



# Franchise and Excise Tax Manual

March 2023

## Contents

<b>Chapter 1: Introduction.....</b>	<b>18</b>
History.....	18
Overview.....	18
1. Entities Subject to Franchise & Excise Taxes .....	19
2. Rates and Impositions.....	19
3. Credits.....	20
4. Exemptions .....	20
<b>Chapter 2: Persons Subject to Tax and Exemptions.....</b>	<b>21</b>
Entities Not Subject to Franchise and Excise Tax.....	21
1. Sole Proprietorships .....	21
2. General Partnerships.....	21
3. Not-for-Profits .....	21
4. SMLLC Owned by Pension Trust.....	22
Franchise and Excise Tax Exemptions.....	22
F&E Exemptions Requiring an Evaluation .....	23
1. Venture Capital Fund .....	24
2. Farming/Holding a Personal Residence.....	25
3. Obligated Member Entity (“OME”).....	25
4. Asset-Backed Securitization.....	32
5. Family-Owned Noncorporate Entity (“FONCE”).....	32
6. Diversified Investing Fund.....	35
Taxable Entities.....	35
1. Types of Taxable Entities.....	35
2. Attributes of Taxable Entities.....	37
Entity Formation .....	40
Entity Classification.....	42
1. Classification for Franchise and Excise Tax Purposes.....	42
2. Federal Default Classification .....	42

3. State Classification of SMLLC.....	43
4. Federal Election to be Treated as a Corporation.....	43
Out-of-State Businesses Responding to State Declared Disaster or Emergency .....	44
<b>Chapter 3: Nexus.....</b>	<b>45</b>
Overview.....	45
1. Doing Business in Tennessee.....	45
2. Substantial Nexus.....	47
Entity Specific Nexus .....	49
1. Trucking Companies .....	49
2. Foreign Corporations .....	49
3. Financial Institutions.....	51
Due Process and Commerce Clause.....	53
Nexus-Related Issues .....	54
1. Ownership Interests Do Not Create Nexus .....	54
2. Standard for Nexus and Right to Apportion .....	55
Public Law 86-272.....	56
1. Overview .....	56
2. Unprotected vs. Protected Activities .....	58
<b>Chapter 4: Identifying the Proper Franchise and Excise Taxpayer.....</b>	<b>63</b>
Separate Single-Entity Reporting.....	63
1. Exceptions to Separate Single-Entity Reporting.....	63
2. Tax Implications of Single Filer Returns vs. Consolidated Return.....	64
3. Direct Taxation of Pass-Through Entities.....	64
Disregarded Entities.....	65
1. Corporations Formed Under State Law.....	65
2. Default Classification .....	66
3. Election to be Taxed as a Corporation .....	66
Organizational Structure – Role in an Audit .....	67
1. Pre-Audit Evaluation.....	67

2. Organizational Chart Symbols .....	68
Special Circumstances .....	69
1. Multimember LLC.....	69
2. Series LLCs .....	71
Disregarded Entities – Federal vs. State Rules .....	72
Additional Examples of Complex Disregarded Business Structures .....	75
1. Scenario One .....	75
2. Scenario Two.....	75
3. Revenue Ruling 11-46 – Disregarded Entities and Filing Requirements.....	77
4. Revenue Ruling 11-53 - Disregarded Entities and Filing Requirements.....	80
<b>Chapter 5: Filing Requirements .....</b>	<b>83</b>
Registration.....	83
Electronic Filing .....	83
Filing Period.....	83
1. Annual Returns .....	84
2. Short-Period Returns .....	85
3. Foreign Entities Newly Subject to Franchise and Excise Tax.....	86
Filing Due Dates .....	86
1. Calendar Year, Fiscal Year, and Short-Period Filers .....	86
2. 52-53 Week Filers.....	87
3. Filing Extension.....	87
4. Estimated Assessment .....	88
Change in Ownership - Filing Periods and Due Dates.....	89
Franchise Tax Proration and Annualizing Rents .....	90
1. Proration .....	90
2. Annualizing Rents.....	90
Final Returns.....	92
1. “True” Final Return.....	92
2. Liquidation and Tax Base Calculation.....	93

3. Tax Clearance.....	96
4. Tax Collection.....	98
5. Events Not Resulting in a Final Return.....	98
6. Corporate Reorganizations.....	101
Estimated Tax Payments.....	103
1. Estimated Payment Requirement.....	103
2. Quarterly Estimated Payment Amount.....	104
3. Remitting Payments.....	105
4. Payment Due Dates.....	105
Penalties.....	105
1. Penalties and Penalty Rates.....	106
2. Penalty Waiver.....	108
Interest.....	110
Delinquent Accounts.....	111
Statute of Limitations.....	111
1. Assessments.....	111
2. Refunds.....	111
3. Statute Waivers.....	113
Records Maintenance.....	113
Assessment.....	114
<b>Chapter 6: Federal Income Tax Returns and Filings.....</b>	<b>115</b>
Corporations.....	115
1. Consolidated Group Election, Form 851 & Subsidiary Statements.....	115
2. Capital Loss.....	117
3. Capital Gain Net Income.....	117
4. Dividends and Inclusions.....	118
5. Exempt Interest Income.....	118
6. Other Income.....	118
7. Charitable Contributions.....	118

8. Balance Sheet.....	118
9. Reconciliation of Income (Loss) per Books with Income per Return.....	119
S-corporations .....	119
Corporations Chartered Outside the United States.....	121
Partnerships .....	121
Limited Liability Company (LLC) .....	123
Single Member LLC.....	123
Other Federal Forms .....	123
1. Form 940 .....	123
2. Form 1125-A.....	124
3. Form 4562.....	124
4. Form 4797.....	125
5. Form 6252.....	125
6. Form 7004.....	125
7. Form 8594.....	126
<b>Chapter 7: Federal Income Revisions .....</b>	<b>127</b>
General Discussion .....	127
Statute of Limitations - FIR.....	129
Audit Procedures.....	130
<b>Chapter 8: Business and Nonbusiness Earnings .....</b>	<b>132</b>
Introduction .....	132
1. Allocation Methodology for Nonbusiness Earnings.....	133
2. Audit Adjustments when Nonbusiness Earnings are Reclassified .....	135
Business Earnings.....	135
1. Transactional and Functional Tests .....	136
2. Rule 23 – Business and Nonbusiness Earnings.....	138
Nonbusiness Earnings .....	142
1. Nonbusiness Earnings Examples .....	142
2. Expenses Related to Nonbusiness Earnings .....	143

Tax Impact of Earnings Classification .....	143
Unitary Earnings.....	145
1. Legal Analysis .....	145
2. Example – Nonunitary Business.....	147
Litigation – Unitary Business Principle.....	147
1. Finding: Nonunitary.....	148
2. Finding: Unitary Business Earnings.....	149
Audit Procedures.....	150
<b>Chapter 9: Franchise Tax .....</b>	<b>152</b>
Overview.....	152
1. Who Must File?.....	152
2. Minimum Franchise Tax .....	152
3. Franchise Tax Base .....	153
4. Minimum Measure (Schedule G) .....	153
5. Cap on Manufacturer’s Franchise Tax Base.....	153
6. GAAP Books and Records.....	154
Non-Consolidated Net Worth – Schedule F1 .....	155
1. Net Worth.....	155
2. Affiliated Indebtedness .....	158
3. Net Worth Apportionment .....	164
Consolidated Net Worth – Schedule F2.....	164
1. Overview .....	164
2. Affiliated Group Members.....	165
3. Consolidated Net Worth Computation.....	168
4. Apportionment of Consolidated Net Worth.....	173
5. Verifying Affiliated Group Members.....	181
6. Other Issues .....	189
7. Audit Procedures .....	190
<b>Chapter 10: Property Valuation.....</b>	<b>195</b>

Overview.....	195
1. Property Included.....	195
2. Property Excluded.....	196
3. Property Exempted.....	197
Property Owned.....	197
1. Land and Buildings .....	198
2. Leasehold Improvements .....	198
3. Depreciable Property.....	199
4. Prepaid Supplies .....	201
5. Inventory .....	202
6. Construction in Progress.....	203
7. Exempt Certified Pollution Control Equipment.....	209
8. Exempt Certified Green Energy Production Facility.....	209
9. Exempt Required Capital Investment.....	210
10. Federal Repair Regulations.....	211
Property Rented or Leased.....	213
1. Property Multiples.....	213
2. Sub-Rents.....	214
3. “In Lieu” of Rents .....	217
4. Rents that Include a Service.....	218
5. Distinguishing Between Leases and Licenses .....	220
6. Annualize Rent in Short Period .....	223
7. Termination Fees, Renewals, and Software Fees.....	224
8. Common Lease Terms.....	225
9. Operating and Finance Leases .....	228
10. Industrial Development Corporation.....	234
Ownership in a General Partnership.....	234
1. Owned Property Held by a General Partnership.....	235
2. Property Leased by a General Partnership.....	236



3. Audit – Ownership of a General Partnership.....	237
Ownership in a Pass-through Entity Not Subject to the Tax.....	238
Property Used and Neither Owned nor Rented.....	238
<b>Chapter 11: Excise Tax.....</b>	<b>240</b>
Overview.....	240
Recent Form Changes.....	242
Schedule J1 – Partnerships.....	242
1. Addition – Ordinary Income (Loss) from Form 1065.....	242
2. Addition – Income Items Specifically Allocated to Partners, Including Guaranteed Payments.....	242
3. Addition – Any Net Loss or Expense Distributed to a Publicly Traded REIT.....	245
4. Deduction – Expense Items Specifically Allocated to Partners .....	245
5. Deduction – Amount Subject to Self-employment Taxes Distributable or Paid to Each Partner or Member .....	246
6. Deduction – Amount of Contribution, Not Previously Deducted, to Qualified Pension or Benefit Plans of any Partner or Member, Including all I.R.C. 401 Plans .....	250
7. Deduction – Any Loss on the Sale of an Asset Sold within 12 Months after the Date of Distribution.....	251
Schedule J2 – Single-Member LLC Filing as Individual .....	252
1. Addition – Net Profit or Loss .....	252
2. Addition – Capital Gains or Losses.....	252
3. Addition – Rental Real Estate and Royalty Income or Loss .....	253
4. Addition – Profit or Loss from Farming .....	253
5. Addition – Ordinary Gain or Loss – Depreciable Property .....	254
6. Deduction – Amount Subject to Self-Employment Taxes Distributable or Paid to the Single Member .....	254
Schedule J3 – Subchapter S-Corporations.....	254
1. Addition/Deduction – Income and Expense Items as if no “S” Election .....	254
2. Deduction – Any Loss on the Sale of an Asset Sold within 12 Months after the Date of Distribution.....	255
Schedule J4 – Corporations and Other Entities.....	255

1. REIT Taxable Income.....	256
2. Unrelated Business Taxable Income (Not-for-Profits).....	256
3. Addition/Deduction – Charitable Contributions .....	257
4. Addition – Capital Gains Offset by Capital Losses.....	258
5. Deduction – Capital Losses Limited at Federal Level .....	259
Schedule J – Computation of Net Earnings Subject to Excise Tax (All Entity Types).....	261
1. Schedule J, Line 1 – Federal Income (Loss) .....	261
2. Addition – Intangible Expense .....	262
3. Addition – Bonus Depreciation.....	264
4. Addition – Gain on the Sale of a Distributed Asset.....	270
5. Addition – Tennessee Excise Tax Deducted on Federal Return .....	273
6. Addition – Gross Premiums Tax.....	274
7. Addition – Interest Income of States and Political Subdivisions .....	274
8. Addition – Depletion.....	276
9. Addition – Excess Fair Market Value over Book Value of Property Donated.....	278
10. Addition – Excess Rent to/from an Affiliate.....	279
11. Addition – Net Loss or Expense Received from a Pass-through Entity Subject to the Excise Tax .....	280
12. Addition – Amount Equal to Five Percent of IRC Section 951A Global Intangible Low- Taxed Income (GILTI).....	283
13. Addition – Business Interest Expense Addback.....	284
14. Addition – Research & Development Expenditures (IRC §174).....	285
15. Total Additions .....	285
16. Deduction – Permitted Depreciation.....	285
17. Deduction – Excess Gain/Loss on Asset with Bonus Depreciation.....	285
18. Deduction – Dividends Received from 80%-owned Corporations .....	286
19. Deduction – Donations to Qualified Public School Support Groups and Nonprofit Organizations .....	287
20. Deduction – Federal Expense Reduction Related to Federal Credit.....	288
21. Deduction – Safe Harbor Lease.....	290

22.	Deduction – Nonbusiness Earnings.....	291
23.	Deduction – Intangible Expense Paid to an Affiliate.....	291
24.	Deduction – Intangible Income from Affiliate.....	292
25.	Deduction – Net Gain or Income Received from a Pass-through Entity Subject to the Excise Tax.....	293
26.	Deduction – Deductible Grants from Governmental Units.....	293
27.	Deduction – IRC Section 951A Global Intangible Low-Taxed Income.....	294
28.	Deduction – Business Interest Expense Deduction.....	294
29.	Deduction – Research & Development Expenditures (IRC §174).....	296
30.	Calculated Amounts.....	296
	Ownership of a Pass-through Entity.....	296
	Tax Cuts and Jobs Act of 2017 (TCJA).....	297
1.	Business Interest Expense Limitation.....	298
2.	State Grants.....	299
3.	Repatriated Earnings (2017).....	299
4.	Repatriated Earnings and Global Intangible Low-Taxed Income (GILTI) – Tax Years Beginning on or after January 1, 2018.....	300
5.	Qualified Opportunity Zones & Funds.....	303
6.	Research & Development Expenditures (IRC §174).....	304
	M-3 and M-1 Federal Schedules.....	305
1.	Schedule M-3.....	305
2.	Chart of Schedule J4, J Adjustments.....	308
	Like-Kind Exchanges.....	309
1.	Overview.....	309
2.	Federal Tax Mechanics.....	310
3.	Excise Tax Implications.....	317
4.	Apportionment Implications.....	319
5.	Franchise Tax Implications.....	321
6.	Appendix (Like-Kind Exchanges) – Federal Forms and Schedules.....	322
	<b>Chapter 12: Net Operating Losses.....</b>	<b>332</b>

Schedule K – Loss Carryover .....	332
Schedule U – Loss Carryover.....	332
Audit Adjustments to Carryover Schedules.....	333
Survivability of NOLs .....	335
1. Successors and “Shell” Entities .....	335
2. Unitary Groups of Financial Institutions .....	336
3. Conversion from Corporation to SMLLC Owned by Non-Shell Parent Corporation.....	336
4. “F” Reorganization – U.S.C. §368(a)(1)(F).....	336
5. Dissolution of Affiliate.....	337
6. Loss Generated by Taxpayer Making an Entity Election .....	337
7. “338(h)(10)” Election Deemed Existence of Two Corporations .....	337
Audit Procedures – Loss Carryovers.....	338
<b>Chapter 13: Discharge of Indebtedness Income .....</b>	<b>339</b>
Summary.....	339
Example – Discharge of Debt.....	339
Report of Bankruptcy Discharge (Chapter 11) .....	340
Federal Treatment (Chapter 11).....	341
GAAP Accounting Treatment (Chapter 11).....	342
Audit Procedures – Discharge of Indebtedness.....	343
<b>Chapter 14: Apportionment.....</b>	<b>344</b>
Introduction to Tax Apportionment.....	344
1. Allocation (Nonbusiness Earnings) Versus Apportionment (Business Earnings) .....	344
2. Right to Apportion.....	345
3. Public Law 86-272 .....	345
Forms – Apportionment .....	346
Apportionment Ratio Calculation.....	347
1. Standard Apportionment – Schedule N.....	347
2. Elective Apportionment for Certain Taxpayers.....	348
3. Consolidated Net Worth Apportionment .....	352

Pass-through Entity Ownership.....	352
Standard Apportionment Factors - Property, Payroll, and Sales .....	354
1. Property Factor.....	355
2. Payroll Factor .....	361
3. Sales Factor.....	375
Variations from the Standard Apportionment Formula .....	428
Special Apportionment for Common Carriers.....	429
1. Schedule O – Apportionment – Common Carriers .....	430
2. Schedule P – Apportionment – Air Carriers.....	432
3. Schedule R – Apportionment – Air Express Carriers .....	432
Apportionment Examples .....	432
1. Example - Standard Apportionment - Franchise and Excise Tax for ABC, LLC.....	434
2. Example – Franchise Tax Consolidated Net Worth Apportionment - ABC, Inc.....	436
3. Example – Consolidated Net Worth and Single Sales Factor Elections.....	438
4. Example – Manufacturer Single Sales Factor Apportionment .....	440
<b>Chapter 15: Credits and Overpayments .....</b>	<b>442</b>
Tax Credits .....	442
1. Gross Premiums Tax Credit.....	443
2. Tennessee (Hall) Income Tax Credit (Through 2021) .....	444
3. Brownfield Tax Credit .....	444
4. Broadband Internet Access Equipment [Repealed 7/1/2019] .....	446
5. Industrial Machinery.....	447
6. Qualified Production Credit .....	454
Financial Institution Tax Credits .....	456
Overpayment Credits .....	456
<b>Chapter 16: Job Tax Credit .....</b>	<b>457</b>
Job Tax Credit Overview .....	457
Terms Defined by Statute .....	458
1. Qualified Business Enterprise.....	458

