

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 06-06**

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 the portion of income or loss that has been passed-through to a corporation but was reported on the excise tax return of a limited partnership in which the corporation, directly or indirectly, has an interest must be deducted from, or added to in the case of a loss, the corporation's federal taxable income or loss before the net operating loss deduction and special deductions.

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

The Taxpayer is a Delaware C corporation with stand-alone Tennessee tax nexus. The Taxpayer holds a 49.49% limited partnership interest in [LP1], a [STATE – NOT TENNESSEE] limited partnership without stand-alone Tennessee tax nexus. [LP1] holds a 99% limited partnership interest in [LP2], a [STATE – NOT TENNESSEE] limited partnership with stand-alone Tennessee tax nexus.

[LP1] and [LP2] also hold other limited partnership interests in various other limited partnerships that do not have stand-alone Tennessee tax nexus. Attached to the Taxpayer's Letter Ruling request as Exhibit A is an organizational chart showing the complex and extensive organizational structure for the [GROUP] of entities.

The Taxpayer timely files Tennessee franchise, excise tax returns with the Tennessee Department of Revenue. Since it has no Tennessee tax nexus, [LP1] has no franchise, excise tax return filing obligation regarding its own income or the flow-through income that it receives from its interest in other limited partnerships. A portion of [LP2's] business operations are based in Tennessee. Thus, [LP2] has tax nexus in Tennessee and timely files Tennessee franchise, excise tax returns.

For federal income tax purposes, the Taxpayer includes 49.49% of the [LP1's] income in its federal taxable income before the net operating loss deduction and special deductions.

QUESTION PRESENTED

Should the portion of income or loss that has been passed-through to the Taxpayer, but that was reported on the Tennessee excise tax return of [LP2], be deducted from, or added to in the case of a loss, the Taxpayer's federal taxable income or loss before the net operating loss deduction and special deductions when the Taxpayer computes its excise tax base?

RULING

Yes.

Assuming that the Taxpayer also has tax nexus in another state(s), it is also important to note that, since [LP2] is doing business in Tennessee and is subject to Tennessee franchise, excise tax, none of its property, payroll compensation or gross receipts are passed-through to the Taxpayer for apportionment formula purposes.

However, in addition to its own property, payroll compensation and receipts, the Taxpayer will include in its apportionment formula for franchise, excise tax purposes, its ownership share of the property, payroll compensation and gross receipts of any limited

partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and that is not doing business in Tennessee and thus is not subject to Tennessee franchise, excise tax.

ANALYSIS

General Analysis and Example

A limited partnership is not subject to federal income tax. Instead, its income and expenses are passed-through to its owners/partners and included in the federal return filed by such owners/partners. For federal income tax purposes, [LP2] will pass 99% of its pass-through income and expenses plus 99% of its own income and expenses through to [LP1]. [LP1] will then pass 49.49% of such income and expenses plus 49.49% of its own income and expenses through to the Taxpayer. The Taxpayer's federal taxable income before the net operating deduction and special deductions will include the income and expenses of entities treated as partnerships in which the Taxpayer directly, or indirectly through another entity treated as a partnership, has an ownership interest.

For purposes of a simplified example, suppose that for federal income tax purposes, [LP2] has ordinary income of \$1,000 plus an ordinary net loss of \$200 passed-through to it from other entities treated as partnerships in which it directly, or indirectly through another entity treated as a partnership, has an ownership interest. [LP2] will then pass-through to [LP1] 99% of its net earnings of \$800 ($\$1,000 - \$200 = \800), which amounts to \$792 ($99\% \times \$800 = \792).

Assume that [LP1] has net income of \$900 consisting of \$1,200 in ordinary income plus a \$300 ordinary net loss passed-through to it from other entities treated as partnerships in which it directly, or indirectly through another entity treated as a partnership, has an ownership interest. [LP1] will then pass-through to the Taxpayer 49.49% of its net earnings of \$1,692 ($\$792 + \$1,200 - \$300 = \$1,692$), which amounts to \$837 ($49.49\% \times \$1,692 = \837). Assume that, in addition to pass-through items, the Taxpayer's own federal net earnings before the net operating loss deduction and special deductions amount to \$2,000.

The question presented concerns how [LP2], [LP1] and the Taxpayer will be treated for Tennessee excise tax purposes.

When computing an entity's excise tax base, Tenn. Code Ann. § 67-4-2006(b)(2)(L) requires any item of gain or income that meets the following criteria to be subtracted from the entity's net earnings (losses).

- (i) Is included in the determination of the taxpayer's net earnings or loss;

- (ii) Is from a pass-through entity which is subject to and files a return for the tax imposed by this part;
- (iii) Is allocated to a partner, shareholder, beneficiary or another owner of such pass-through entity; and
- (iv) Is not subtracted from the net earnings or loss of such pass-through entity under subdivision (b)(2)(M)[.]

