

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #98-46**

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 real estate investment trust and its two subsidiaries should be disregarded as separate entities for Tennessee franchise, excise tax purposes and whether the real estate investment trust is subject to Tennessee franchise, excise taxes as a result of its ownership of 100% of the stock of a corporation that is a general partner in a partnership doing business in Tennessee. Also, whether a qualified real estate investment trust subsidiary that is a limited partner in a partnership doing business in Tennessee is subject to franchise, excise taxes.

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

Corporation A is a foreign corporation that is qualified as a real estate investment trust (REIT) for federal income tax reporting purposes pursuant to I.R.C. § 856. Corporation A has two wholly-owned subsidiaries, Sub 1 and Sub 2, that qualify as “qualified REIT subsidiaries” under I.R.C. § 856(i). As qualified REIT subsidiaries, Sub 1 and Sub 2 are disregarded as separate taxable entities for federal reporting purposes and are treated as divisions of Corporation A. Corporation A’s only connection with Tennessee is its ownership of 100% of the stock of Sub 1.

Sub 1 owns a [PERCENT] general partnership interest in a limited partnership known as [PARTNERSHIP]. The Partnership owns and operates [BUSINESS] in several states including Tennessee. As a general partner in a partnership doing business in Tennessee, Sub 1 will qualify to do business in Tennessee and will have an obligation to file Tennessee franchise, excise tax returns.

Sub 2 is a corporation organized under the laws of a state other than Tennessee and is not qualified to do business in Tennessee. Sub 2 is an approximately [PERCENT] limited partner in the Partnership. As a limited partner, Sub 2 exercises no management or control over the Partnership. All decisions regarding the operations of the Partnership are made either by Partnership employees and/or the employees, officers and/or directors of Sub 1 from offices outside Tennessee. Apart from its interest in the Partnership, Sub 2 has no other connections with Tennessee. All of Sub 2’s business activities are conducted in a state other than Tennessee and Sub 2 only acts as a passive investor in Partnership.

The remaining [PERCENT] of the Partnership is held by third party investors as limited partners.

QUESTIONS PRESENTED

1. For Tennessee franchise, excise tax purposes, will Corporation A be treated as a corporation separate from Sub 1 and Sub 2?
2. Is Corporation A doing business in Tennessee so as to be subject to Tennessee franchise, excise taxes?
3. Is Sub 2 doing business in Tennessee so as to be subject to Tennessee franchise, excise taxes?

RULINGS

1. Yes.

2. No.

3. No.

ANALYSIS

1. For Franchise, Excise Tax Purposes, Corporation A Is A Corporation Separate And Independent From Its Qualified REIT Subsidiaries

Title 26 U.S.C.A. § 856(i), set forth below, defines a qualified REIT subsidiary and provides that, for federal tax purposes, it is treated as a division of its parent rather than as a separate corporate entity.

(i) Treatment of certain wholly owned subsidiaries.

(1) In general. For purposes of this title- -

(A) a corporation which is a qualified REIT subsidiary shall not be treated as a separate corporation, and

(B) all assets, liabilities, and items of income, deduction, and credit of a qualified REIT subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the real estate investment trust.

(2) Qualified REIT subsidiary. For purposes of this subsection, the term ‘qualified REIT subsidiary’ means any corporation if 100 percent of the stock of such corporation is held by the real estate investment trust at all times during the period such corporation was in existence.

(3) Treatment of termination of qualified subsidiary status. For purposes of this subtitle, if any corporation which was a qualified REIT subsidiary ceases to meet the requirements of paragraph (2), such corporation shall be treated as a new corporation acquiring all of its assets (assuming all of its liabilities) immediately before such cessation from the real estate investment trust in exchange for its stock.

T.C.A. §§ 67-4-806 and 67-4-903 impose franchise, excise taxes on “All corporations, cooperatives, joint-stock associations and business trusts, including regulated investment companies and real estate investment trusts, organized for profit . . . and doing business in Tennessee . . .”. Corporation A, Sub 1 and Sub 2 are three individual, separately chartered corporations. Because Corporation A is a REIT and its two subsidiaries are qualified REIT subsidiaries, Title 26 U.S.C.A. § 856(i) treats them as one corporation for purposes of federal income taxation.

Although, under T.C.A. § 67-4-805(a), the starting point for determining net earnings for Tennessee excise tax purposes is federal taxable income before the net operating loss deduction

and special deductions, nothing in Tennessee's franchise, excise tax statutes (T.C.A. §§ 67-4-801 et seq. and 67-4-901 et seq.) require or permit the use of the federal classification of a business entity for franchise, excise tax purposes.¹

With the exception noted in footnote 1 below, T.C.A. §§ 67-4-806 and 67-4-903 are applied to the business entities named therein in accordance with the way such entities are legally classified without regard to how they may be classified for federal income tax purposes.

TENN. COMP. R. & REGS. 1320-6-1-.02(2) requires franchise, excise tax returns to be filed to coincide with each accounting period for which a federal return has been filed. *DAACO, Inc. v. Huddleston*, 891 S.W.2d 920 (Tenn. App. 1994), permission to appeal denied by Supreme Court 1-30-95. For federal income tax filing purposes, it may be that a corporation is considered to be a division of its parent or is included in the consolidated federal return filed by its parent. However, under T.C.A. § 67-4-805(a), the starting point for computing its net earnings for Tennessee excise tax purposes is the pro forma federal net earnings, before the net operating deduction and special deductions, that the corporation would have had if it had been filing on a separate entity basis for federal income tax purposes.