2. Required Capital Investment.....	459
3. Enhancement County.....	460
4. Qualified Job .....	461
5. Investment Period.....	464
Net Increase in Qualified Jobs during the Investment Period.....	466
Standard JTC.....	468
1. Table of Standard JTC - Jobs, Years & Tiers .....	468
2. Business Plan and Recommended Documentation .....	470
3. When Credit May Be Claimed, Offset Limits, and Carryover.....	473
Additional Annual Job Tax Credits .....	474
1. Tier 2, Tier 3, or Tier 4 Enhancement Counties.....	474
2. Higher Level of Investment and Job Creation.....	475
3. Adventure Tourism Zone.....	478
Persons with Disabilities .....	480
Community Resurgence JTC.....	481
Wage Rate Requirements .....	482
Common Law Employer.....	482
Order of Use – One-time Credits and Credits with Carryovers .....	483
Tax Planning .....	484
1. Investment Period.....	484
2. Credit Selection: Enhancement County or HLIJC Additional Annual Credit.....	484
Survival of Credits in Reorganizations and Unitary Group Carryover Issues.....	485
1. Corporation Becomes SMLLC Disregarded to Parent.....	485
2. Merger .....	485
3. Taxpayer Sells its Disregarded SMLLC that Created the JTC.....	485
4. Unitary Group of Financial Institutions .....	485
Audit Documentation.....	485
1. Retained Documents and Workpaper Organization .....	487
2. Auditor’s Authority to Request Additional Information .....	489

3. Audit Summary Report and Sample Language.....	490
Audit Procedures.....	494
1. Preliminary Audit Research.....	495
2. Business Plan Review.....	495
3. Identifying the Common Law Employer .....	496
4. Qualified Business Enterprise.....	496
5. Required Capital Investment.....	497
6. Position Increase.....	500
7. JTC Credit Carryover .....	505
8. Tier Minimums – Job Creation.....	506
9. Additional Annual Credits .....	506
<b>Chapter 17: Real Estate Investment Trusts.....</b>	<b>507</b>
What is a Real Estate Investment Trust? .....	507
REIT Requirements .....	508
REIT Structure.....	509
1. Qualified REIT Subsidiary.....	509
2. Taxable REIT Subsidiary.....	509
3. Lower-tier LPs and LLCs.....	509
REIT Types.....	509
1. Publicly-Traded REIT .....	510
2. Private REIT.....	510
3. Captive REIT .....	510
4. Captive REIT Affiliated Group .....	510
5. Chart of REIT Types and F&E Implications .....	511
REIT Audit .....	512
1. REIT.....	513
2. Captive REIT .....	514
3. Qualified REIT Subsidiary.....	515
4. Taxable REIT Subsidiary.....	516

5. LPs and LLCs.....	516
REIT Examples.....	518
1. Publicly Traded REIT A.....	518
2. Publicly Traded REIT B.....	518
3. Non-Public REIT .....	519
<b>Chapter 18: Financial Institutions.....</b>	<b>520</b>
Overview of Financial Institution Taxation.....	520
Financial Institution Defined.....	522
1. Holding Company.....	522
2. Regulated Financial Corporation.....	523
3. Subsidiary of a Holding Company or Regulated Financial Corporation .....	525
4. An Investment Entity that is <i>Indirectly</i> More Than 50% Owned by A Holding Company or Regulated Financial Corporation.....	525
5. An Entity Carrying on the Business of a Financial Institution .....	526
Doing Business.....	527
Unitary Group.....	530
1. Captive Real Estate Investment Trust Affiliated Group .....	531
2. Exempt Unitary Entities and Apportionment .....	531
3. Disclosure Requirement for Financial Institutions.....	532
Combined Basis.....	532
1. Joint Liability .....	533
2. FI Unitary Group versus GAAP Consolidated Group .....	534
3. Unitary Group - Federal Form 851.....	534
Franchise Tax Net Worth Tax Base .....	536
1. Schedule F – Non-Consolidated Net Worth .....	536
2. Schedule F2 – Consolidated Net Worth.....	543
3. Schedule F1 – Captive REIT Net Worth.....	545
Franchise Tax Real and Tangible Property Tax Base.....	547
Unitary Members with Short Periods.....	547



Excise Tax.....	548
1. Captive REIT Affiliated Group.....	549
2. Excise Tax Apportionment – Schedule SE .....	549
3. Loss Carryovers.....	552
Credits Available to Financial Institutions.....	553
1. Affordable Housing (Community Investment Credit).....	553
2. Community Development Financial Institutions (Community Investment Credit).....	559
3. Rural Opportunity Fund & Small Business Opportunity Fund Credits .....	560
4. Job Tax Credit.....	561
Credit Carryover.....	561
Audit Procedures.....	561
1. Gather Data.....	562
2. Determine the Unitary Group and CNW Affiliated Group.....	564
3. Filing Period .....	566
4. Verify Data.....	566
Examples of Common Audit Findings .....	567

## Chapter 1: Introduction

### History

Since the enactment of the Tennessee Corporate Excise Tax (“excise tax”) in 1923, and the Tennessee Franchise Tax (“franchise tax”) in 1937, businesses operating for-profit have been subject to tax for the privilege of doing business or exercising the corporate franchise in Tennessee. The imposition of the excise tax was first upheld by the Tennessee Supreme Court in 1924 in *Bank of Commerce & Trust Co. v. Senter*.<sup>1</sup> The imposition of the franchise tax was first upheld by the Tennessee Supreme Court in the 1936 case of *Corn v. Fort*.<sup>2</sup>

Initially, franchise and excise tax was levied solely upon the privilege of engaging in business in the corporate form.<sup>3</sup> In 1999, the Tennessee General Assembly passed the Tax Revision and Reform Act that broadened the scope of the franchise and excise tax to all “persons” doing business in Tennessee, including pass-through entities such as limited liability companies (“LLC”) and limited partnerships (“LP”).<sup>4</sup> In 2015, the Tennessee General Assembly made another significant update to franchise and excise tax law when it passed the Revenue Modernization Act, which made significant changes to the state’s nexus provisions.

Current excise tax laws are found in Tenn. Code Ann. §§ 67-4-2001 *et seq.*, and franchise tax laws are found in Tenn. Code Ann. §§ 67-4-2101 *et seq.* Rules and regulations can be found at TENN. COMP. R. & REGS. 1320-06-01-.01 *et seq.* or online under the Tax Resources page on the Department’s website.<sup>5</sup>

### Overview

Franchise and excise tax is imposed on entities that operate in Tennessee and offer their owners limited liability protection. In-state and out-of-state entities can both be subject to franchise and excise tax.<sup>6</sup> These taxes are accrued taxes imposed on the privilege of doing business in this state or by exercising the corporate franchise.<sup>7</sup> Both taxes are solely for state purposes and no county, municipality, or local taxing district has the power to levy similar taxes.<sup>8</sup>

Although the franchise and excise taxes are two separate taxes and are computed separately, the Department of Revenue (the “Department”) administers both taxes together under a singular tax structure. Taxpayers must file both taxes on one return, [Form FAE170](#).<sup>9</sup> The return is filed on an annual basis, concurrent with each federal return filing period.

## 1. Entities Subject to Franchise & Excise Taxes

For franchise and excise tax purposes, each taxpayer is considered a separate and single business entity and must file individual tax returns. Entities other than unitary groups of financial institutions and captive real estate investment trust (“REIT”) affiliated groups are not permitted to file a consolidated or combined franchise and excise return.<sup>10</sup> Unitary groups of financial institutions and captive REIT affiliated groups are required to file [Form FAE174](#).

General partnerships and sole proprietors are not subject to franchise and excise tax because they do not offer their owners limited liability protection.<sup>11</sup> Not-for-profit entities are not generally subject to franchise and excise tax.<sup>12</sup>

Businesses disregarded for federal income tax purposes are not disregarded for franchise and excise tax purposes except for LLCs whose single member is a corporation (“SMLLC”).<sup>13</sup> Additionally, a taxable business that is inactive or has had its charter or other registration forfeited, revoked, or suspended, but has not been dissolved or otherwise properly terminated with the Tennessee Secretary of State, is not relieved from filing a return and paying the minimum franchise tax.<sup>14</sup>

## 2. Rates and Impositions

### *Franchise Tax*

Franchise tax is based on the greater of the taxpayer’s net worth or the book value of real or tangible personal property owned or used in Tennessee, based upon values determined at the end of the taxable period.<sup>15</sup>

- The franchise tax rate is 25 cents per \$100, or .25% of a taxpayer’s net worth at the close of the tax year covered by the required return.
- The minimum franchise tax payable each year is \$100.<sup>16</sup>

### *Excise Tax*

Excise tax is based on the taxpayer’s net earnings or net loss for the taxable year.<sup>17</sup> “Net earnings” or “net loss” is defined as a taxpayer’s federal taxable income or loss before the operating loss deduction and special deductions,<sup>18</sup> with certain adjustments that are required under Tennessee excise tax law.<sup>19</sup>

- Tennessee imposes a 6.5% corporate excise tax on the fiscal year net earnings of all persons engaged in business in Tennessee except nonprofit entities, entities otherwise specifically exempt, and businesses not subject to excise tax, such as sole proprietors.<sup>20</sup> This rate was set in 2002 by the Tennessee General Assembly.<sup>21, 22</sup>

### 3. Credits

Credits offset tax liability. Depending on the type of credit and the year, a credit may offset both franchise and excise tax or it may offset just one of the taxes. Unused tax credit may or may not be allowed to offset future tax. While the tax code does not specify the order in which to apply credits, the Department applies credits that do not have a carryover provision first. Franchise and excise tax credits that are currently in effect are found in Tenn. Code Ann. §§ 67-4-2009, 67-4-2109. (Please see Chapter 15 for more information on Credits.)

### 4. Exemptions

There are seventeen types of exemptions available to entities which will be explained in detail in this publication.<sup>23</sup> Filing requirements differ based on the exemption type. Two of the most common exemptions are Family-Owned Non-Corporate Entities (“FONCE”) and Obligated Member Entities (“OME”). (Please see Chapter 2 for more information on Exempt Entities.)

## Chapter 2: Persons Subject to Tax and Exemptions

One of the most important steps in determining if a business is subject to franchise and excise tax is determining if the business operates as a taxable entity. Some businesses, such as those that operate as a sole proprietor, are not subject to franchise and excise tax. While other businesses, such as those that operate as a corporation, are generally subject to franchise and excise tax. This chapter provides an overview of the most common entity types and exemptions that apply to otherwise taxable entities.

### Entities Not Subject to Franchise and Excise Tax

#### 1. Sole Proprietorships

Sole proprietorships are not subject to franchise and excise tax because they do not provide their owners limited liability protection. Sole proprietorships report their business activity on federal Form 1040, Schedules C, E, or F.

#### 2. General Partnerships

General partnership (“GP”) is defined by Tenn. Code Ann. § 67-4-2004(19) as a “partnership in which all partners, as defined by state law, are fully liable for the debts of, or the claims against, the partnership.” GPs are not subject to franchise and excise tax because they do not provide their owners limited liability protection. GPs file on federal Form 1065. A GP can usually be identified by its name (the GP’s name would not include “LP” or “LLC”), and it would identify as a GP on Form 1065, Schedule B.

While GPs are not taxable entities, if a taxable entity is a partner in a GP, then the activities of the GP that pass through to that GP partner on federal Schedule K-1 are taxable to that GP partner for franchise and excise tax purposes.<sup>24</sup>

#### 3. Not-for-Profits

Not-for-profit is defined in Tenn. Code Ann. § 67-4-2004(34) and refers to numerous federal classifications of exemptions, the most common being an entity described in Internal Revenue Code § 501. Not-for-profits are generally not subject to franchise and excise tax. They file an information return, Form 990, for federal income tax purposes. However, a not-for-profit entity that has earnings from activities outside the scope of the activities that give it its exempt status *is* subject to federal and franchise and excise taxes. The not-for-profit’s unrelated business taxable income is reported on federal Form 990-T<sup>25</sup> and is subject to the excise tax. A not-for-

profit entity is also subject to the franchise tax on the greater of its net worth or real and tangible property owned or used in the state that is attributable to any activities that are unrelated to, and outside the scope of, the activities that give the not-for-profit its exempt status.

#### **4. SMLLC Owned by Pension Trust**

If a single-member limited liability company (“SMLLC”) is wholly-owned by a pension trust, which is a not-for-profit entity, the SMLLC is disregarded to the pension trust for federal income tax purposes. The SMLLC is also disregarded for franchise and excise tax purposes, and its earnings are considered to be net earnings of the pension trust. The combined net earnings of the pension trust and the SMLLC are not subject to franchise and excise tax unless the earnings constitute unrelated business taxable income.<sup>26</sup>

### **Franchise and Excise Tax Exemptions**

There are 17 types of exemptions available to entities that would otherwise be subject to franchise and excise tax. The following exemptions apply to both the franchise and excise taxes. If a taxpayer fails to meet the requirements for the exemption at any time during the taxable period, the taxpayer loses the exemption for the entire taxable period. The complete list of franchise and excise tax exemptions and requirements can be found in Tenn. Code Ann. § 67-4-2008. The exemptions are as follows:

- Industrial development corporations
- Masonic lodges and similar lodges
- Regulated investment companies whose investments consist of at least 75% U.S., state or local bonds
- Federal and state credit unions
- Venture capital funds\*
- Farming or the holding of a personal residence\*
- LLCs, LLPs, LPs, or business trusts that acquire receivables from an affiliate that reports the income in Tennessee\*
- LPs or LLCs that provide affordable housing and receive low-income housing credits<sup>27\*</sup>

- Obligated member entities\*
- Partnerships, trusts, REMICs, and FASITs that have asset-backed securities of debt obligations<sup>28\*</sup>
- Family-owned noncorporate entities\*
- Diversified investing funds\*
- Tennessee historic property preservation entities
- Insurance companies
- TNInvestco entities that receive investment credits under the Tennessee Small Business Investment Company Credit Act<sup>29</sup>
- Any entity that is owned, in whole or in part, by the United States armed forces and derives more than 50% of its gross income from operating facilities which are located on property owned or leased by the federal government and operated primarily for the benefit of members of the United States armed forces\*
- Qualified low-income community historic structure owners or lessees\*

\* An entity claiming this exemption must file an Application for Exemption/Annual Exemption Renewal (Form FAE183) for the initial and subsequent taxable periods for which the entity is claiming the exemption. This form is due on or before the 15<sup>th</sup> day of the fourth month following the close of the entity's taxable period. The Department will grant an extension of time of seven months in which to file the form if the entity makes a valid extension request.<sup>30</sup> While failure to timely file the form will not preclude the entity from qualifying for the exemption, the Department may assess the entity a penalty of \$200, per occurrence, for late filing.

## **F&E Exemptions Requiring an Evaluation**

Of the 17 exemptions listed above, there are six that might require an evaluation by the Audit Division to verify the taxpayer's eligibility. These exemptions include: 1) venture capital fund, 2) farming/holding a personal residence, 3) obligated member entity, 4) entities created for asset-back securitization of debt obligations, 5) family-owned noncorporate entity, and 6) diversified investing fund. The Department may request documents such as federal tax returns (including all forms and schedules), articles of organization, or partnership agreements (to determine an entity's business purpose) when evaluating an entity's eligibility for exemption. An overview of the requirements for each of these exemptions is listed below.

**⚠ Entity Classification for F&E Exemption Purposes:**

**If an entity is organized under the laws of this state (or another state) as a type of entity that is eligible for an F&E exemption, under Tenn. Code Ann. § 67-4-2008, the entity may qualify for the F&E exemption regardless of how it is classified for federal income tax purposes.\*\***

**For example: The obligated member entity (“OME”) exemption is available to LLCs, LPs, or LLPs. An entity is organized as an LLC, but it elects to be taxed as a corporation for federal income tax purposes. The LLC may claim the OME exemption regardless of its federal election to be taxed as a corporation.**

**\*\*One exception to this general rule is the Asset-Backed Securitization exemption under Tenn. Code Ann. § 67-4-2008(a)(10). This exemption looks to an entity’s classification for federal income tax purposes.**

## **1. Venture Capital Fund**

- Entity must be an LLC, LLP, LP, or a business trust.
- Entity is operated for the exclusive purpose of buying, holding, and/or selling securities and over 50% of the securities are in non-publicly traded companies.
  - To determine whether over 50% of the entity’s securities are in non-publicly traded companies, the entity should compare the historical cost (the original cost to acquire the asset) of the securities held in non-publicly traded companies to the historical cost of all securities held by the entity, as of the end of the tax year to which the exemption will apply.
  - The entity will satisfy this exemption requirement if over 50% of the total historical cost of its securities is comprised of securities held in non-publicly traded companies.
- Entity buys, holds, and/or sells securities on its own behalf and not as a broker.
- Over 50% of the fund’s capital is derived from investments by entities and/or individuals neither related to nor affiliated with the fund.



- An investment made in the fund by an affiliated entity that also qualifies for the venture capital fund exemption will also count toward this funding requirement.

