

# Q&A Responses

## FONCE/OME Webinar

### 1. What are the requirements to qualify for the FONCE exemption?

An entity may qualify for the FONCE exemption if it meets all the following criteria:

1. The entity must be a noncorporate entity, such as an LLC, LP, or LLP;
2. At least 95% of the entity's ownership units must be directly held by family members; and
3. Substantially all (at least 66.67% or more) of the activity/gross receipts of the entity must be derived from the production of passive investment income or the combination of the production of passive investment income and farming.

Passive investment income is gross receipts derived from royalties, rents from residential property or farm property, dividends, interest, annuities, and gains on the sale or exchange of stock or securities. Rents from residential property are considered passive investment income only if the residential property from which they are derived includes not more than four residential units.

Farming is defined under Tenn. Code Ann. § 67-4-2008(a)(6)(A)(i). Non-passive income is all other gross receipts that are not listed above as passive investment income.

### 2. My brother and I own a restoration company. Would we qualify for the FONCE exemption?

To qualify for the FONCE exemption, the entity must meet all the requirements listed under Q&A 1.

While an entity owned jointly by siblings will generally meet the family-owned requirement, income derived from operating a trade or business such as a restoration company will generally be considered ordinary income (i.e., non-passive income). If substantially all of the income derived from the restoration company consists of non-passive income, the business would not meet the qualifications for the FONCE exemption.

### 3. Does a property management company that manages homeowner's associations qualify for the FONCE exemption?

To qualify for the FONCE exemption, the entity must meet all the requirements listed under Q&A 1.

A property management company that manages properties for others generally derives its income from management fees that it charges to the property owners for services performed. This type of income is generally not considered "passive investment income" for purposes of the FONCE exemption, and thus, property management companies generally will not meet the passive investment income requirement and will not qualify for the FONCE exemption.

- 4. If a family partnership is a partner in a lower tier partnership and the lower tier partnership files a Tennessee franchise and excise tax return, then would the family partnership be considered a FONCE if its only other income is interest and it meets the family ownership rules?**

The family partnership will qualify for the FONCE exemption if the family partnership is a limited partnership that is at least 95% directly owned by family members and its only source of income is interest income.

- 5. Does the FONCE exemption apply to a single member LLC that holds residential rental properties from which it derives passive investment income, when the LLC has limited liability?**

Yes, the SMLLC may qualify for the FONCE exemption as long as it meets the family ownership requirements.

- 6. Does a single member LLC qualify for the FONCE exemption if the SMLLC holds properties that are rented out for passive income?**

The single member LLC will qualify for the FONCE exemption if it is family-owned and substantially all (at least 66.67% or more) of its gross receipts consist of passive investment income. For purposes of the FONCE exemption, passive investment income includes rents from residential property *but does not include* rents from commercial property. To meet the passive investment income requirement, at least 66.67% or more of the SMLLC's gross receipts for the tax period must consist of rents from residential property.

- 7. Can a family member owner of an LLC have an interest in a revocable trust, which is considered a disregarded entity by the Internal Revenue Service and equivalent to the trust's creator, and will the LLC qualify for the FONCE exemption?**

Family members are not prohibited from holding ownership interests in multiple entities. However, for an entity to qualify for the FONCE exemption, the family member must directly hold the entity's ownership units. Ownership units that are held by a family member indirectly through another entity (regardless of whether such entity is disregarded to the family member for federal income tax purposes) are not considered to be family-owned.

In this case, the LLC will qualify for the FONCE exemption if it is directly owned by the family member and meets the other exemption requirements. If the ownership units of the LLC are held indirectly by the family member through a revocable trust, the LLC will not qualify for the FONCE exemption. Only individuals can be family members, with the single exception being a testamentary trust of an individual who, while living, was a family member.

## 8. What is passive investment income for FONCE exemption purposes?

For purposes of the FONCE exemption, passive investment income means gross receipts derived from:

- royalties
- rents from residential property or farm property
- dividends
- interest
- annuities
- gains on the sale or exchange of stock or securities

Non-passive income means all other gross receipts that are not listed above, regardless of how such income is characterized for federal income tax purposes.