Corporation A, Sub 1 and Sub 2 are each separately chartered legal entities and, as such, they must be so classified for Tennessee franchise, excise tax purposes.

2. Corporation A Is Not Doing Business In Tennessee So As To Be Subject To Franchise, Excise Taxes

Corporation A has no business contacts or activities in Tennessee. It owns 100% of the stock of Sub 2 who, as is discussed below, is not doing business in Tennessee for franchise, excise tax purposes. It also owns 100% of the stock of Sub 1 who, as is correctly stated in the FACTS above, is doing business in Tennessee so as to be subject to franchise, excise taxes.

The only connection that Corporation A has with Tennessee is its stock investment in Sub 1. As a result of its general partnership interest in a partnership doing business in Tennessee, Sub 1 is doing business in Tennessee and is subject to Tennessee franchise, excise taxes. However, Sub 1's Tennessee activities resulting from its general partnership interest in a partnership doing business in Tennessee can not be attributed to Corporation A solely as a result of the fact that Corporation A owns 100% of Sub 1's stock.

¹ T.C.A. § 48-211-101 does require the federal income tax classification of a Limited Liability Company to be followed for all state and local tax purposes, including the franchise, excise tax. However, this is the sole instance in which the federal income tax classification of a business entity is required or permitted for franchise, excise tax purposes. T.C.A. § 67-4-805(a)(3) requires unitary financial institutions, as defined by T.C.A. § 67-4-804, to file combined franchise, excise tax returns, but such returns would not necessarily include the same business entities included in a combined return for federal income tax purposes.

Corporation A has no business activities in Tennessee and thus, is not subject to Tennessee's franchise, excise taxes.

3. Sub 2 Is Not Doing Business In Tennessee
So As To Be Subject To Tennessee Franchise, Excise Taxes

For many years the Tennessee Department of Revenue has taken the position that a foreign corporate limited partner is not doing business in Tennessee so as to be subject to Tennessee corporate franchise, excise taxes if its activities are limited as follows:

- (1) The corporate limited partner's only business activity in Tennessee is the holding of a limited partnership interest in a partnership(s) with nexus in Tennessee; and
- (2) The corporate limited partner exercises no power, management or control over the partnership(s) except such powers or capacities outlined in T.C.A. § 61-2-302 which limited partners may exercise without participating in the management or control of a partnership.

A foreign corporate limited partner's involvement in a partnership doing business in Tennessee appears to be similar to the interest of a foreign corporation whose only Tennessee activity is that of a stockholder in a corporation doing business in Tennessee. Neither the limited partner nor the stockholder have the right to participate in the management or control of the partnership, or corporation, as the case may be, and thus neither are said to be "doing business" in Tennessee so as to be subject to corporate franchise, excise taxes imposed by T.C.A. §§ 67-4-901 et seq. and 67-4-801 et seq. The Department's policy with regard to this matter considers a foreign corporate limited partner in a partnership having nexus in Tennessee as having only a passive investment in Tennessee just as does a foreign corporate stockholder in a corporation having nexus in Tennessee. Such a passive investment would not create sufficient tax nexus for Tennessee to impose corporate franchise, excise taxes.

Chapter 1092 of the Public Acts of 1998, effective May 19, 1998, adopted the Department's long-standing position with regard to foreign corporate limited partners in partnerships doing business in Tennessee. Section 1 of the Act provides that a business entity shall not be considered "doing business in Tennessee" or "doing business within this state" so as to be subject to Tennessee franchise, excise taxes solely because its:

- (A) Ownership of a limited partnership(s) interest when the activities of such owner are limited as follows:
 - (i) The limited partner's only business activity in Tennessee is the holding of a limited partnership interest in a partnership(s) located in or doing business in Tennessee; and

(ii) The limited partner has no right to exercise any power, management or control over the partnership(s), except such powers or capacities outlined in T.C.A. § 61-2-302 that limited partners may exercise without participating in the management or control of the partnership, and the limited partner, in fact, exercises no such power, management or control over the partnership(s).

Of course, it would be possible for a foreign corporate limited partner in a partnership having nexus in Tennessee to engage in other transactions in Tennessee, either with the limited partnership itself, or with other parties, that would result in sufficient Tennessee minimum contacts to subject it to corporate franchise, excise taxes. For example, such a foreign corporate limited partner that also has a general partnership interest in a partnership with Tennessee nexus, or that has Tennessee activities that are not protected by Title 15 U.S.C.A. §§ 381-384, would be subject to Tennessee franchise, excise taxes. When a foreign corporate limited partner has nexus in Tennessee due to activities other than its limited partnership interest, T.C.A. §§ 67-4-910 and 67-4-811 require inclusion of the foreign corporation's share of partnership property, payroll and sales in its apportionment formula.

Sub 2 is not incorporated in Tennessee and has no Tennessee certificate of authority to transact business or conduct affairs in Tennessee. It is neither legally nor commercially domiciled in Tennessee. Sub 2 states that it is only a passive investor in the Partnership and, as such, does not exercise any power or control over the Partnership and does not participate in the Partnership's management in any way.

Under the facts presented, Sub 2 will not be subject to Tennessee franchise, excise taxes and will not be required to file a franchise, excise tax return. This is true both before and after Chapter 1092 of the Public Acts of 1998 became effective.

Arnold B. Clapp, Senior Tax Counsel

APPROVED: _____
Ruth E. Johnson, Commissioner

DATE: 11-13-98