## 2. Farming/Holding a Personal Residence<sup>31</sup>

- Entity must be an LLC, LP, or LLP.
- At least 66.67% of the entity's activity is in farming and 66.67% of its assets are used by the owner or the owner's lessee for farming, or at least 66.67% of the entity's activity is the holding of one or more personal residences where one or more of the members/partners reside.
- At least 95% of the voting rights, capital interests, or profits are owned by natural persons who are relatives or by trusts for their benefit.
- Entity must complete a Disclosure of Activity form, which is due with its Application for Exemption and each Annual Exemption Renewal, to inform the Department of the entity's activities relating to the exemption.

**⚠ It is imperative that the taxpayer complete the Disclosure of Activity form in its entirety, including all pertinent addresses and the county in which the assets are located.**

## 3. Obligated Member Entity ("OME")

- The entity must be an LP, LLP, or LLC.<sup>32</sup>
- All members or partners (direct owners) of the entity must become "obligated members" by making an election to be fully liable for the debts, obligations, and liabilities of the entity.
  - An "obligated member" is a member or partner of an obligated member entity that is fully liable for the debts, obligations, and liabilities of the entity, as provided in Tenn. Code Ann. § 67-4-2008(b)-(d), and that has filed appropriate documentation to that effect with the Tennessee Secretary of State.<sup>33</sup>
  - An eligible entity (i.e., an LP, LLP, or LLC) will qualify for the franchise and excise tax OME exemption only if **ALL** of its members or partners (direct owners) make

an election to be fully liable for the debts, obligations, and liabilities of the entity, in accordance with Tenn. Code Ann. § 67-4-2008(b)-(d), and file appropriate documentation to that effect with the Tennessee Secretary of State.<sup>34</sup> If one or more of the entity's members or partners do not make such election and do not file the appropriate documentation with the Tennessee Secretary of State, the entity's franchise and excise tax OME exemption will be invalid.

- If some, but not all, of the members or partners of an entity that is seeking the OME exemption elect to be fully liable for the debts, obligations, and liabilities of the entity, in accordance with Tenn. Code Ann. § 67-4-2008(b)-(d), the entity cannot apply the OME exemption on a proportional basis, based on the members or partners of the entity who make such election.
  - For example, ABC, LP is a limited partnership that has four partners – a corporation (a general partner) and three individuals (all of whom are limited partners). ABC, LP would like to become an obligated member entity; however, one of the individual limited partners does not want to waive the limited liability protection that is provided by ABC, LP. Unless all of ABC, LP's partners elect to waive the limited liability protection that is provided by this limited partnership, in accordance with Tenn. Code Ann. § 67-4-2008(b), ABC, LP will not qualify for the franchise and excise tax OME exemption. The OME exemption cannot be prorated so as to apply to ABC, LP to the extent that its other three partners elect to waive the limited liability protection afforded by ABC, LP.
- An otherwise exempt OME will be subject to franchise and excise tax to the extent any obligated member, or any owner of an obligated member, of the OME is a type of entity that provides limited liability protection.<sup>35</sup> The information needed to compute the franchise and excise tax liability is generally found on the OME's federal Schedule(s) K-1. For example:
  - XYZ, LLC ("XYZ") has two members who are individuals, A and B. XYZ qualifies as an obligated member entity because A and B have filed documentation with the Tennessee Secretary of State to make them fully liable for the debts, obligations, and liabilities of XYZ. Generally, the corporate, LP, and LLC forms of entity organization shield the entity's owners from being subject to the entity's debts, obligations, and liabilities; however, in this example, A and B have given up this limited liability protection by becoming obligated members. As A and B are both individuals, there are no additional, indirect ownership interests to consider with

respect to XYZ. OMEs that are directly and solely owned by individuals do not have indirect ownership interests to consider, and such OMEs will always be fully exempt from the franchise and excise tax.<sup>36</sup>

- Consider the same facts as in the above example, except that Member A is an individual and Member B is a corporation with shareholders of its own. As stated above, generally, corporations provide their owners with limited liability protection and shield them from liabilities of the corporation. This remains true even though Member B has agreed to be an obligated member of XYZ, LLC. When one or more of the obligated members of an OME is a type of entity that confers limited liability protection upon its owners, then the OME will only be partially exempt<sup>37</sup> from the franchise and excise tax. In this case, the franchise and excise tax liability is computed based on the information reported on B's federal Schedule K-1 received from XYZ. Specifically, the values shown on B's federal Sch. K-1, Part III, Lines 1-13, are reported on Schedule J1 of XYZ's Tennessee excise tax return. In addition, the equity of XYZ (including the portion of XYZ's real and tangible property owned or used in Tennessee) attributable to Member B is subject to the franchise tax. In this example, XYZ's equity (net worth), as reported under generally accepted accounting principles, is \$100,000. XYZ owns land, buildings, and equipment located in Tennessee that have a combined book value of \$400,000. Member B's ending capital percentage reported on Sch. K-1, Part II, Item J, is 50%. (This is the percentage share of the capital that Member B would receive if XYZ was liquidated by means of the distribution of undivided interests in XYZ's assets and liabilities.) The net worth reported on XYZ's franchise tax return Sch. F1, Line 1, is \$50,000 (\$100,000 x 50%). XYZ will report a total of \$200,000 on Sch. G (\$400,000 x 50%).
- QRS, LP ("QRS") is owned directly and indirectly by several entities, as follows: QRS is directly owned 50% by Individual P (the limited partner) and 50% by General Partnership X (the general partner), and it is indirectly owned by Individual S and Corporation Y, which directly own 75% and 25%, respectively, of General Partnership X. QRS' direct owners, Individual P and General Partnership X, are both obligated members that have elected to be fully liable for the debts, obligations, and liabilities of QRS. However, because one of QRS' indirect owners, Corporation Y, is a type of entity that provides its owners with limited liability protection, QRS is a partially exempt OME. QRS will be subject to the franchise and excise tax based on the 50% portion of its net worth and net earnings attributable to obligated member General Partnership X.

- Note: In the above example, the indirect owners of QRS – Individual S and Corporation Y – are not required to become obligated members of QRS in order for QRS to qualify as an exempt OME for franchise and excise tax purposes; only the direct owners of QRS must become obligated members. In addition, although Corporation Y only has an indirect economic ownership interest of 12.5% in QRS (Corporation Y's 25% ownership interest in General Partnership X multiplied by General Partnership X's 50% ownership interest in QRS), QRS will owe franchise and excise tax based on the 50% portion of its income and equity attributable to the *obligated member* in which Corporation Y has an ownership interest, which is General Partnership X.<sup>38</sup> QRS does not look through to the 12.5% indirect economic ownership interest held by Corporation Y in determining QRS' franchise and excise tax liability.

**⚠ An obligated member entity whose direct and indirect owners are individuals or entities that do not offer limited liability protection (e.g., a general partnership) will be fully exempt from the franchise and excise tax. An OME that has one or more direct or indirect owners that provide limited liability protection (e.g., a corporation, LLC, or LP) will only be partially exempt from the tax, as explained above.**

- For the purpose of evaluating an OME's partially-exempt status, *estates, trusts that are not taxpayers, not-for-profit entities, or other entities that are exempt from the franchise and excise tax*, are not deemed to provide limited liability protection. Nevertheless, as members or partners of an entity seeking the OME exemption, these entities must still follow the same procedures<sup>39</sup> to renounce their limited liability protection, with respect to the entity seeking the OME exemption, with the Tennessee Secretary of State in order for the exemption-seeking entity to qualify as an obligated member entity.
  - Even in situations where one or more of an OME's obligated members (direct owners) is not deemed to provide limited liability protection, pursuant to Tenn. Code Ann. § 67-4-2008(a)(9)(D), the OME must continue to evaluate whether any owners (indirect owners) of such exempt obligated members provide limited liability protection. If so, then the OME will only be partially-exempt from franchise and excise taxes.
- A partially-exempt OME will file both an Annual Exemption Renewal (Form FAE 183) and a franchise and excise tax return (Form FAE170) for the taxable period.

- The entity must file the required documentation, as detailed at Tenn. Code Ann. § 67-4-2008(b)-(d), with the Tennessee Secretary of State to be eligible for this exemption and must provide a copy of such documentation to the Department when applying for this exemption.
  - The OME must file the required documentation on or before the first day of the taxable period for which the exemption applies.
  - If the OME files the required documentation after the first day of the taxable period, the exemption will not become effective until the following taxable period. **The exemption may not be prorated.**

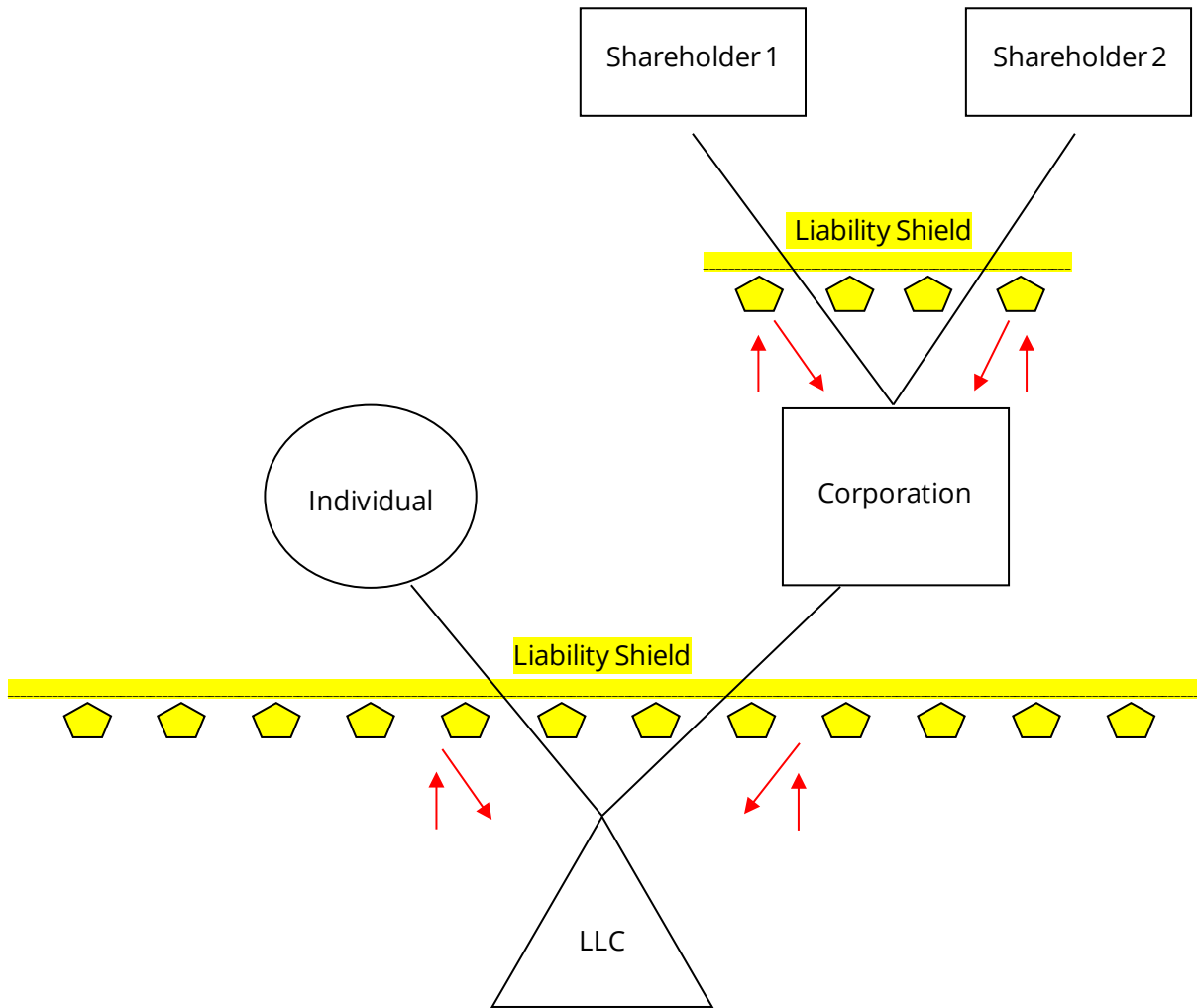
**⚠ Audit Tip: Auditors should not rely solely on the information provided through the Tennessee Secretary of State's online Business Information Search to confirm that an entity qualifies for the OME exemption. The auditor may request copies of the entity's corporate filings from the Division of Business Services of the Tennessee Secretary of State to verify that all the entity's members or partners have elected to be obligated members.**

**The auditor may also request from the taxpayer a copy of its federal Form 1065, including all Schedules K-1 issued, in order to identify all direct owners of the entity and to verify that all such owners have elected to be obligated members, as indicated by a review of the entity's corporate filings.**

**If, upon reviewing the Schedules K-1 issued by the taxpayer, the auditor finds that one or more of the entity's owners is a general partnership, then additional audit work should be performed to determine whether any of the owners of the general partnership(s) are a type of entity that provides limited liability protection, which would result in the OME being partially exempt.**

- The following charts show how the flow of limited liability protection is affected before and after an LLC with direct and indirect ownership interests becomes an OME.

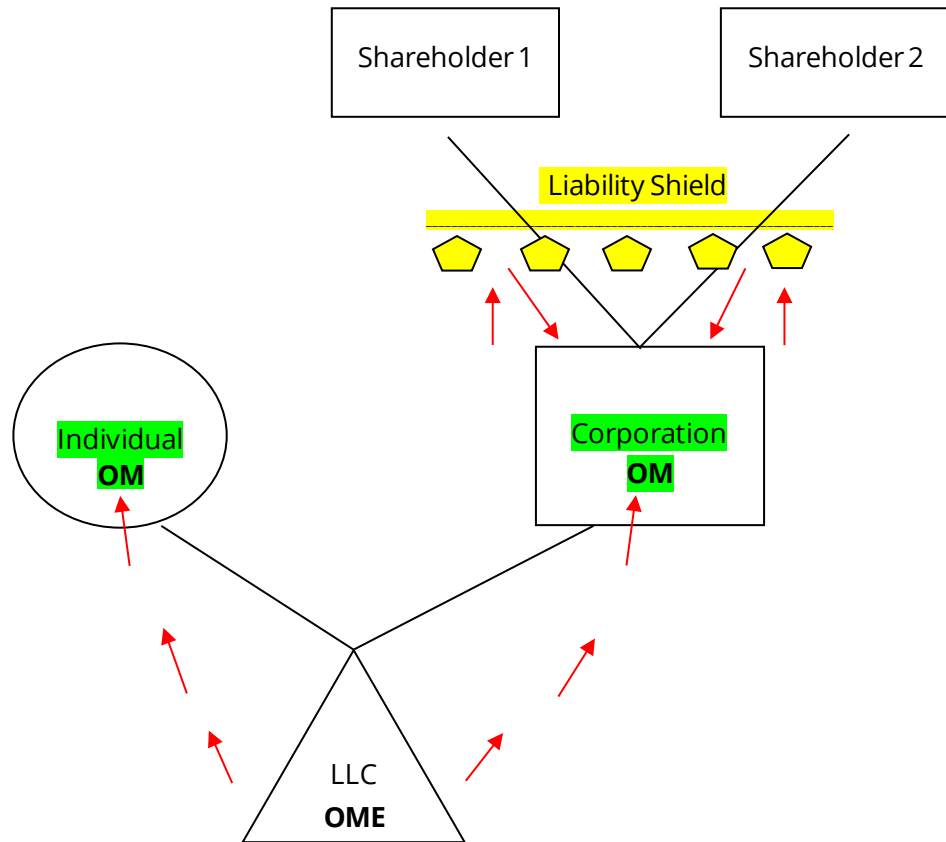
### Liability Limitations Before LLC Becomes an OME



The LLC form of organization provides limited liability protection to the entity's owners. The red arrows shown above represent the liabilities, debts, and obligations of the LLC. The yellow line shows that direct and indirect owners of the LLC are not required to satisfy the liabilities, debts, and obligations of the LLC.

The LLC would be required to file a franchise and excise tax return if it was doing business in Tennessee and if it had a substantial nexus in Tennessee.

### Liability Limitations After LLC Becomes an OME



The individual and corporate owners of the LLC (highlighted in green above) have agreed to be obligated members (“OM”) and forego the limited liability protection normally afforded to LLC owners. Note, the bottom yellow shield shown in the previous chart has been removed to show that the direct owners of the LLC may now have to satisfy the debts, obligations, and liabilities of the LLC (the shareholders of Corporation OM continue to receive limited liability protection from the corporation and are protected against any debts, obligations, or liabilities of Corporation OM, including those the corporation may incur as an obligated member of LLC OME). Because the corporate member is a type of entity that confers limited liability protection upon its owners, the OME is only partially exempt from the franchise and excise tax. The OME would prepare a franchise and excise tax return (Form FAE170) based on information found on the federal Sch. K-1 the OME issues to Corporation OM. The OME would also file Form FAE 183 - Application for Exemption/Annual Exemption Renewal - to report its partial exemption.

