenue (“Department”) interprets the “substantially all” language contained in Tenn. Code Ann. § 67-4-2008(a)(10) to mean that at least 66.67% of the gross receipts of the entity must be from passive investment income.⁴

The facts indicate that the principal business of [GROUP], LLC, the six entities owned at least 95% by [GROUP], LLC, and the four entities owned less than 95% by [GROUP], LLC is the rental of residential [REAL ESTATE] to the public. For the calendar year 2000, each entity derived more than 90% of its total gross receipts from rental real estate activities. Therefore, [GROUP], LLC satisfies the requirement that substantially all of its activity be the production of passive investment income.

Because of the nature of the hypothetical liquidation calculations advanced herein, it appears that [B], Inc.’s ownership percentage could possibly fluctuate. Therefore, this ruling is qualified in that it is applicable to [GROUP], LLC only as long as the facts remain the same i.e., as long as [B], Inc. maintains its five percent (5%) or less ownership of [GROUP], LLC. Furthermore, in making this ruling the Department is obviously relying upon the information submitted by the taxpayer and is assuming that such information and calculations are taken from the taxpayer’s books and records. The result reached herein is, of course, subject to re-determination in the event an audit of [GROUP], LLC’s books and records reveal contrary information.

2. As noted above, Tenn. Code Ann. § 67-4-2008(a)(10)(A) requires that an entity be “family-owned” as a prerequisite to qualifying for the exemption. To be “family-owned” means at least ninety-five percent (95%) of the ownership units of an entity be owned by members of a family related by blood or marriage or by certain estates or trusts of deceased individuals. Tenn. Code Ann. § 67-4-2008(a)(10)(B). Notwithstanding the fact that [GROUP], LLC is itself exempt, the six entities that it owns are not family-owned. [GROUP], LLC owns ninety-nine percent (99%) of the six entities. As a result, the entities are disqualified from the exemption. There is simply no provision in the law to allow for an entity such as [GROUP], LLC to qualify as either an individual, an estate or a trust. Therefore, the six entities owned at least 95% by [GROUP], LLC do not qualify for the exemption.

a. Not applicable.

⁴ The Department bases its interpretation on section 18 of Public Chapter 982, which replaced “substantially all” as it appeared in Tenn. Code Ann. § 67-4-2008(6)(A) with the phrase “at least 66.67%.”

b. If [A] is granted 95% of the voting rights for each entity, but the capital and profits interests of each entity remain the same, the response to issue number 2 will not change.

In accordance with the plain wording of Tenn. Code Ann. § 67-4-2008(a)(10)(A), the Department interprets the term “ownership units” to mean a members’ capital interest of an entity or that portion of an entities assets that would accrue to the member if the entity were to dissolve. Furthermore, the plain wording of the statute dictates that the ownership units be owned directly by family members. See Tenn. Code Ann. § 67-4-2008(a)(10)(B). The statute says as much in plain terms. Therefore, since exemptions from taxation are only allowed when granted in clear and unmistakable terms⁵, the ownership units must be owned directly by family members to qualify for the exemption.

3. Under Tennessee law, exemptions from taxation are construed against taxpayers. *Kingsport Pub. Corp. v. Olsen*, 667 S.W.2d 745 (Tenn. 1984). Furthermore, exemptions must positively appear and will not be implied. *LeTourneau Sales & Service, Inc. v. Olsen*, 691S.W.2d 531 (Tenn. 1985). Generally, exemptions will only be allowed when granted in clear and unmistakable terms and will be granted exactly according to those terms. *Metropolitan Government of Nashville and Davidson County v. Nashville Pi Beta Phi House Corp.*, 407 S.W.2d 197 (Tenn. App. 1966). Tenn. Code Ann. § 67-4-2008(a)(10) does not provide for partial exemptions. That being the case, the precedents from Tennessee courts dictate that no partial exemption can be applied to the four entities owned less than 95% by [GROUP], LLC.

a. Not applicable.

b. Please see response to question 2. b. above.

c. As noted in question 2 above, to be “family-owned” means at that at least ninety-five percent (95%) of the ownership units of an entity must be owned by family members. Thus, even if the unrelated third party ownership in the four entities is reduced below five percent (5%), the four entities will not be exempt from franchise and excise tax as family-owned non-corporate entities for the same reasons discussed in question number 2 above.

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Tax Counsel

⁵ See *Metropolitan Government of Nashville and Davidson County v. Nashville Pi Beta Phi House Corp.*, 407 S.W.2d 197 (Tenn. App. 1966).

APPROVED: Ruth E. Johnson
Commissioner

DATE: 03-12-02