## 9. Are long term capital gains from the sale of real estate considered passive income?

No. For FONCE exemption purposes, capital gains from the sale of real property are considered non-passive income regardless of how such capital gains are characterized for federal income tax purposes.

## 10. Does a family-owned LLC that operates to produce ordinary (or earned) income qualify for the FONCE exemption?

To qualify for the FONCE exemption, substantially all (at least 66.67% or more) of the family-owned noncorporate entity's activity must consist of either the production of passive investment income or the combination of the production of passive investment income and farming. Passive investment income means gross receipts derived from royalties, rents from residential property or farm property, dividends, interest, annuities, and gains on the sale or exchange of stock or securities.

Ordinary (or earned) income derived from operating a trade or business is non-passive income for FONCE exemption purposes. If substantially all of the LLC's income consists of non-passive income, the entity does not meet the qualifications for the FONCE exemption.

## 11. Does vacant land qualify for the FONCE exemption? It is not farming land.

A noncorporate entity (LLC, LP, or LLP) that meets the family-owned requirement will qualify for the FONCE exemption if, during the tax year, the only activity of the entity is owning vacant land and the entity does not derive any income from any source. If, during the tax year, the entity sells the vacant land, the gain on the sale of the land will not qualify as passive investment income, and the entity will not qualify for the FONCE exemption.

**12. Does the rental of commercial property owned by family members qualify for the FONCE exemption?**

Rents derived from commercial property do not qualify for the FONCE exemption.

**13. Would storage facilities or buildings be considered residential rentals, or would this be considered commercial?**

For purposes of the FONCE exemption, a particular property will be classified as either residential property, industrial and commercial property, or farm property, consistent with how the property is classified for Tennessee property tax purposes, except that residential property includes any property leased or rented for residential purposes that includes not more than four residential units. Generally, storage facilities or buildings will be classified as commercial property.

**14. Is an Airbnb rental considered commercial property for FONCE exemption purposes?**

For purposes of the FONCE exemption, a particular property will be classified as either residential property or commercial property, consistent with how the property is classified for Tennessee property tax purposes, except that residential property includes any property leased or rented for residential purposes that includes not more than four residential units.

**15. Is rent from short-term vacation rentals (which are zoned and taxed as residential property) passive investment income?**

Rents from residential properties such as short-term vacation rentals may qualify as passive investment income for purposes of the FONCE exemption. Rents from residential property are considered passive investment income only if the residential property from which they are derived includes not more than four residential units.

**16. Can an LLC own 4 separate residential condos, even if the condo complex has 10+ condos built/available, and qualify for the FONCE exemption?**

Yes, so long as each separately deeded condo owned by the LLC includes not more than four residential units per condo. There is no limit as to the number of separately deeded residential properties an entity can own and qualify for the FONCE exemption, so long as each separately deeded property owned by the entity includes not more than four residential units per property.

**17. Can a single-member LLC own more than 4 properties at different locations and still qualify for the FONCE exemption?**

Yes, so long as each separately deeded property owned by the single-member LLC includes not more than four residential units per property. There is no limit as to the number of separately

deeded residential properties an entity can own and qualify for the FONCE exemption, so long as each separately deeded property owned by the entity includes not more than four residential units per property.

**18. Can an LLC that has filed the federal election to be taxed as an S corporation or a C corporation still make the Tennessee obligated member entity (OME) election? For state purposes, the entity is still an LLC.**

Yes.

**19. What specific forms must be filed with the Tennessee Secretary of State's Office to register an entity as an OME?**

In order to become an obligated member entity (OME), the entity must file original or amended formation documents that contain the required appropriate documentation necessary to become an OME. The appropriate documentation requirements for LPs, LLPs, and LLCs are listed at Tenn. Code Ann. § 67-4-2008(b)-(d). To qualify for the franchise and excise tax OME exemption, all members or partners of the entity must become obligated members, as reflected in the OME documentation.