#### 4. Asset-Backed Securitization

- Entity is classified as a partnership or trust for federal income tax purposes;
- Elects to be treated as a real estate mortgage investment conduit (REMIC) under I.R.C. § 860D;
- Elects to be treated as a financial asset securitization investment trust (FASIT) under I.R.C. § 860L; **or**
- Is a business trust, as defined in Tenn. Code Ann. § 48-101-202(a)
  - or is classified as a trust under the laws of the state in which it is created and is disregarded for federal income tax purposes, when the commercial domicile of the trustee is not in this state; **and**
- The sole purpose of the entity must be the asset-backed securitization of debt obligations, such as mortgages, home equity loans, trade receivables, or similar debt obligations.<sup>40</sup>

#### 5. Family-Owned Noncorporate Entity (“FONCE”)

- Entity must be an LLC, LP, or LLP.
  - An SMLLC owned by an individual also qualifies.
  - The exemption is not available to corporate entities, including S corporations.
- At least 95% of the ownership units of the entity are owned by members of the family or the estate or trust of a deceased individual who, while living, was a member of the family (e.g., a testamentary trust). Members of the family means, with respect to an individual,<sup>41</sup>
  - An ancestor of such individual;
  - The spouse or former spouse of such individual;
  - A lineal descendent of such individual, of such individual’s spouse or former spouse, or of a parent of such individual; or



- The spouse of a former spouse of any lineal descendent described in the preceding bullet point.
- At least 66.67% of the entity's activity is either 1) the production of passive investment income, or 2) the combination 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 (not gross sales proceeds) from sales or exchanges of stocks or securities.<sup>42</sup>
    - Rents from industrial and commercial real estate are not considered passive investment income for the purpose of the FONCE exemption.
    - Residential property, for the purpose of the FONCE exemption, cannot have more than **four** residential units per separately deeded property.<sup>43</sup> For example:
      - A condominium with *four* separately deeded units would qualify as residential property.
      - A family-owned noncorporate entity that owns *ten* condominiums, each of which is under a separate master deed and has *four* units per condominium, would qualify for the exemption.
      - A family-owned noncorporate entity owns *two* condominiums, each of which is under a separate master deed and has *eight* units per condominium. The condominiums do **not** qualify as residential property.
      - A five-unit apartment building would **not** qualify as residential property.
  - There is no requirement that a FONCE own four or fewer separately deeded properties in order to qualify for the exemption. A single FONCE may own more than four separately deeded properties and qualify for the exemption, so long as the FONCE meets the family ownership and passive income requirements.
  - Ownership of commercial and industrial property does not automatically disqualify a noncorporate entity from claiming the FONCE exemption.

The entity must take into consideration its total gross receipts from all sources (passive and non-passive) for the tax period; assuming that the noncorporate entity meets the FONCE ownership requirements, and as long as 66.67% or more of the entity's gross receipts for the tax period consist of passive investment income, the entity will qualify for the FONCE exemption. For example:

- A non-corporate entity is equally owned by two spouses. The entity owns several real estate properties from which it derives rents. The following is a schedule of the annual rents derived from the entity's real estate properties, broken down by property:

Residential home	\$ 9,000
Residential home	\$ 9,900
Condominium (four units)	\$ 34,200
Condominium (four units)	\$ 37,620
Condominium (six units)	<u>\$ 45,000</u>
	<u>\$ 135,720</u>

All of the above properties qualify as residential property except for the six-unit condominium. The entity's passive investment income from all the other properties totals \$90,720. Because **66.84%** ( $\$90,720 / \$135,720$ ) of the entity's gross receipts consist of passive investment income, the entity qualifies as a FONCE.

- Rents from a tenant in common interest in commercial property in which there is no active participation is not considered passive income. Active participation is not a determining factor of passive investment income for the FONCE exemption; because the property in which the entity has an ownership interest is not residential property, the rents do not qualify as passive investment income.
- Only gains from the sale or exchange of stocks or securities qualify as passive investment income. Gains from the sale or disposition of real, tangible, or intangible property do not qualify.
- An entity will meet the passive investment income test for the purpose of the FONCE exemption if it does not have any income derived from any source for the taxable period.

- Entity must complete a Disclosure of Activity form which is due with its Application for Exemption and each Annual Exemption Renewal, to inform the Department of the entity's activities relating to the exemption.

**⚠ It is imperative that the taxpayer complete the Disclosure of Activity Form in its entirety, including all pertinent addresses and the county in which the assets are located.**

## 6. Diversified Investing Fund

- Entity must be an LLC, LLP, LP, or a business trust.
- At least 90% of the cost of the entity's total assets consists of qualifying investment securities, bank deposits, and office space and equipment.
- At least 90% of the entity's gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities.
- The entity's primary purpose is buying, holding, and selling qualified securities on its own behalf and not as a broker.
- The entity's capital is primarily derived from investments by entities or individuals not affiliated with the fund.

## Taxable Entities

### 1. Types of Taxable Entities

Prior to 1999, only C corporations and S corporations were subject to franchise and excise tax. However, in 1999, the definition of a taxpayer<sup>44</sup> was expanded to include all the following types of entities:

- Corporation (C corporation)
- Subchapter S corporation (S corporation)
- Limited liability company (LLC)
- Professional limited liability company (PLLC)

- Registered limited liability partnership (RLLP)
- Professional registered limited liability partnership (PRLLP)
- Limited partnership (LP)
- Cooperative
- Joint-stock association
- Business trust
- Regulated investment company
- Real Estate Investment Trust (REIT)
- State-chartered or national bank
- State-chartered or federally-chartered savings and loan association

Of the above entities, the most common ones subject to franchise and excise tax are C corporations, S corporations, LLCs, and LPs.

The 1999 tax reform also expanded the franchise and excise tax base to include several non-corporate pass-through entities. A *pass-through entity* that offers limited liability protection to its owners is subject to the tax. A pass-through entity can be 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 that has a single owner and that is disregarded as an entity separate from its owner for federal income tax purposes<sup>45</sup> (disregarded entities will generally be treated as separate taxpaying entities for franchise and excise tax purposes).

The mechanics of federal tax law provide that pass-through entities such as S corporations, LPs, and LLCs do not pay federal income tax at the entity level, but instead distribute their income or loss to their owners, which in turn report and pay the tax on their respective income tax returns, hence the term *pass-through entity*. This distribution is reported by the pass-through entity to its owner(s) on federal Schedule K-1. For example, owners that are individuals report the pass-through income or loss on their Individual Income Tax Returns (Form 1040) along with their individual activities. Tennessee is unique in its taxation of pass-through entities in that it taxes these entities *directly* at the entity level, rather than taxing the owners to which the pass-through entity makes distributions of its income or loss.

## 2. Attributes of Taxable Entities

### *Corporation (C Corporation)*

- Incorporates, or charters, under the provisions of *Tennessee Code Annotated* Title 48 with the Tennessee Secretary of State.
  - Out-of-state corporations may obtain a certificate of authority from the Tennessee Secretary of State to conduct business in Tennessee.
- Files a federal income tax return on Form 1120 or other variant of this form such as 1120-REIT (real estate investment trust), 1120-RIC (regulated investment company), 1120-C (cooperative association), 1120-F (foreign corporation chartered outside the U.S.), 1120-FSC (foreign sales corporation), 1120-H (homeowners association), or 1120-IC-DISC (interest charge domestic international sales corporation).
- May file federally as a single entity or may elect to file on a consolidated basis with affiliates. Federal Form 851 lists the affiliated group members.
- LLCs may file Form 1120 and be taxed as a corporation if the LLC makes this election on federal Form 8832.
- Business trusts that are classified as corporations file on federal Form 1120.

### *Subchapter S Corporation (S corporation)*

- Files a federal income tax return on Form 1120S. The income or loss is distributed to the owners on Schedule K-1, and the owners report and pay the tax due on their individual returns. S corporations do not pay federal income tax at the entity level.
- Stockholders of a C corporation may make an election on Form 2553 to be treated as an S corporation as long as the stockholders are individual persons (not corporations).
- May have wholly-owned subsidiaries known as qualified subchapter S subsidiaries (“QSub”) that, upon election, are included in the federal Form 1120S of the parent S corporation.
  - The parent S corporation files federal Form 8869 to make the QSub election.

- The election results in a deemed liquidation of the QSub into the parent S corporation.
- Following the deemed liquidation, the QSub is treated as a division of the parent S corporation, and all of its assets, liabilities, items of income, deduction, and credits are treated as those of the parent.
- If the QSub was a separate corporation prior to the deemed liquidation, it may have to file a final federal return.
  - A final return is not required if the QSub election was made pursuant to a tax-free reorganization under IRC §368(a)(1)(F).

#### *Limited Liability Company (LLC)*

- Formed by filing articles of organization with the Tennessee Secretary of State, pursuant to *Tennessee Code Annotated* Title 48.
- LLC owners are called *members*; LLC members can be corporations, partnerships, individuals, or other entities.
- Files federal Form 1065 as a partnership if it has more than one owner.
  - If the LLC has only one member, it is treated as a single-member limited liability company (“SMLLC”) for federal income tax purposes, and its income or loss is generally included in the return of its owner.
  - An SMLLC is not disregarded for franchise and excise tax purposes unless its single-member is a corporation.
- The income or loss reported by an LLC on Form 1065 is distributed to its members on Schedule K-1, and each member reports and pays tax on their distributive share of the LLC’s income or loss on their individual returns.

#### *Professional Limited Liability Company (PLLC)*

- Files federal Form 1065 as a partnership.
- Members are engaged in providing a professional service (e.g., doctors, attorneys, accountants, etc.).

- Organized pursuant to *Tennessee Code Annotated* Title 48.

#### *Registered Limited Liability Partnership (RLLP)*

- Limits an individual partner's liability for acts committed by other partners of the RLLP or employees of the RLLP, but not for the individual partner's own actions.<sup>46</sup>
- Files federal Form 1065 as a partnership.

#### *Professional Registered Limited Liability Partnership (PRLLP)<sup>47</sup>*

- Files federal Form 1065 as a partnership.
- Members are engaged in providing a professional service (e.g., doctors, attorneys, accountants, etc.).

#### *Limited Partnership (LP)*

- Formed by filing a certificate of limited partnership with the Tennessee Secretary of State, pursuant to *Tennessee Code Annotated* Title 61.
- Must have more than one partner.
- Must have at least one general partner.
- Limited partners are only liable to the extent of their investment in the LP.
- The partners of an LP can be any combination of corporations, partnerships, individuals, or other entities.
- Files federal Form 1065 as a partnership.

#### *Series Limited Liability Companies (SLLC)/Master LLC*

In 2006, Tennessee's LLC laws were expanded to allow the creation of one or more *series limited liability companies* within an LLC commonly referred to as a *master LLC*. Each SLLC is treated as a separate entity with respect to its debts, liabilities, obligations, and expenses.<sup>48</sup> The master LLC is separate from the SLLCs.

- An SLLC will designate a series of LLCs within the SLLC's formation. Each series (LLC) is treated as a separate entity for franchise and excise tax purposes.<sup>49</sup>
- A common use of the SLLC is to hold separate pieces of real estate for development purposes.
- Each LLC in the series can segregate the risk of the property, loan, and legal liability from other properties held in each SLLC.
- Only the master LLC is required to file with the Tennessee Secretary of State.
- The master LLC and each SLLC must register with the Department and set up separate franchise and excise tax accounts. Each LLC must file separate returns unless they meet the criteria to be disregarded.

### Trusts

- Business trusts generally file a federal income tax return on federal Form 1120 and are taxable entities for franchise and excise tax purposes.<sup>50</sup>
- Estates and trusts generally file a federal income tax return on federal Form 1041 and are not subject to franchise and excise taxes, except for "business trusts," which *are* subject to these taxes.<sup>51</sup>
- In general, "business trusts" are arrangements other than simple arrangements to protect or conserve property for beneficiaries. Business trusts generally are created by beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code.<sup>52</sup>
- Real Estate Investment Trusts (REITs) are corporations that file federal Form 1120-REIT and are subject to franchise and excise taxes. An in-depth explanation of REITs can be found in Chapter 17 of this manual.

## Entity Formation

An entity providing limited liability protection for its owners is incorporated or organized through the Tennessee Secretary of State's office ("SOS"). Any corporate entity formed with the SOS by filing articles of incorporation, or articles of organization/certificate of limited partnership for LLCs/LPs, respectively, will have established franchise and excise tax nexus with the state and



is considered a *domestic entity*. Entities that are formed out-of-state may qualify their charter or other registration with the SOS and receive a certificate of authority to do business in Tennessee. Out-of-state entities are considered *foreign entities* (meaning, formed in another state). Entities that are registered with the SOS are required to file an annual report and remit a filing fee with the SOS.

Information regarding business entities (both domestic and foreign) registered with the SOS can be accessed through the Business Information Search on the SOS website at [www.tn.gov/sos](http://www.tn.gov/sos) (the direct link to this search engine is <https://tnbear.tn.gov/Ecommerce/FilingSearch.aspx>). Accessible information includes the official name of the business entity, state in which it was formed, initial filing date, fiscal year, location of its principal office, number of members (if applicable), whether the entity is an obligated member entity, and its status (such as active, administratively dissolved or revoked, etc.).

Occasionally, small, individually-owned businesses operate in the state and claim corporate, LLC, or LP status, even though they have not submitted articles of incorporation or organization to the SOS or received a certificate of authority from the SOS to do business in Tennessee. In this case, the business will be subject to franchise and excise tax since the owners are operating and using a business name indicating corporate, LLC, or LP status. The use of such business name may include, but is not limited to, advertising, the store front, business cards, customer invoices, bank accounts or loans, business documents and contracts, or any other type of documentation of the business.

A taxpayer, within 15 days of becoming subject to franchise and excise tax, must complete and submit an Application for Registration to the Department.<sup>53</sup> The taxpayer can file the form online through TNTAP at <https://tntap.tn.gov/eservices> or mail/hand deliver the application to any Taxpayer Services Division office. The purpose of the form is to ensure the Department has the taxpayer's correct information, including address, federal employer identification number (FEIN), Secretary of State control number, reporting or filing period, etc. This helps make certain that the taxpayer is properly registered for all applicable taxes.

A taxpayer doing business in Tennessee, regardless of whether it is registered with the SOS, must file a franchise and excise tax return. This filing requirement applies to both taxpayers that have not registered with a secretary of state in any state as well as taxpayers that have not qualified their out-of-state registration with the Tennessee SOS. Any taxpayer doing business in Tennessee who is registered with the SOS, but whose charter or other registration becomes inactive, administratively dissolved or revoked, is still required to file a franchise and excise tax

return.<sup>54</sup> A taxpayer with delinquent returns will be required to file up-to-date returns to reinstate with the SOS.

## Entity Classification

### 1. Classification for Franchise and Excise Tax Purposes

Businesses are classified for franchise and excise tax purposes as corporations, partnerships, or other types of business entities, consistent with the way they are classified for federal income tax purposes.<sup>55</sup> Taxpayers indicate their entity type when registering their business with the Department. Generally, an entity will be treated the same for both federal and Tennessee franchise and excise tax purposes. For example, a non-corporate entity that would normally file a Form 1065 partnership return may elect to be treated as a corporation and file Form 1120 for federal income tax purposes. In this case, the Department will accept the taxpayer's federal entity classification election and will treat the taxpayer as a corporation for franchise and excise tax purposes.

If a business that is normally a non-taxable entity, such as a sole proprietorship, holds itself out to the public as a type of entity that would be subject to franchise and excise tax (e.g., a corporation, LLC, or LP) then the business will be subject to franchise and excise tax.

### 2. Federal Default Classification

Depending on whether a pass-through entity and its owners makes an election to change the entity's federal default classification, the Internal Revenue Service may treat a partnership or LLC as either 1) a corporation, 2) a partnership, or 3) part of the owner's return (a disregarded entity). Federal regulations dictate how an entity files for federal income tax purposes. If the entity does not make any election or other action regarding its federal entity classification, the following is the standard federal income tax treatment that will be applied to the entity:

- If a pass-through entity has only one owner, the entity is *disregarded* as an entity separate from its owner and is treated as a division of its owner for federal income tax purposes. For example, an SMLLC is disregarded as a separate taxpayer, and its activities are included in its owner's (single-member) return.
- Non-corporate entities (such as LLCs and LPs) are taxed as partnerships if the entity has two or more owners. For example, a joint venture (a business arrangement without an actual partnership or corporate formation) would file as a partnership on federal Form 1065.

Under federal default classification rules, an entity that is the owner (single-member) of an SMLLC will include the SMLLC's activities with those of its own on a single federal return filed by the owner.

### 3. State Classification of SMLLC

If the single-member of a SMLLC is a corporation, the federal tax treatment will conform to franchise and excise tax filing requirements. In addition, a corporation that has no activity of its own in Tennessee is required to register with the Department and file franchise and excise tax returns if it is the single-member of a SMLLC that is doing business in the state (even if the parent corporation's ownership interest in the SMLLC is its only connection to the state). However, if the ultimate owner (single-member) of the SMLLC is any entity other than a corporation, the SMLLC will not be disregarded for franchise and excise tax purposes. In this instance, the federal and state income tax filing requirements of the taxpayer will differ. SMLLCs that do not meet the criteria to be disregarded for franchise and excise tax purposes should maintain separate-entity records or pro forma federal income tax returns to show the separate activity (i.e., items of income, deduction, etc.) of the individual SMLLC for franchise and excise tax purposes. (Please see Chapter 4 for more information on disregarded entities and identifying the Tennessee taxpayer in complex organizational structures.)