Subdivision (b)(2)(M), referenced above in Tenn. Code Ann. § 67-4-2006(b)(2)(L)(iv), has no application to the facts presented in this Letter Ruling because it concerns a pass-through entity's items of gain or income that are included in the federal taxable income of a real estate investment trust. Tenn. Code Ann. § 67-4-2006(b)(1)(J) contains provisions identical to those set forth above with regard to the criteria for adding losses and expense items to an entity's net earnings or losses.

A "pass-through entity," as the term is used in Tenn. Code Ann. § 67-4-2006(b)(2)(L)(ii)-(iv) set forth above, is defined as follows by Tenn. Code Ann. § 67-4-2004(28):

"Pass-through entity" means an S corporation, an entity treated as a partnership for federal income tax purposes, an entity treated as a trust for federal income tax purposes or a business entity which has a single owner and which is disregarded as an entity separate from its owner for federal income tax purposes, but not for purposes of this part and part 21 of this chapter[.]

Because they are entities treated as partnerships for federal income tax purposes, [LP2] and [LP1] qualify as pass-through entities for Tennessee excise tax purposes.

Application of Tennessee Excise Tax Statutes to [LP2]

The facts presented state that [LP2] has stand-alone Tennessee tax nexus. Tenn. Code Ann. § 67-4-2006(a)(4) requires [LP2] to compute its net earnings for Tennessee excise tax purposes in the following manner:

In the case of a person or taxpayer treated as a partnership for federal tax purposes, or any other person required to file a federal partnership return on a federal form 1065 or any variation of that form, including, but not limited to, limited liability companies, "net earnings" or "net loss" is defined as an amount equal to:

- (A) The amount of ordinary income or loss determined under the applicable provisions of the Internal Revenue Code, including, but not limited to, guaranteed payments to partners and capital gains, which additional items are not already included in ordinary income or loss; less

- (B) The amount subject to self-employment taxes, without regard to any cap, Distributable or paid to each partner or member; provided, that this amount shall not create or increase any net loss; less
- (C) The amount contributed to qualified pension or benefit plans, including all plans described in 26 U.S.C. § 401, of any partner or member, provided, however, that this amount shall not create or increase any net loss; as adjusted by subsections (b) and (c).

Because none of [LP2's] income or loss is from a pass-through entity that is subject to excise tax and files an excise tax return, the additions and deductions required by Tenn. Code Ann. §§ 67-4-2006(b)(2)(L) and 67-4-2006(b)(1)(J) do not apply. According to the organizational chart that accompanied the Taxpayer's Letter Ruling request, none of the owner's of [LP2] are individuals, so it would have no income subject to self-employment taxes distributable or paid to its partners and would not contribute to a pension plan of any partner. [LP2] is subject to excise tax on its ordinary income plus or minus any other applicable additions or deductions required by Tenn. Code Ann. § 67-4-2006.

Continuing with the simplified example set forth above, assuming that none of the items required by Tenn. Code Ann. § 67-4-2006 to be added to or deducted from its pro-forma federal net earnings apply, and assuming for the simplicity of this example that [LP2] has no tax nexus outside Tennessee, [LP2] would be subject to Tennessee excise tax on its net ordinary income of \$800.

Application of Tennessee Excise Tax Statutes to [LP1]

The facts presented state that [LP1] has no Tennessee tax nexus. Therefore, it is not subject to Tennessee excise tax.

Application of Tennessee Excise Tax Statutes to the Taxpayer

The Taxpayer's federal net earnings (loss) before the net operating loss deduction and special deductions consist of the following items:

1. 100% of its own income (loss).
2. 49.49% of [LP1's] income (loss).
3. 49.49% of 99% of [LP2's] income (loss).

Tenn. Code Ann. §§ 67-4-2006(b)(2)(L) and 67-4-2006(b)(1)(J) operate to remove any income or loss passed-through to the Taxpayer by a pass-through entity that has already been subjected to the Tennessee excise tax. [LP2's] income (loss) has already been subjected to Tennessee excise tax in the hands of [LP2], but 49.49% of 99% of such income (loss) now appears again in the federal net earnings of the Taxpayer. Such income qualifies for subtraction from the Taxpayer's federal net earnings (loss) under Tenn. Code Ann. § 67-4-2006(b)(2)(L) because:

1. It is included in the determination of the taxpayer's net earnings or loss;
2. It is from a pass-through entity ([LP2]) that is subject to the excise tax and files an excise tax return;
3. It is allocated to an owner (the Taxpayer) of such pass-through entity ([LP2]); and
4. It is not subtracted from the net earnings or loss of the pass-through entity ([LP2]) under Tenn. Code Ann. § 67-4-2006(b)(2)(M).