Please contact the Business Services Division of the Tennessee Secretary of State at 615-741-2286 for information regarding the specific forms that must be filed.

**20. I have an LLC that is registered as an OME with the Tennessee Secretary of State and is taxed as a C corporation for federal income tax purposes. The Department of Revenue rejected the OME application. Why was my LLC's OME application rejected?**

The following are a few reasons why we might reject an OME application:

1. The Department was not able to obtain stamped copies of the taxpayer's formation documents/amendments that contain the OME documentation filed with the Secretary of State.
2. The taxpayer is a corporation formed under state law (entity must be an LLC, LP, or LLP).

**21. Would an LLC qualify for the OME exemption if 100% of the LLC is owned by spouses through a grantor trust and 100% of the LLC's assets are stocks and bonds?**

The LLC may qualify for the obligated member entity (OME) exemption if it satisfies the exemption requirements. The LLC may qualify for the OME exemption if its direct owner, the grantor trust, agrees to be fully liable for the debts, obligations, and liabilities of the LLC and files appropriate documentation to that effect with the Tennessee Secretary of State. See Tenn. Code Ann. § 67-4-2008(b)-(d).

# Q&A Responses

---

The LLC will not be precluded from qualifying for the OME exemption because it is directly owned by a grantor trust, presuming the grantor trust is not itself a type of entity that is subject to F&E (e.g., a business trust). This is because trusts, with the exception of business trusts, are not deemed to provide limited liability protection for OME exemption purposes. See Tenn. Code Ann. § 67-4-2008(a)(9)(D).

## **22. When must the F&E Application for Exemption/Annual Exemption Renewal (Form FAE183) be filed with the Department?**

Form FAE183 must be filed on or before the 15<sup>th</sup> day of the fourth month following the close of the tax year for which the taxpayer is claiming an exemption. The taxpayer should not submit this form before the fiscal year end of the exemption year. The Department will not process any early submitted renewals.

## **23. If the taxpayer has requested a federal extension, by what date must the F&E exemption form (Form FAE183) be filed?**

Generally, Form FAE183 must be filed on or before the 15<sup>th</sup> day of the fourth month following the close of the taxpayer's tax year. However, if the taxpayer has requested an extension for federal income tax purposes, the Department will grant an extension of time of seven months in which to file the F&E exemption form. In this case, the taxpayer must file Form FAE183 with the Department on or before the 15<sup>th</sup> day of the 11<sup>th</sup> month following the close of its tax year.

## **24. If the taxpayer does not file the F&E exemption form (Form FAE183) by the due date (including extensions), will the Department assess a \$200 penalty?**

The F&E exemption form must be postmarked or electronically transmitted by the due date (including extensions) to avoid penalty assessment. If the taxpayer fails to timely file the F&E exemption form, the Department may assess the taxpayer a penalty of \$200, per occurrence, for late filing.

## **25. Are there other exemptions besides the FONCE exemption and the exemptions for farming?**

Yes. To view the list of exemptions, please visit our website - <https://www.tn.gov/revenue/taxes/franchise---excise-tax/exemptions.html>

## **26. Where can I find additional information regarding the 17 franchise and excise tax exemptions?**

For the complete list, please visit the [Exemptions and Credits](#) section on the Department's website.

For additional information, please see the Department's [Franchise and Excise Tax Manual](#).

The law regarding exemptions is located at Tenn. Code Ann. § 67-4-2008. The *Tennessee Code Annotated* can be accessed online through [the Department's website](#).

## **27. Is online software as a service subject to Tennessee franchise and excise taxes?**

Determining whether a particular activity subjects an entity to franchise and excise taxes is a fact-specific matter. In general, a taxable entity will be subject to franchise and excise taxes if it is doing business in this state and has a substantial nexus in this state. This would generally apply to a taxable entity that engages in the activity of delivering software to customers in this state via the internet, if the entity regularly derives gross receipts attributable to customers in this state from such activity or the entity has a bright-line presence in this state, which is established if the entity's total receipts in this state during the tax period exceed the lesser of \$500,000 or 25% of the taxpayer's total receipts everywhere during the tax period.