**⚠ Audit Tip: Federal returns that include disregarded entities do not distinguish between the reported activity of the parent and any disregarded entities included in the return. Therefore, auditors examining SMLLC taxpayers (not corporate owned) may request the SMLLC taxpayer to produce pro forma federal returns showing the SMLLC's activity on a separate-entity basis.**

### 4. Federal Election to be Treated as a Corporation

A non-corporate entity (such as an LLC or LP) may make an election on federal Form 8832 to be classified as a corporation for federal income tax purposes. This is commonly referred to as a "check-the-box" election.<sup>56</sup> For example, an LP may make this federal election and file as a corporation on Form 1120 for corporations instead of Form 1065 for partnerships. For franchise and excise tax purposes, the Department recognizes the federal election and will treat the entity as a corporation.<sup>57</sup> In addition, a non-corporate entity may make an election on Form 2553 to be an S corporation, in which case it would file a Form 1120S income tax return.

## **Out-of-State Businesses Responding to State Declared Disaster or Emergency**

Out-of-state businesses, who do not otherwise have nexus in Tennessee, who are responding to a state-declared disaster are exempt from franchise and excise taxes for the income generated from performing disaster or emergency related work in the state. This work includes repairing, renovating, installing, building, and rendering services or other business activities that relate to critical infrastructure that has been damaged, impaired, or destroyed during a disaster or emergency and activities conducted in good faith before a potential disaster to prepare for the provision of this work. After a disaster response period, if a responding out-of-state business remains in the state the business loses this exemption and may be subject to the franchise and excise tax from the date that business activities first began in the state. The disaster response period is the period that begins ten days before the date of the earliest event establishing a disaster or emergency and that ends 120 days thereafter, or later if set by the governor or president of the United States.<sup>58</sup>

## Chapter 3: Nexus

### Overview

Nexus describes a connection that must be present before a taxing jurisdiction has the right to impose a tax on an entity's activity. An entity must have some contact or connection with a state before it may be taxed. At what point is that connection sufficient to trigger taxation in that state? Traditional nexus principles published in court cases, Revenue Rulings, and the Tennessee code help answer this question.

The Tennessee code states that "persons" or "taxpayers"<sup>59</sup> that are "doing business" *and* having a "substantial nexus in this state" are subject to the franchise tax<sup>60</sup> and excise tax.<sup>61</sup>

**⚠ Businesses formed and operating in Tennessee will always have nexus in this state. The question of nexus applies to out-of-state businesses with a limited connection to the state.**

### 1. Doing Business in Tennessee

Only entities "doing business in Tennessee"<sup>62</sup> may be taxed. Doing business in Tennessee is defined, in part, as "any activity purposefully engaged in within Tennessee, by a person with the object of gain, benefit, or advantage, consistent with the intent of the general assembly to subject such persons to the Tennessee franchise/excise tax to the extent permitted by the United States Constitution and the Constitution of Tennessee."

The law provides four exceptions for certain activities that otherwise would be considered doing business in Tennessee.<sup>63</sup> The exceptions involve:

- Product samples at a trade show;
- Activities of magazine publishers;
- Out-of-state person's equipment is in state on a temporary basis; or
- The temporary presence of employees in Tennessee.

More specifically, the following activities do not create nexus:

- The presence of employees and/or product samples and/or other promotional materials at one or more trade shows, exhibits, conventions, or similar events in Tennessee for a

total of not more than twenty days per calendar year; provided, that the activities of the entity's employees while in the state are limited to:

- Maintaining or facilitating the trade show or convention;
  - Purchasing of goods on behalf of their employer;
  - Soliciting sales; and
  - Gathering samples, promotional material or other information offered at the event.
- Activities by publishers of magazines and books who contract with Tennessee printers for the printing of their magazines or books, when such activities in the state are limited solely to activities having to do with:
    - The printing, storage, labeling, and/or delivery to the United States mail or common carrier of such magazines or books;
    - The maintenance of raw materials with respect to such activities;
    - The maintenance of employees solely in connection with the production and quality control of such printing, storage, labeling and/or delivery; provided, that the publisher and printer are not affiliated with one another.
      - Persons are affiliated with one another, if, either directly or indirectly, one controls the other, or if the persons are directly or indirectly controlled by a common parent.
- Physical presence in this state of an out-of-state person's equipment, tooling, inventory, and employees on a temporary basis, when:
    - The activity in which such items and employees are engaged is not the pursuit, creation or maintenance, by the out-of-state person or any person that is affiliated with it, of a market in this state;
    - The equipment and tooling are not used, worked on, or held in this state by a person that is affiliated with the out-of-state person;
    - The out-of-state person's employees have no control over the use or work done in this state by the in-state person; and

- The extent and value of such items, the number of such employees, and the number of days the employees work in this state, in light of all the facts and circumstances, are qualitatively and quantitatively de minimis. Persons are affiliated with one another, if, either directly or indirectly, one controls the other, or if the persons are directly or indirectly controlled by a common parent.
- The temporary presence of employees solely for the purpose of purchasing goods from vendors in this state for use in the employer's business out-of-state, provided that:
  - The total number of days the employer has one or more employees present in this state does not exceed thirty per calendar year; and
  - The employer does not furnish, directly or indirectly, any office in this state for their use.

## 2. Substantial Nexus

In addition to “doing business,” an entity must have substantial nexus in the state to be subject to tax. The term “substantial nexus in this state” was enacted in 2015 by the Revenue Modernization Act of 2015 (“RMA”) and applies to all tax years beginning on or after January 1, 2016. It means any direct or indirect connection of the taxpayer to this state such that the taxpayer can be required under the U.S. Constitution to remit franchise and excise tax.<sup>64</sup> Such connection includes, but is not limited to:

- The taxpayer is organized or commercially domiciled in this state;
- The taxpayer owns or uses its capital in this state;
- The taxpayer has systematic and continuous business activity in this state that has produced gross receipts attributable to customers in this state;
- The taxpayer licenses intangible property for use by another party in this state and derives income from that use of intangible property in this state; or
- The taxpayer has “bright-line presence” in this state. A person has bright-line presence in this state for a tax period if any of the following applies:
  - The taxpayer’s total receipts in this state during the tax period, as determined under the apportionment formula,<sup>65</sup> exceed the lesser of \$500,000 or 25% of the taxpayer’s total receipts everywhere during the tax period;

- The average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period, as determined under the apportionment formula,<sup>66</sup> exceeds the lesser of \$50,000 or 25% of the average value of all the taxpayer's total real and tangible personal property; or
- The total amount paid in this state during the tax period by the taxpayer for compensation, as determined under the apportionment formula,<sup>67</sup> exceeds the lesser of \$50,000 or 25% of the total compensation paid by the taxpayer.

### *Revenue Modernization Act Expands Nexus*

The RMA's addition of "substantial nexus in this state" expands the number of businesses that might have nexus under the Due Process Clause and/or Commerce Clause. Persons that would have been subject to the franchise and excise tax before the enactment of the RMA and the substantial nexus definition will continue to be subject to the tax even if they do not meet any of the bright-line tests. However, under the substantial nexus definition, out-of-state businesses that previously were not subject to the franchise and excise tax may now be subject to the tax. For example:

- Prior to the law change, an out-of-state company whose only connection with Tennessee was sales made into the state from outside the state would not be subject to the franchise and excise tax. However, for tax years beginning on or after January 1, 2016, this taxpayer would be subject to the tax if its sales into the state exceed the lesser of \$500,000 or 25% of the taxpayer's total receipts, or if any other contact with the state is sufficient to create substantial nexus. Note that physical presence is not required.

If a taxpayer does not meet the bright-line presence test in Tennessee, it may have substantial nexus if its contact with the state is sufficient. For instance:

- A company incorporated in Tennessee (a domestic entity) is always subject to the tax. If there is no property, payroll, or sales within the state, a franchise and excise tax return and minimum franchise tax payment of \$100 is required.
- An out-of-state entity doing business in the state may have nexus if it is engaged in systematic and continuous business activity that has produced receipts attributable to Tennessee customers that are short of the bright-line threshold. The frequency and nature of the activity in the state should be evaluated to determine if the connection with the state is sufficient to create nexus. However, a taxpayer with only economic



presence (customers) in Tennessee does not automatically have substantial nexus solely on the basis that it has systematic and continuous activity in the state that produces some amount of income that is less than the bright-line threshold.

- An out-of-state business that contracts with full-time agents to conduct business in the state for less than \$50,000 a year would create nexus under traditional nexus principles, as published in court cases, even though the bright-line test was not met.

Physical presence in the state will often create nexus, but a small physical presence will not always create nexus.

Furthermore, inventory located at a warehouse in the state will not always create nexus unless the bright-line threshold is met. However, it might in some cases. If the “doing business” requirement is met and the inventory is substantial in amount, but is short of the bright-line threshold, this might create nexus.

## Entity Specific Nexus

### 1. Trucking Companies

A trucking company is subject to franchise and excise tax if it provides intrastate transportation services within Tennessee, makes deliveries of goods into Tennessee that originate in another state, or transports goods from Tennessee for delivery into another state. However, a motor carrier traveling through Tennessee that originates and terminates outside Tennessee, where the vehicle makes no pickups or deliveries and conducts no other business activity in Tennessee, does not constitute doing business in Tennessee and therefore does not establish nexus.<sup>68</sup> For example:

- A motor carrier is not doing business in Tennessee and is not subject to franchise and excise tax if its only connection with the state is that it operates trucks traveling from Indiana through Kentucky and Tennessee to a destination in Alabama. The trucks do not have any pickups or deliveries in Tennessee. Truck drivers stopping in Tennessee to refuel or purchase a meal does not otherwise constitute doing business in Tennessee.

### 2. Foreign Corporations

A company that is treated as a foreign corporation under the Internal Revenue Code (“IRC”) and has no effectively connected income (“ECI”) with a United States trade or business will not be considered to have a substantial nexus in Tennessee. If a company is treated as a foreign corporation under the IRC but has income effectively connected with a United States trade or

business, then its net earnings and net worth connected with its United States trade or business will be its net earnings and net worth for franchise and excise tax purposes. Furthermore, only property used in, payroll attributable to, and receipts effectively connected with its company's United States trade or business will be considered when calculating its apportionment factors.

Whether a company has income effectively connected with a United States trade or business and the amount of its net earnings and net worth connected with its United States trade or business will be determined in accordance with the provisions of the IRC. Guidance from the IRS<sup>69</sup> states generally, when a foreign person engages in a trade or business in the United States, all income from sources within the United States connected with the conduct of that trade or business is ECI. This applies whether there is any connection between the income and the trade or business being carried on in the United States during the tax year. Generally, an entity must be engaged in a trade or business during the tax year to be able to treat income received in that year as ECI. Entities are usually considered to be engaged in a U.S. trade or business when they perform personal services in the United States. Whether they are engaged in a trade or business in the United States depends on the nature of their activities. Deductions are allowed against ECI, and it is taxed at the graduated rates or lesser rate under a tax treaty. Consider the following when deciding whether an entity is engaged in a trade or business in the United States. Certain kinds of fixed, determinable, annual, or periodical income are treated as ECI because:

- Certain IRC sections require the income to be treated as ECI;
- Certain IRC sections allow elections to treat the income as ECI;
- Certain kinds of investment income are treated as ECI if they pass either of the two following tests:
  - The Asset-Use Test – The income must be associated with U.S. assets used in, or held for use in, the conduct of a U.S. trade or business.
  - Business Activities Test – The activities of that trade or business conducted in the United States are a material factor in the realization of the income.
- If the entity's only U.S. business activity is trading in stocks, securities, or commodities (including hedging transactions) through a U.S. resident broker or other agent, it is not engaged in a trade or business in the United States.

### *Party to a Treaty*

A taxpayer treated as a foreign corporation under the IRC, who would have income effectively connected with a United States trade or business under the IRC, does not have substantial nexus with Tennessee for purposes of the franchise and excise tax if the United States is a party to a treaty under which the taxpayer has no effectively connected income. If a company is treated as a foreign corporation under the IRC and has no income effectively connected to a United States trade or business, it does not have substantial nexus with Tennessee.<sup>70</sup> IRC §894 provides that the provisions of the IRC shall be applied to any taxpayer with “due regard” for the treaty obligations of the United States that apply to the taxpayer.

### **3. Financial Institutions**

Financial institutions doing business and having substantial nexus in Tennessee file a combined franchise and excise return with unitary businesses<sup>71</sup> on Form FAE174.

#### *Financial Institution Defined*

A financial institution<sup>72</sup> is a:

- Holding company;<sup>73</sup>
- Regulated financial corporation;<sup>74</sup>
- Subsidiary of a bank holding company or a regulated financial corporation;
- Investment entity<sup>75</sup> that is indirectly owned (more than 50%) by a bank holding company or a regulated financial corporation; or
- Any other person that is carrying on the “business of a financial institution.”<sup>76</sup>
  - If more than 50% of an entity’s gross receipts are from carrying on the “business of a financial institution,” franchise and excise tax Form FAE174 should be completed instead of Form FAE170. For example, Car Wash, Inc. has \$151,000 in gross receipts. The washing service generated gross receipts of \$75,000 and the remainder of the receipts is interest income from a note receivable. Car Wash, Inc. is a financial institution because the \$76,000 in interest income constitutes over 50% of the entity’s gross receipts.

**⚠ Credit unions, insurance companies, and certain trusts are exempt from franchise and excise tax. Tenn. Code Ann. § 67-4-2008(4), (10), (14).**

### *Doing Business*

As stated previously, an entity must be doing business in the state in order to be subject to franchise and excise tax.

In addition to the standard definition of “doing business,” a financial institution is presumed to be doing business in this state if the total of its assets and the absolute value of its deposits attributable to sources within this state, regardless of whether the deposits are accepted or maintained at locations in this state, is \$5,000,000 or more.<sup>77</sup> Tangible assets are attributable to Tennessee if they are located in the state. Intangible assets are attributable to Tennessee if the income earned on those assets is attributable to this state. Deposits are attributed to Tennessee if they are made by this state or any of its agencies, instrumentalities, or subdivisions; or by any resident of this state, regardless of whether the deposits are accepted or maintained at locations in this state.

A financial institution may also be deemed to be doing business in this state if it:

- Maintains an office in this state;
- Has an employee, representative or independent contractor conducting business in this state;
- Regularly sells products or services to customers that receive the product or service in this state;
- Regularly solicits business from potential customers in this state;
- Regularly performs services outside this state that are consumed in this state;
- Regularly engages in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state;

- Owns or leases property located in this state; or
- Regularly solicits and receives deposits from customers in this state.

## Due Process and Commerce Clause

The state applies the franchise and excise tax to the extent permitted by the United States Constitution and the Constitution of Tennessee. According to the Commerce Clause and Due Process Clause of the United States Constitution, the flow of interstate commerce cannot be impeded and there must be a minimal connection between the company's interstate activities and the taxing state. These constitutional restrictions are considered before Tennessee can assert nexus to tax an out-of-state entity.

According to the U.S. Supreme Court, there must be a "minimal connection" between a company's interstate activities and the taxing state for the Due Process Clause to be satisfied. A company must have "substantial nexus" in that state for the Commerce Clause to be satisfied. Specifically, the Supreme Court in *Complete Auto Transit, Inc. v. Brady*<sup>78</sup> listed four requirements that must be met to satisfy the Commerce Clause:

- The tax is applied to an activity with a substantial nexus with the taxing state;
- The tax is fairly apportioned;
- The tax does not discriminate against interstate commerce; and
- The tax is fairly related to the services provided by the state.

To determine if an entity is taxable under the U.S. Constitution, one must know the meaning of the terms "minimal" (minimal contacts) and "substantial" (substantial nexus). Some courts have interpreted these terms to mean physical presence in the state is required. However, the Supreme Court in *South Dakota v. Wayfair, Inc.*<sup>79</sup> has ruled that physical presence is not necessary to create substantial nexus. Substantial nexus requires substantial activities in the taxing state (e.g., the entity has customers in the taxing state). This interpretation is commonly referred to as "economic nexus."

## Nexus-Related Issues

### 1. Ownership Interests Do Not Create Nexus

For federal income tax purposes (and in most other states), some entities are taxed directly, such as corporations, and others are taxed indirectly to their owners, such as S corporations, limited liability companies, and partnerships. Tennessee franchise and excise tax applies directly to all taxpayers. In other words, pass-through entities are taxed at the entity level and not at the owner level.

Each taxable entity stands on its own attributes as to whether it is doing business and has substantial nexus in the state. An ownership interest in a pass-through entity (e.g., an LP, LLC, or S corp.) that operates in Tennessee does not create a franchise and excise tax filing requirement for the owner. The taxpayer subject to the franchise and excise tax is always the entity that conducts business in the state. However, there are two exceptions to this rule, as described below.

#### *SMLLC Owned by a Corporation*

An SMLLC owned by an entity taxed as a corporation is disregarded for franchise and excise purposes. If either entity has nexus with the state, the activities of *both* the corporation *and* the SMLLC are included in one franchise and excise tax return filed under the corporation. Although the corporate owner may not otherwise have a connection with the state, the activities of the SMLLC operating in the state will subject the corporate owner to franchise and excise tax.