Applying this to the facts set forth in the above simplified example, the Taxpayer's federal net earnings (loss) before net the operating loss deduction and special deductions consist of the following items:

1. Its own income of \$2,000.
2. [LP1's] income of \$445 ($49.49\% \times \900).
3. [LP2's] income \$388 ($49.49\% \text{ of } 99\% \times \$792 = \$388$).

The Taxpayer's total income is \$2,833 ($\$2,000 + \$445 + \$388 = \$2,833$). However, under the provisions of Code Ann. § 67-4-2006(b)(2)(L), \$388 will be subtracted from this amount. Assuming that, for purposes of this simplified example, none of the other items required by Tenn. Code Ann. § 67-4-2006 to be added to or deducted from the Taxpayer's federal net earnings before the net operating loss deduction and special deductions apply, and assuming that the Taxpayer has no tax nexus outside Tennessee, the Taxpayer would be subject to Tennessee excise tax on \$2,445 ($\$2,833 - \$388 = \$2,445$).

Although [LP2's] income passes through [LP1] to the Taxpayer, under Tennessee's excise tax law such income retains its character in the hands of the Taxpayer as income previously subjected to Tennessee excise tax in the hands of [LP2].

Applicable Franchise, Excise Tax Apportionment Formula Statutes

Tenn. Code Ann. §§ 67-4-2012 and 67-4-2111 permit business entities that are doing business both within and without the State of Tennessee to apportion their net earnings and net worth to Tennessee by multiplying such net earnings and net worth by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the receipts factor and the denominator of which is four.

Tenn. Code Ann. §§ 67-4-2012(b) and 67-4-2111(b)(4), the pertinent parts of which are set forth below, make the following provisions concerning the computation of a taxpayer's franchise, excise tax apportionment formula property factor:

"Property" also includes a taxpayer's ownership share of the real or tangible property owned or rented by any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or

more such entities, and which is not doing business in Tennessee and, therefore is not subject to Tennessee [franchise] excise tax.

With regard to the payroll factor, the pertinent parts of Tenn. Code Ann. §§ 67-4-2012(e) and 67-4-2111(e)(5) make the following provisions:

“Compensation” also includes a taxpayer’s ownership share of any specific compensation of any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and which is not doing business in Tennessee and thus is not subject to Tennessee [franchise] excise tax.

Similar provisions are made by pertinent parts of Tenn. Code Ann. §§ 67-4-2012(g) and 67-4-2111(e)(4) with regard to the receipts factors:

“Gross receipts” also includes a taxpayer’s ownership share of gross receipts of any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and which is not doing business in Tennessee and thus is not subject to Tennessee [franchise] excise tax.

Application of Franchise, Excise Tax
Apportionment Formula Statutes to [LP2]

If [LP2] also has tax nexus in another state(s), it will apportion its net earnings and net worth to Tennessee for franchise, excise tax purposes using the property, payroll compensation and receipts apportionment formula previously described.

In addition to its own property, payroll compensation and receipts, [LP2] will include in its apportionment formula for franchise, excise tax purposes, its ownership share of the property, payroll compensation and gross receipts of any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and that is not doing business in Tennessee and thus is not subject to Tennessee franchise, excise tax.

Application of Franchise, Excise Tax
Apportionment Formula Statutes to [LP1]

The facts presented state that [LP1] has no Tennessee tax nexus. Therefore, it is not subject to franchise, excise tax and will not compute an apportionment formula.

Application of Franchise, Excise Tax
Apportionment Formula Statutes to the Taxpayer

If the Taxpayer also has tax nexus in another state(s), it will apportion its net earnings and net worth to Tennessee for franchise, excise tax purposes using the property, payroll compensation and receipts apportionment formula previously described.

In addition to its own property, payroll compensation and receipts, the Taxpayer will include in its apportionment formula for franchise, excise tax purposes, its ownership share of the property, payroll compensation and gross receipts of any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and that is not doing business in Tennessee and thus is not subject to Tennessee franchise excise tax. This will include the following:

1. 100% of its own property, payroll compensation and receipts.
2. 49.49% of [LP1's] property, payroll compensation and receipts.
3. 49.49% of property, payroll compensation and gross receipts passed-through to [LP1] by any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the Taxpayer has an ownership interest, directly or indirectly through [LP1] and that is not doing business in Tennessee and thus is not subject to Tennessee franchise excise tax.

It is important to note that the Taxpayer's indirect ownership share (49.49% of 99%) of property, payroll compensation and receipts of [LP2] will be excluded from the Taxpayer's apportionment formula because, although the Taxpayer indirectly has an ownership interest in [LP2] through [LP1], [LP2] is doing business in Tennessee and is subject to Tennessee franchise, excise tax. Thus, none of [LP2's] property, payroll compensation and receipts are passed-through to the Taxpayer.

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APPROVED: Loren L. Chumley, Commissioner

DATE: 3/14/06