## **28. Can an entity register as being exempt from franchise and excise taxes, but individual members of the entity elect to pay the tax on their respective percentage of annual income from the exempt entity?**

Franchise and excise taxes are imposed on taxable entities at the entity level, rather than the owner level. There is no election available to owners of a taxable entity to file returns and pay the tax on behalf of the taxable entity. However, if the owner of a pass-through entity that is exempt from franchise and excise taxes is itself a taxable entity that is subject to the tax, then the owner's excise tax return will include its percentage of pass-through income or loss from the exempt pass-through entity.

## **29. Does Tennessee follow the federal tax deferral when a property is exchanged in a 1031 exchange?**

Yes. The Tennessee excise tax calculation begins with federal taxable income, to which certain add-backs and deductions are made for Tennessee excise tax purposes. The 1031 exchange deferred gain is not delineated as an add-back. See Tenn. Code Ann. § 67-4-2006(b).

## **30. Does Tennessee follow the federal tax treatment regarding investments in a qualified opportunity zone/fund?**

Yes. Transactions related to the qualified opportunity zone/fund deferral are reported on federal Form 4797 and would automatically be incorporated in federal taxable income, which is the starting point in preparing the Tennessee excise tax return. For example, Tennessee Form FAE170, Schedule J4, Line 1 asks for "Taxable income or loss before net operating loss deduction and special deductions (federal Form 1120, Line 28)." The qualified opportunity zone/fund deferral reported on federal Form 4797 is automatically part of the amount reported on federal Form 1120, Line 28. The Tennessee excise tax law does require that certain add-backs and deductions be made to the excise tax starting point, but the qualified opportunity zone/fund deferral is not one of them.

**31. What is the lookback period for franchise and excise taxes on a property that was previously held in an LLC but is subsequently distributed to an LLC member and sold by the member? Can the member defer gain realized on the sale of the property for Tennessee excise tax purposes if the member invests the gain in a federal qualified opportunity zone fund?**

The Tennessee excise tax law contains special provisions that address this type of situation. If an entity that is subject to Tennessee excise tax distributes an asset to an entity or individual that is not subject to Tennessee excise tax and that entity or individual sells the asset at a gain within 12 months of the asset distribution, then the gain is required to be reported by the entity who made the asset distribution (rather than the seller) for excise tax purposes (Tenn. Code Ann. § 67-4-2006(b)(1)(I)). However, if the entity making the asset distribution ceases to exist prior to the sale of the asset, then the entity or individual who sells the asset will be subject to excise tax on the gain, as explained below.

Any entity or individual that is not otherwise subject to the Tennessee excise tax must pay an excise tax equal to 6.5% of the gain from the sale of any asset if any of the following criteria is met (Tenn. Code Ann. § 67-4-2007(f)):

- The entity or individual received the asset through a distribution from a taxpayer within the 12-month period immediately prior to the sale and the taxpayer making the asset distribution ceased to exist prior to the sale;
- The entity or individual received the asset through a merger, liquidation, or any similar transaction involving a taxpayer subject to the Tennessee excise tax during the 12-month period immediately prior to the sale;
- The entity or individual qualified for the obligated member entity exemption provided in § 67-4-2008(a)(9) during the 12-month period immediately prior to the sale; or
- The asset was owned, during the 12-month period immediately prior to the sale, by an affiliate subject to the Tennessee excise tax.

Regardless of whether the gain in this type of situation is required to be reported by the entity making the asset distribution or the entity that sells the asset, in either case, the entity cannot defer the Tennessee excise tax due on the gain by investing the gain in a federal qualified opportunity zone fund. This is because, in the case of an entity that is normally subject to Tennessee excise tax, the distributed asset gain is a state-imposed add-back to the taxpayer's excise tax base, and the federal opportunity zone provisions have no bearing on this add-back. In the case of an entity that is *not* normally subject to Tennessee excise tax, the excise tax due is based solely on the distributed asset gain, *and not the entity's net earnings based on federal taxable income*, so the federal opportunity zone provisions do not apply.