- For example, a New York corporation that has no connection with Tennessee becomes the sole owner of an LLC in Nashville, TN. The SMLLC is disregarded to the corporation for federal income tax purposes. The New York corporation will file one franchise and excise tax return that includes the activities of both the corporation and the SMLLC.

#### *General Partnership with a Limited Liability Owner*

The second exception is when an entity that offers its owner(s) limited liability protection, and that otherwise has no connection with the state, owns an interest in a general partnership (“GP”) that is doing business and has substantial nexus in the state. The GP is not a type of entity that is subject to franchise and excise tax, but its Tennessee activity is taxed at the first ownership level that offers limited liability protection. For example:

- A limited liability company that otherwise has no connection with the state has an ownership interest in a GP that is doing business in the state. The limited liability company will be subject to franchise and excise tax and must file a return and compute its tax liability based on its percentage ownership share of the GP's net worth/property and income attributes.

## 2. Standard for Nexus and Right to Apportion

Another nexus-related issue is whether a taxpayer's activities in another state are sufficient to permit the taxpayer to apportion its net worth and net earnings subject to Tennessee franchise and excise tax. For example, if a taxpayer's only connection with another state is an insignificant sale made into that state, the taxpayer does not have the right to apportion.

Tennessee statutes provide the test for determining when a taxpayer has the right to apportion.<sup>80</sup>

- A taxpayer with business activities that are taxable both inside and outside the state is entitled to apportion its net worth and net earnings.
- A taxpayer is considered taxable in another state only if the taxpayer is conducting activities in that state that, if conducted in Tennessee, would constitute doing business in Tennessee and would subject the taxpayer to either Tennessee's franchise tax **or** excise tax.

*Therefore, the same "doing business" standard for nexus also applies to the right to apportion.*

Taxpayers that are subject only to a franchise tax or similar tax in another state would still have the right to apportion their net earnings for the excise tax base, even when the taxpayer is protected from paying an excise tax or similar tax in that other state.

Taxpayers entitled to apportion must compute apportionment ratios and apply such ratios in the manner set forth by statute so that franchise and excise tax is levied only on the portion of the taxpayer's net worth and net earnings generated by Tennessee operations.<sup>81</sup> Please see Chapter 14 for more information on apportionment.

### Example of Nexus and Right to Apportion

Corporation X is based in Tennessee but has five salespeople whose annual salaries are \$30,000 each, and the salespeople are all based in another state along with tangible personal property such as a car, computer, inventory samples, and advertising materials. The salespeople work out of their homes. All of their activity in the other state falls within the protections for sales solicitation activities provided under Public Law 86-272 (discussed in the next section). Corporation X will be allowed to apportion since the connections in the other state would have required that a Tennessee franchise tax return be filed if they had occurred in Tennessee.

**⚠ Being subject to taxation in another state under that state's tax laws is *not* the criteria for determining if an entity may apportion.**

## Public Law 86-272

### 1. Overview

Public Law 86-272 ("P.L. 86-272")<sup>82</sup> is federal statutory law that preempts state law. The application of P.L. 86-272 should be considered after nexus has been determined. This law prohibits any state from imposing an *income tax* on out-of-state taxpayers whose only connection with the state is the *solicitation*<sup>83</sup> of orders for sales of *tangible personal property* when such orders are approved and shipped from outside the state. P.L. 86-272 states:

- No State, or political subdivision thereof, will have power to impose a *net income tax* on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
  - The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
  - The solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person enable such customer to fill orders resulting from such solicitation are orders described in paragraph above.
- The above provisions do not apply with respect to any corporation which is



incorporated under the laws of that State; a domestic corporation.

- P.L. 86-272 prohibits a state from taxing the income of a corporation formed under the laws of another jurisdiction whose only business activities within the state consist of “solicitation of orders” for tangible goods, provided that the orders are sent outside the state for approval and the goods are delivered from out of state.

Limited liability entities that are subject to excise tax in this state but meet the requirements of P.L. 86-272 are exempt from the excise tax. They should check the box “Public Law 86-272 applied to excise tax” on page one of the franchise and excise tax return and complete only the franchise tax portion of the return. This law does not apply to the franchise tax because the franchise tax is not based on income.<sup>84</sup>

The limitation on taxation afforded by P.L. 86-272 may be lost if a taxpayer performs activities outside those protected by the law. If in-state activities go beyond the mere solicitation of orders for sales of tangible personal property, the protection of P.L. 86-272 is lost and the excise tax return must be completed for all activities for the entire tax year. Actions that will preempt a taxpayer from claiming exemption under P.L. 86-272 are called unprotected activities.

Solicitation is specifically defined and means:

- Speech or conduct that explicitly or implicitly invites an order; and
- Activities that neither explicitly nor implicitly invite an order but are entirely *ancillary* to requests for an order.
  - *Ancillary activities* are those activities that serve no independent business function for the seller apart from their connection to the solicitation of orders. Activities that a seller would engage in apart from soliciting orders are not considered ancillary to the solicitation of orders. The mere assignment of activities to sales personnel does not, merely by such assignment, make such activities ancillary to solicitation of orders. Additionally, activities that seek to promote sales are not ancillary because P.L. 86-272 does not protect activity that facilitates sales; it only protects ancillary activities that facilitate the request for an order.

- Conducting activities that do not fall within this definition of solicitation will cause the company to lose its protection from a net income tax afforded by P.L. 86-272, unless the disqualifying activities, taken together, are *de minimis*.

## 2. Unprotected vs. Protected Activities

The Multistate Tax Commission (“MTC”) has published the *Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272*,<sup>85</sup> which provides a national standard for what constitutes solicitation. This document lists activities that do and do not go beyond mere solicitation. Protected activities are often referred to as immune activities because they may be performed without losing P.L. 86-272 protection. The performance of any unprotected (or non-immune) activities will cause the taxpayer to lose its P.L. 86-272 protection. The lists of unprotected and protected activities are as follows:

### *Unprotected/Non-Immune Activities*

The following in-state activities will cause otherwise protected sales to lose their protection:

- Making repairs or providing maintenance or service to the property sold;
- Collecting current or delinquent accounts, whether directly or by third parties;
- Investigating credit worthiness;
- Installation or supervision of installation at or after shipment or delivery;
- Conducting training courses, seminars or lectures, other than for sales personnel;
- Providing any kind of technical assistance or service (including engineering assistance or design service), other than for solicitation;
- Handling customer complaints;
- Approving or accepting orders;
- Repossessing property;
- Securing deposits on sales;
- Picking up or replacing damaged or returned property;
- Hiring, training, or supervising personnel, other than sales personnel;

- Using agency stock checks or other methods to facilitate sales;
- Maintaining a sample or display room in excess of 14 days at any one location within the state during the tax year;
- Carrying samples for sale, exchange or distribution in any manner for consideration or other value;
- Owning, leasing, using or maintaining any of the following facilities or property in-state:
  - Repair shop
  - Parts department
  - Office (other than an in-home office)
  - Warehouse
  - Meeting place for directors, officers, or employees
  - Stock of goods (other than samples for sales personnel)
  - Telephone answering service
  - Mobile stores (e.g., trucks with driver salesmen)
  - Real property or fixtures to real property of any kind
- Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale;
- Maintaining, by either an in-state or an out-of-state resident employee, an office or place of business (other than an in-home office), unless the office is not publicly attributed to the company and used solely for sales solicitation;
- Entering into, selling or otherwise disposing of franchising or licensing agreements; and
- Conducting any activity which is not entirely ancillary to requests for orders.

### *Protected/Immune Activities*

The following in-state activities will not cause the loss of protection for otherwise protected sales:

- Soliciting orders for sales by any type of advertising (e.g., notice in a newspaper that a salesman will be in town at a certain time);
- Soliciting orders from an in-home office;
- Carrying samples and promotional materials only for display or distribution without charge or other consideration;
- Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration;
- Providing automobiles to sales personnel for their use in conducting protected activities;
- Passing orders, inquiries and complaints on to the home office;
- Missionary sales activities (e.g., solicitation of indirect customers for the company's goods through other entities, such as wholesalers);
- Coordinating shipment or delivery without payment or other consideration;
- Checking of customers' inventories for reorder (this does not include checking inventory for other purposes, such as quality control and on-site restocking);
- Maintaining a sample or display room for 14 days or less at any one location within the state during the tax year;
- Recruiting, training or evaluating sales personnel;
- Mediating direct customer complaints to foster customer relations and facilitate requests for orders; and
- Owning, leasing, using or maintaining personal property in an in-home office or automobile that is solely limited to conducting protected activities (e.g., a salesman's use of a cell phone, fax machine, copier, laptop computer, etc. for solicitation)

### *De Minimis Exception*

Tax immunity is not lost if an unprotected activity establishes only a trivial (or *de minimis*) connection with the state. *De minimis* is a legal term that means "trifling" or "minimal."<sup>86</sup> If a non-immune activity is *de minimis* in volume and/or amount (i.e., it does not have some degree of

regularity), the protection afforded by P.L. 86-272 will not be lost. The taxpayer will not be subject to the excise tax.

### *Independent Contractors*

P.L. 86-272 provides protection to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by a taxpayer or its employees or other representatives. Independent contractors may engage in the following limited activities in the state without affecting the taxpayer's immunity:

- Soliciting sales
- Making sales
- Maintaining an office

However, sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as those provided under P.L. 86-272 and the MTC's *Statement of Information*.

Also, maintenance of a stock of goods in the state by an independent contractor under consignment or any other type of arrangement with the company, except for purposes of display and solicitation, will remove the protection afforded by P.L. 86-272.

### *P.L. 86-272 Examples*

- A regional manager's activities in state include recruitment, training, and evaluation of sales employees. The company uses in-state hotels and homes for sales-related meetings. Salesmen are provided a car and a stock of free samples for the purpose of soliciting orders. The company was careful to not have the salesmen engage in activities that the company would normally engage in, such as repairing or servicing the products sold. In this case, the company is protected under P.L. 86-272 and is not subject to excise tax, but it would report the car and other equipment used in Tennessee on its franchise tax return.
- A corporation has 25 employees in the state who primarily solicit orders for sales of tangible personal property, which are approved and fulfilled from a location outside of the state. The company is *doing business* in the state; it is purposefully engaged in the state with the object of gain, benefit or advantage. In addition, the salaries of the

employees in the state exceed the *substantial nexus* bright-line threshold of \$50,000. The corporation must file a franchise and excise tax return. The corporation has determined that it is eligible to claim exemption from excise tax under P.L. 86-272, so the corporation checked the applicable box on the first page of the return. Upon examination, however, it was determined that the corporation's in-state activities went beyond those protected under P.L. 86-272; the corporation's employees did research and development activities that were not *de minimis* in nature. The corporation is subject to both the franchise and excise taxes.

## Chapter 4: Identifying the Proper Franchise and Excise Taxpayer

### Separate Single-Entity Reporting

Tennessee is known as a separate single entity reporting state. Each taxpayer is considered a separate and single business entity and should file its franchise and excise tax return reflecting only its own business activities.

- Consolidated returns are *not* allowed for franchise and excise tax purposes.
- Each separate entity must file a separate franchise and excise tax return annually.<sup>87</sup>

**⚠ This reporting method is unique from other states that require consolidated or combined franchise and excise/corporate income tax reporting. This unique requirement illustrates why determining the taxpayer is an important first step before filing a franchise and excise tax return.**

This separate single-entity reporting requirement also applies to corporate subsidiaries and qualified S-corporation subsidiaries (“Q-Subs”) that do not file separate federal returns. If consolidated returns are filed federally, including S-corporations and Q-Subs, the taxpayer must provide the Department with a pro-forma federal return reflecting only the activities of each separate single-entity franchise and excise taxpayer.

**⚠ Audit Tip**  
**In an S-corporation audit, the auditor will likely ask whether there are any qualified S-corporation subsidiaries because it is often not readily apparent. If such subsidiaries are present, the auditor will request additional information to determine if those subsidiaries have sufficient nexus to be required to file a separate franchise and excise tax return.**

#### 1. Exceptions to Separate Single-Entity Reporting

There are two exceptions to the separate single entity reporting requirement.

- First, unitary groups of Financial Institutions and REIT affiliated groups, as defined in Tenn. Code Ann. §§ 67-4-2004(17) and (7), respectively.

- Financial Institutions and Captive REITs are required to file a combined return, including all affiliated group members, on Form FAE174.<sup>88</sup>
- Second, LLCs that have a single owner/member (“SMLLC”) that is an entity taxed as a corporation for federal income tax purposes.
  - The SMLLC and corporate owner file a single franchise and excise tax return in the name of the parent/owner. This also applies if the SMLLCs are stacked in an ownership tier, owning each other, if a corporation is the ultimate single-member owner of the top-tier SMLLC.

## 2. Tax Implications of Single Filer Returns vs. Consolidated Return

This separate single entity filing requirement is important to follow, as it has tax liability implications. Many times, two single returns versus a consolidated return will result in different apportionment ratios (see Chapter 14 for more information). Different apportionment ratios will affect different values for the net worth tax base, income subject to excise tax, loss carryovers used, and credits used and available to offset future years. Furthermore, intercompany transactions between affiliated entities will not be eliminated; depending on the profits (or losses) and credits earned by the affiliated entities, the tax computed on a combined basis may be more or less than that computed on a separate-entity basis.

Finally, although Tennessee is a separate single entity reporting state, there is an election available for affiliated groups to compute their individual *net worth* for franchise tax purposes on a consolidated basis. This computation is reported on Form FAE170, Schedule F2. This election is only a computation method used to calculate separate entity franchise tax; it is not a method of actually filing the franchise and excise tax return.<sup>89</sup> For more information on this election, see Chapter 9 of this manual.

## 3. Direct Taxation of Pass-Through Entities

Tennessee is unique in that it taxes pass-through entities directly. Most states and the Internal Revenue Service (“IRS”) do not directly tax pass-through entities, such as an S-corporations, LPs, and LLCs. Instead, they tax the entity’s owners based on their distributive share of the pass-through entity’s net income or loss reflected on federal Schedule K-1, which is issued by the pass-through entity to each of its owners. Because Tennessee is unique in taxing pass-through entities directly, out-of-state taxpayers may erroneously submit returns for the Schedule K-1 recipient rather than the pass-through entity itself.



## Disregarded Entities

As stated above, a disregarded SMLLC and its corporate owner are not required to file separate franchise and excise tax returns because the SMLLC is treated as a division (or part) of the corporation. An SMLLC is disregarded for franchise and excise tax purposes when it is:

- disregarded for federal income tax purposes; and
- its single member is a corporation.

In these circumstances, the taxpayer will file one franchise and excise tax return in which the SMLLC's activity is included with the activity of its corporate owner.<sup>90</sup> Treatment as a disregarded entity for franchise and excise tax is not an option or an election.

**⚠ This rule *only* applies to SMLLCs. Other pass-through entities, such as LPs and multi-owned LLCs, that may otherwise be disregarded for federal tax purposes and owned by a corporation, are *not* disregarded for Tennessee franchise and excise tax purposes.**

A corporation, for franchise and excise tax purposes, means any entity that:

- was formed as a corporation under state law; or
- was not formed as a corporation but whose default classification for federal income tax purposes is to be treated as a corporation, such as a pass-through entity owned by a single corporate owner; or
- has made an election on federal Form 8832 to be classified as a corporation for federal income tax purposes and has received IRS approval to be classified as such.

### 1. Corporations Formed Under State Law

If the entity is chartered and registered with the Tennessee Secretary of State as a corporation, the entity will always be considered a corporation for franchise and excise tax purposes. This applies to entities that may be federally designated as either a C-corporation or elect to be treated as an S-corporation. The separate single entity reporting exception applies in both scenarios, as both entities are "corporations." Thus, in both cases, the SMLLC is disregarded, and the franchise and excise tax return will include the activities of both the SMLLC and its corporate (C-corporation or S-corporation) owner.

## 2. Default Classification

Some entities are disregarded to their owner's return for federal income tax purposes by default. Default means that this is the standard federal tax treatment applied to the entity without any other action taken (e.g., an SMLLC always defaults to its owner for federal income tax purposes). There are three possible federal tax classifications:

- Disregarded entity
- Corporation
- Partnership

Federal classification rules also allow for certain non-corporate entities to be taxed as corporations. These are called "eligible entities" and include:

- Limited liability companies
- Limited liability partnerships
- Limited liability limited partnerships
- Limited partnerships
- General partnerships

Depending on the elections made and the number of owners, the IRS may treat a partnership or LLC as a corporation, partnership, or part of its owner's return (a disregarded entity). If there is only one owner, the entity is by default disregarded as an entity separate from its single owner (treated as a division of the parent) for federal income tax purposes. The federal default classification is to tax non-corporate entities as partnerships if there are two or more owners.<sup>91</sup>

## 3. Election to be Taxed as a Corporation

Some entities that do not disregard to their owner by default can "check the box," (or elect) on Form 8832 to be disregarded for federal income tax purposes. This form is also used by partnerships and LLCs to elect a corporate classification for federal income tax purposes, rather than be disregarded. If an entity elects to be treated as a corporation and is the single member of an LLC, the SMLLC will be disregarded to its owner. For example:

- An SMLLC is owned by an LP that elects to be treated as a corporation. The SMLLC would be disregarded and included in the LP's franchise and excise tax return.

This election also applies to the SMLLCs themselves. For example:

- An entity organizes as an SMLLC. The SMLLC then elects to be treated as a corporation. In such a case, the SMLLC is not disregarded, even if its single owner is a corporation.

## Organizational Structure – Role in an Audit

### 1. Pre-Audit Evaluation

It is very helpful at the start of an audit for a taxpayer to provide the auditor with an organizational chart to assist the auditor in determining the ownership structure between entities. Many times, an audit will involve an entity that is just one component of an overall business structure. Because business structures can change year-to-year, the auditor will discuss the organizational structure with the taxpayer and confirm its accuracy.

If a chart is unavailable, the auditor will request an explanation of the group's structure. The auditor will analyze the organizational structure to identify disregarded entities that should be included in the franchise and excise tax return of the corporate owner. This is also important because of a requirement, in some cases, to reverse the pass-through income/loss amounts from pass-through entities on Form FAE170, Schedule J and to include the attributes of pass-through entities in the apportionment factors on Form FAE170, Schedule N. (See Chapters 11 and 14 for more information on the excise tax and apportionment, respectively).

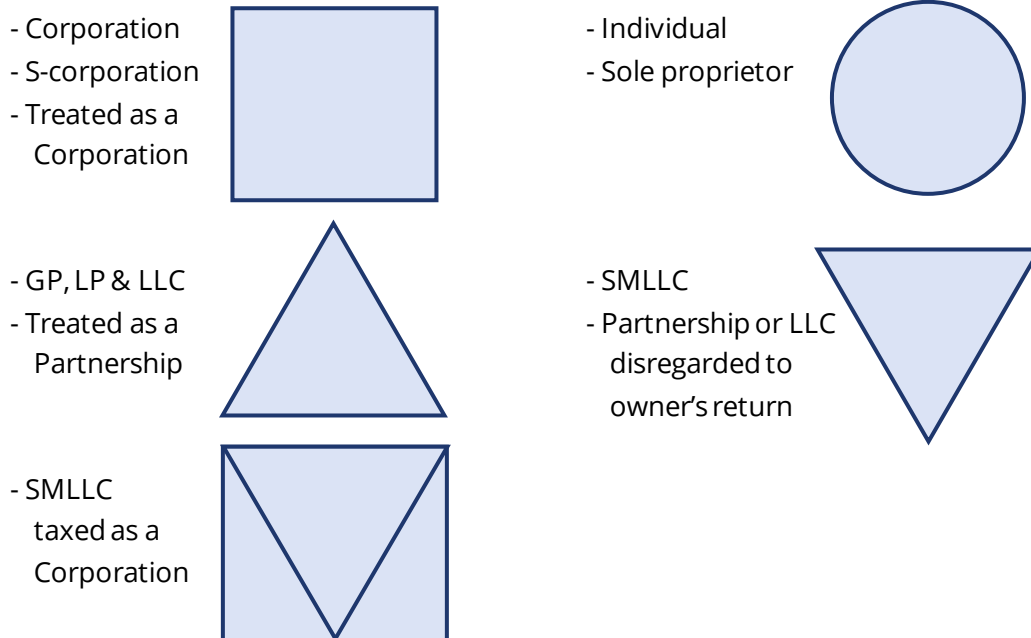
Because non-corporate entities, such as LPs and LLCs, are not listed on federal Form 851, the auditor will inquire whether there are any of these entities in the business structure. If so, the auditor will inquire whether these entities are disregarded entities or file a federal Form 1065.

Once each separate entity can be identified, the auditor will confirm that entities registered with the Tennessee Secretary of State, or "doing business" in the state, are filing franchise and excise tax returns. The auditor will also identify if an entity is a holding company to determine if the lower-tier entity that it is holding would be the franchise and excise taxpayer. The auditor will also determine if the lower-tier entity is a general partnership, in which case the entity with the ownership interest in the general partnership is the franchise and excise taxpayer, assuming it is a type of entity that offers limited liability protection to its owners (e.g., corporation, LLC, LP).

## 2. Organizational Chart Symbols

Organizational charts sometimes use various symbols to represent entity types. Symbols make it easier to identify the type of entity in question, especially with large affiliated groups with many levels or tiers of entities. Generally, the chart should also indicate the ownership percentage on the line connecting the entities.

Below are examples of symbols commonly used in organizational charts and preferred for consistent use by the Department.



## Special Circumstances

### 1. Multimember LLC

A multi-member limited liability company may be disregarded for franchise and excise tax purposes in certain situations where, in a “top-down” analysis,<sup>92</sup> it effectively becomes an SMLLC.

See the organization chart on the next page in relation to the following example:

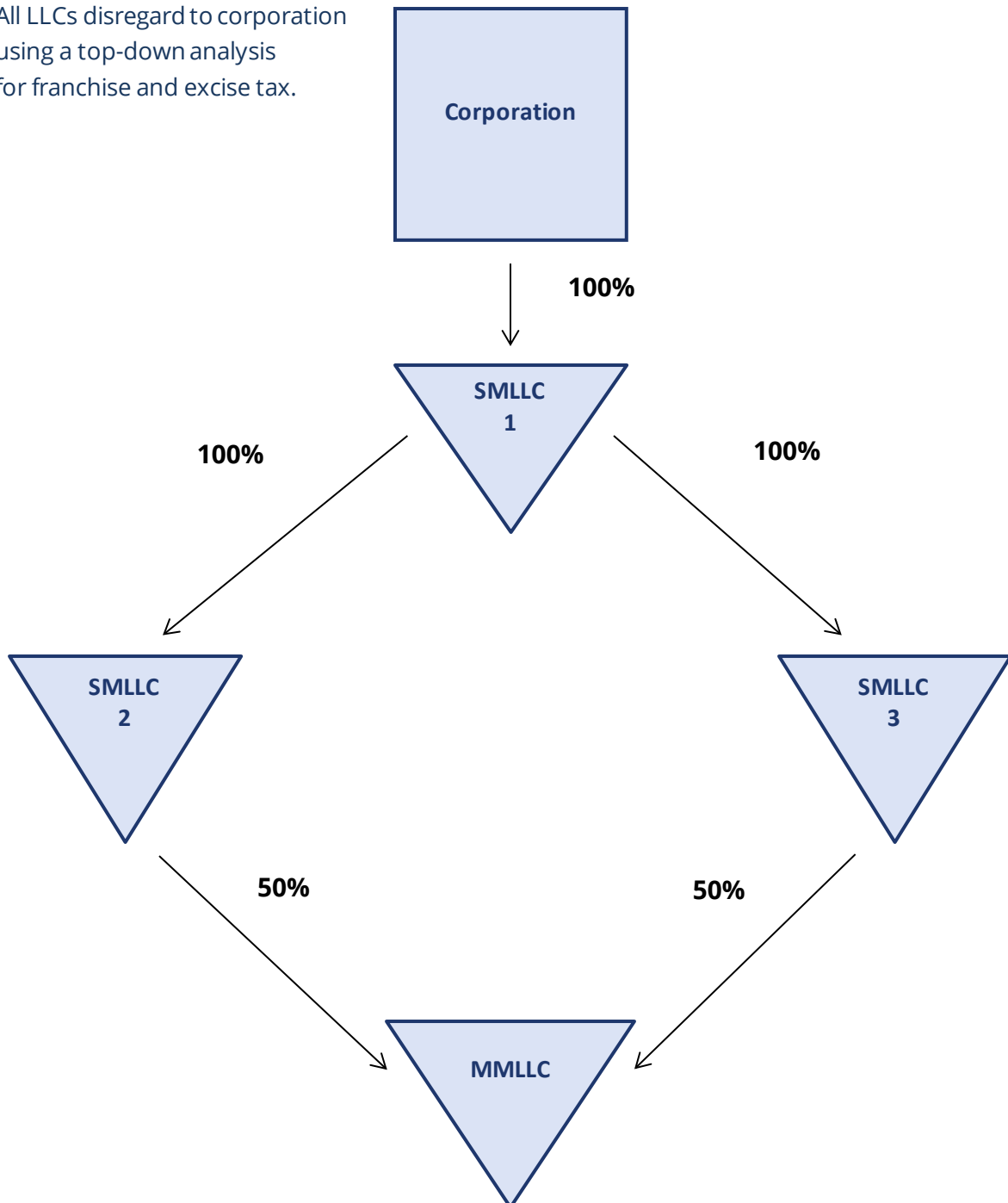
Multi-member LLC (MMLLC) is owned by two disregarded SMLLCs (SMLLC2 and SMLLC3) that are in turn owned by a disregarded SMLLC (SMLLC1) that is itself owned by a single corporation. MMLLC will be disregarded for franchise and excise tax purposes if it is disregarded for federal income tax purposes.

To arrive at this conclusion, a “top-down” analysis is done.

- SMLLC1 is disregarded into the corporation;
- SMLLC2 and SMLLC3 are disregarded into the corporation; and then
- MMLLC is disregarded into the corporation.

A multimember LLC that does not disregard into a single corporation using this “top-down” analysis is not disregarded for franchise and excise tax purposes.

All LLCs disregard to corporation using a top-down analysis for franchise and excise tax.



## 2. Series LLCs

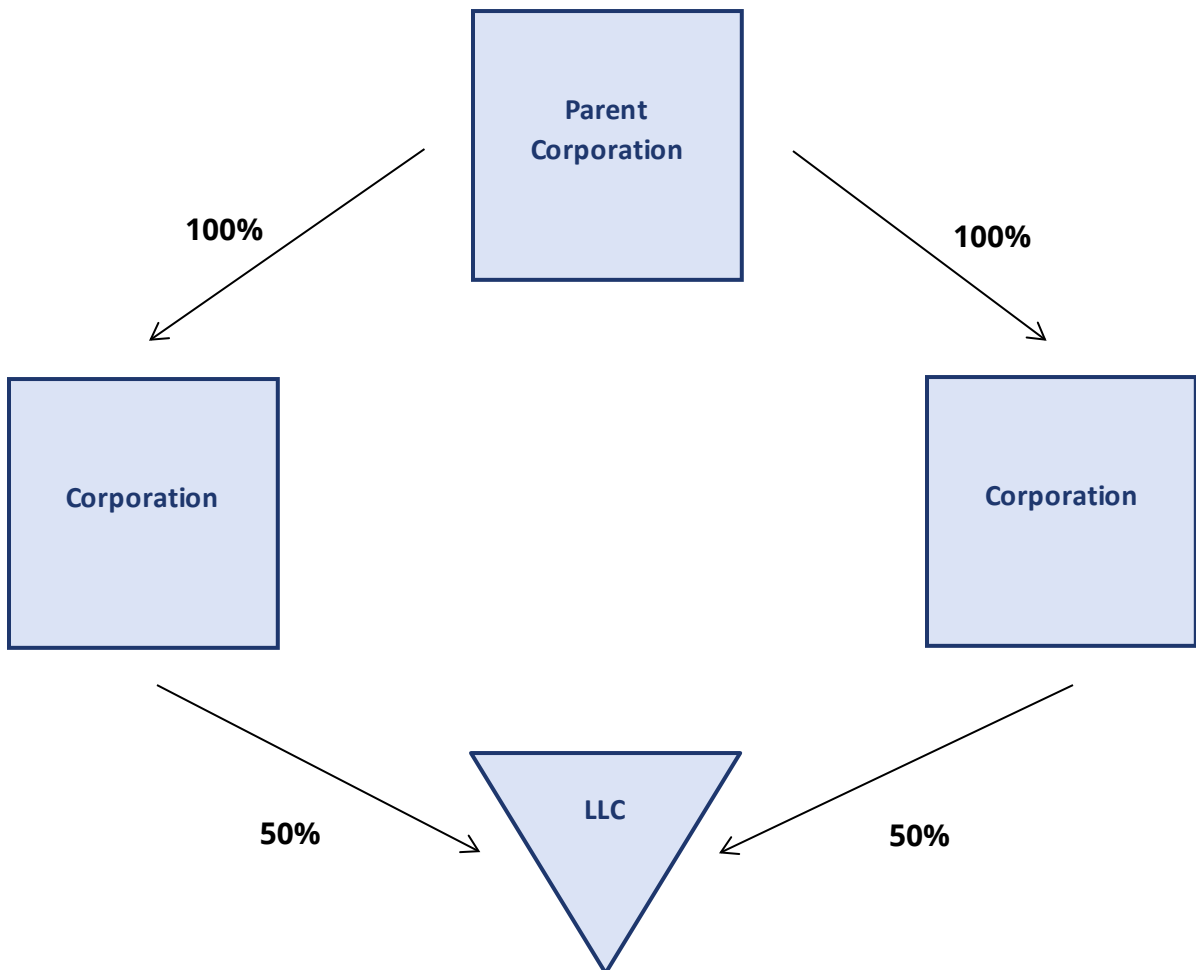
The series limited liability company is a relatively-new entity type that was established in 2006, but it is treated like any other entity in evaluating whether or not it meets the state's requirements to be disregarded.<sup>93</sup> For franchise and excise tax purposes, the Master LLC and each LLC series will generally be classified as a corporation, partnership or other type of business entity, consistent with the way it is classified for federal income tax purposes.

A Master LLC, or a series, that is wholly-owned by a corporation and is disregarded for federal income tax purposes will be disregarded for Tennessee franchise and excise tax purposes. All other federally disregarded Master LLCs or series are treated as separate entities for franchise and excise tax purposes.

## Disregarded Entities – Federal vs. State Rules

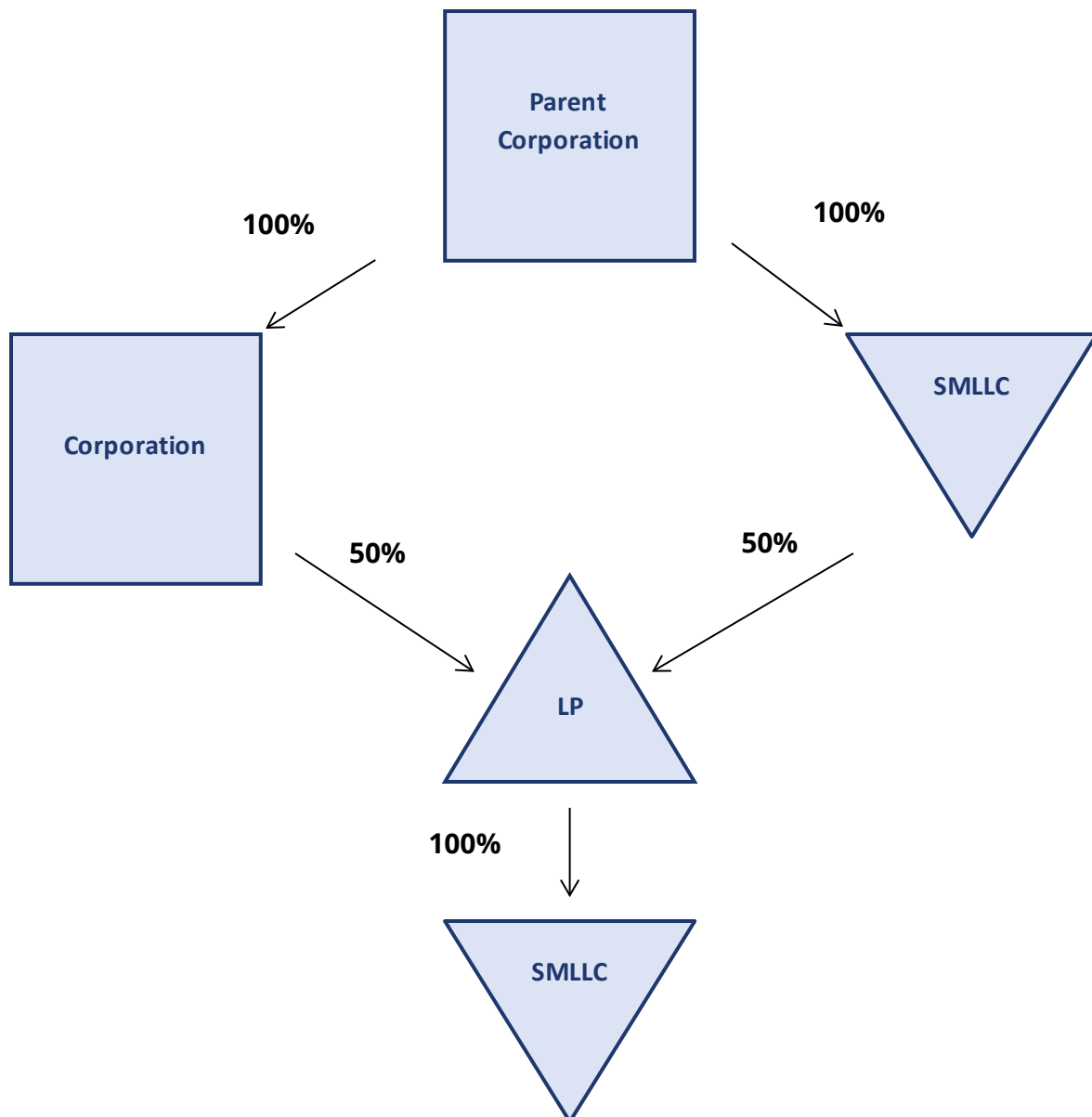
The following example emphasizes the differing federal and state rules for disregarded entities. An LLC is owned by two affiliated corporations (50% each) who are included in the same consolidated Form 1120 federal tax return. The LLC is disregarded, and its financials are reported on its owners' Forms 1120.<sup>94</sup>

However, the LLC is a separate stand-alone taxpayer for franchise and excise tax purposes and must file its own franchise and excise tax return. Additionally, the two corporations must file their own franchise and excise tax returns as well.

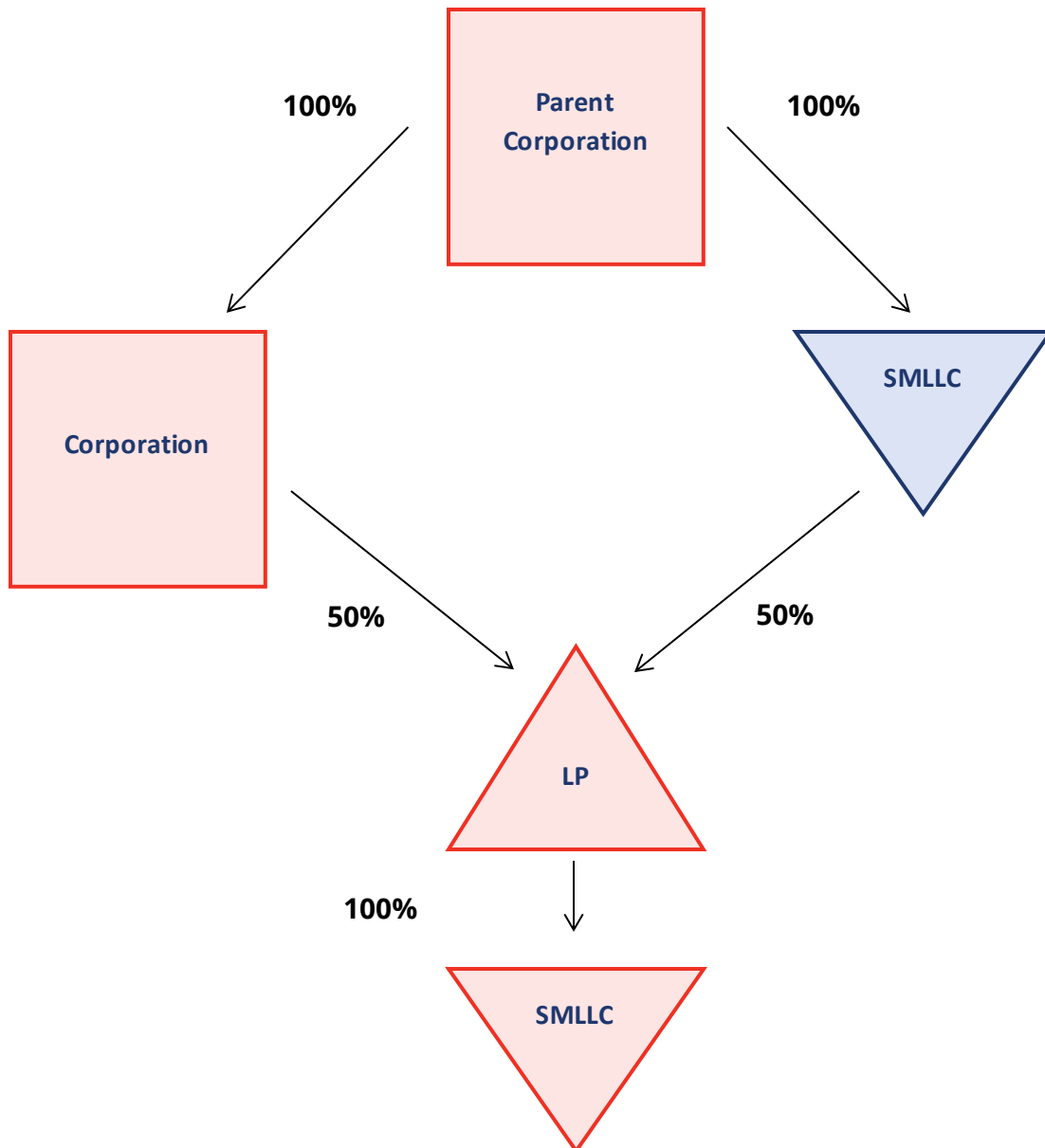




In the following example, one *federal* return would be filed. All entities would be disregarded to the parent for federal income tax purposes, but not for Tennessee franchise and excise tax purposes. See the next page for the state's treatment.



This is the same organizational structure as previously shown. The entities highlighted in red are separate single-entity franchise and excise taxpayers. The SMLLC highlighted in blue would disregard to its parent and would not file a separate franchise and excise tax return.



## Additional Examples of Complex Disregarded Business Structures

### 1. Scenario One

Corporation A is the single-member owner of AA, LLC. Corporation A also has one subsidiary: Corporation B. Corporation B is the single-member owner of BB, LLC, who in turn is the single-member owner of CC, LLC. For federal income tax purposes, all of the LLCs are disregarded; AA, LLC disregards to Corporation A, BB, LLC and CC, LLC disregard to Corporation B. Corporation A files a consolidated Form 1120 with its wholly-owned subsidiary, Corporation B. All five of these entities file on one federal Form 1120 filed by Corporation A.

However, the Tennessee filing requirements differ:

- Corporation A must file a franchise and excise tax return.
- Corporation B must file a franchise and excise tax return.
- AA, LLC is disregarded to Corporation A and its activities are included in Corporation A's franchise and excise tax return.
- BB, LLC is disregarded to Corporation B and its activities are included in Corporation B's franchise and excise tax return.
- CC, LLC is also disregarded to Corporation B because its single-member, BB, LLC, is an SMLLC whose single-member is Corporation B; the activities of CC, LLC will be included in Corporation B's franchise and excise tax return. This is an example of the "top-down" analysis found in TENN. COMP. R. & REGS. 1320-06-01-.40.

### 2. Scenario Two

QQ, LLC; RR, LLC; and SS, LLC are all SMLLCs and are all disregarded to their single-member owner TT, LLC for federal income tax purposes. TT, LLC is a multi-member LLC that is 90% owned by UV Corporation and 10% owned by XY Corporation, which are both unrelated corporations that each file their own Form 1120. TT, LLC files a Form 1065 because it is a multi-member entity (a partnership) that has not elected to file as a corporation. All these entities except SS, LLC do business in Tennessee.

Again, the LLCs' Tennessee filing requirements differ from their federal filing requirements:

- UV Corporation and XY Corporation each file their own franchise and excise tax and federal returns.
- TT, LLC must file a separate franchise and excise tax return.
- QQ, LLC and RR, LLC must file separate franchise and excise tax returns. They are not disregarded because their single-member owner is not a corporation or an SMLLC whose single-member is a corporation.
- Pro forma returns will need to be created from the federal Form 1065 of TT, LLC to report the activities of TT, LLC; QQ, LLC; and RR, LLC each on a separate-entity basis.
- SS, LLC is not required to file a franchise and excise tax return because it does not do business in Tennessee and is not disregarded to another entity's return.

If TT, LLC had made the election on federal Form 8832 to be taxed as a corporation, the Tennessee filing requirements would be as follows:

- No change in the filing requirements for UV Corporation and XY Corporation.
- TT, LLC would be required to file a franchise and excise tax return that includes the activities of its disregarded SMLLCs (QQ, LLC; RR, LLC; and SS, LLC). Note that even though SS, LLC does not do business in the state and would not be taxed as a separate entity, it is included in the franchise and excise tax return of TT, LLC because it is disregarded and treated as a division of this corporate taxpayer.
- The excise tax portion of TT, LLC's return would be based on its federal Form 1120 and would produce a single taxable income or loss, since intercompany transactions between it and its SMLLCs would offset or be eliminated.

Simply examining a copy of the completed federal income tax return or Tennessee franchise and excise tax return of a single-member owner may not reveal that the activities of one or more SMLLCs are included in its return. Therefore, the auditor may request and examine the taxpayer's workpapers, any available pro forma returns, federal elections, consolidation schedules, or other records deemed necessary to ascertain the validity of the entities included in the tax returns. A preliminary audit analysis or inquiry of the organizational structure should alert the auditor that there are SMLLCs present within the structure. Once the federal filing

status of any SMLLCs or other disregarded entities is determined, the franchise and excise tax filing status can be properly determined.

### 3. Revenue Ruling 11-46 – Disregarded Entities and Filing Requirements

Revenue Ruling 11-46 addresses the changes in Tennessee filing requirements for the potential reorganization of a group of related companies. The parent is a corporation that wholly owns a group of SMLLCs and LPs. For federal income tax purposes, all of the SMLLCs and LPs are disregarded under the default rules to the parent’s corporate return.

**Chart A** on the next page shows an organizational chart detailing how the entities are structured in this Ruling. Federally, the whole group files as one taxpayer under the name of the parent corporation. LP1 and LP2 are disregarded entities, since their partners are disregarded to the same entity.

There are *potentially* five franchise and excise taxpayers: **1)** Parent Corporation, including disregarded LLCA, LLCA1, and LLCA2, **2)** LP1, **3)** LP 2, **4)** LLCA3 and **5)** LLCA4.

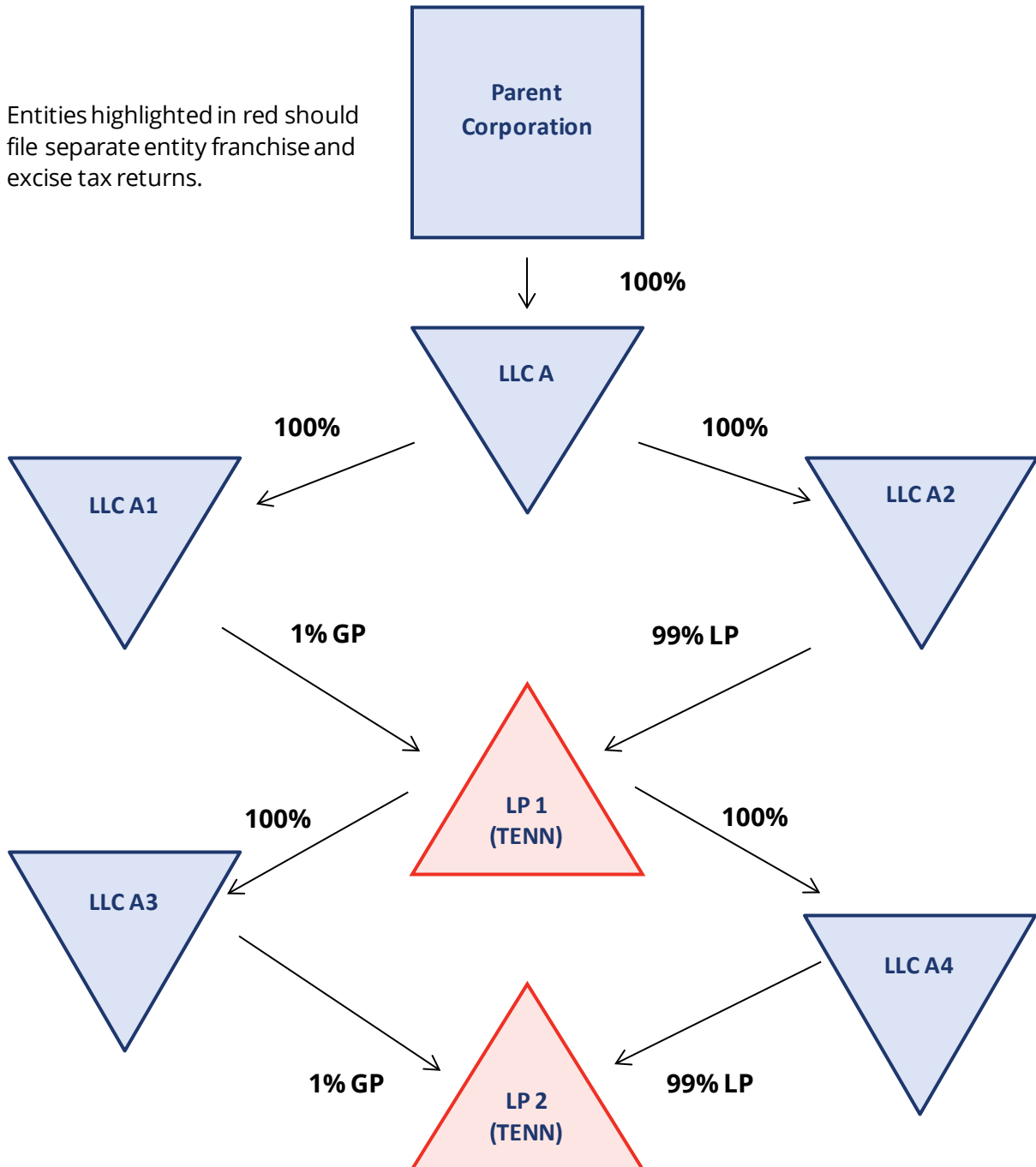
In this Ruling Parent Corporation, LLCA, LLCA1, and LLCA2 are not doing business and do not have substantial nexus in the state; there is no franchise and excise tax filing requirement. Also, LLCA3 and LLCA4 are not subject to the state tax because they are not disregarded and do not have nexus with Tennessee. However, for franchise and excise tax purposes, LP1 and LP2 are both separate-entity taxpayers that should file their own returns. In this scenario, auditors would need to request pro forma returns for LP 1 and LP2.

Note that under the “top-down” analysis discussed earlier, LLCA disregards into the parent corporation, then LLCA1 and LLCA2 disregard into the parent corporation. Any one of these four entities may create a franchise and excise tax filing requirement for the group.

**Chart B**, located below after Chart A, shows a proposed reorganization. The reorganization would convert LP1 and LP2 to LLC B and LLC C and would eliminate LLCs A1-A4. Under Chart B, for both state and federal purposes, a single return would be filed that includes the activities of Parent Corporation, LLCA, LLC B, and LLC C. After the restructuring the parent owns three LLCs in a tiered structure. All three SMLLCs will be disregarded to the parent’s corporate return for both state and federal income tax filing purposes. One franchise and excise tax return is filed to report the activities of all four entities. This determination is based on the ownership and type of entity, rather than whether the entities are “doing business” in the state.

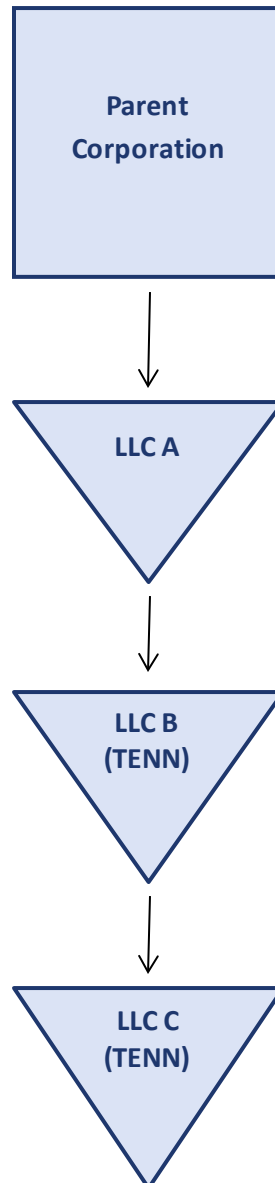
Chart A

Entities highlighted in red should file separate entity franchise and excise tax returns.



*Chart B*

This chart shows the reorganization of the structure shown in Chart A, described earlier. Note the conversion of LP 1 and LP 2 (see Chart A) to LLC B and LLC C. Also, note the elimination of LLCs A1, A2, A3 and A4. One state and federal return would be filed including all four entities.



#### 4. Revenue Ruling 11-53 - Disregarded Entities and Filing Requirements

The following discussion, based on Ruling 11-53, addresses the franchise and excise tax filing requirements of individual members within a group. The parent is a foreign company, located outside of the United States, and Corp I is a foreign subsidiary of the foreign parent. Corp C is the U.S. subsidiary of Corp I.

##### In **Chart C**:

- *Federal return filing* – Corp I would file on Form 1120F to report its 50% share of its Schedule K-1 distribution from LLC D. Corp C would file a standard Form 1120 to report its 50% share of its Schedule K-1 distribution from LLC D. LLC D would file a Form 1065 partnership return and issue Schedule K-1s to its two owners. It is not disregarded since the Schedule K-1s are issued to entities that report on different federal returns. All the SMLLCs owned by LLC D are tiered in a 100% ownership stack and would be disregarded to LLC D for federal income tax purposes.
- *Tennessee return filing* – Multi-member LLC D would be a taxpayer because it has activity in the state and is not disregarded. Auditors will request that LLC D provide a pro forma Form 1065, reflecting only the activities of LLC D. Because LLC F and LLC G have Tennessee activities, they would each file individually. Even though they are owned by LLC D, they would not be disregarded to it, since LLC D is not a corporation but a multi-member LLC filing on Form 1065.

##### In **Chart D**:

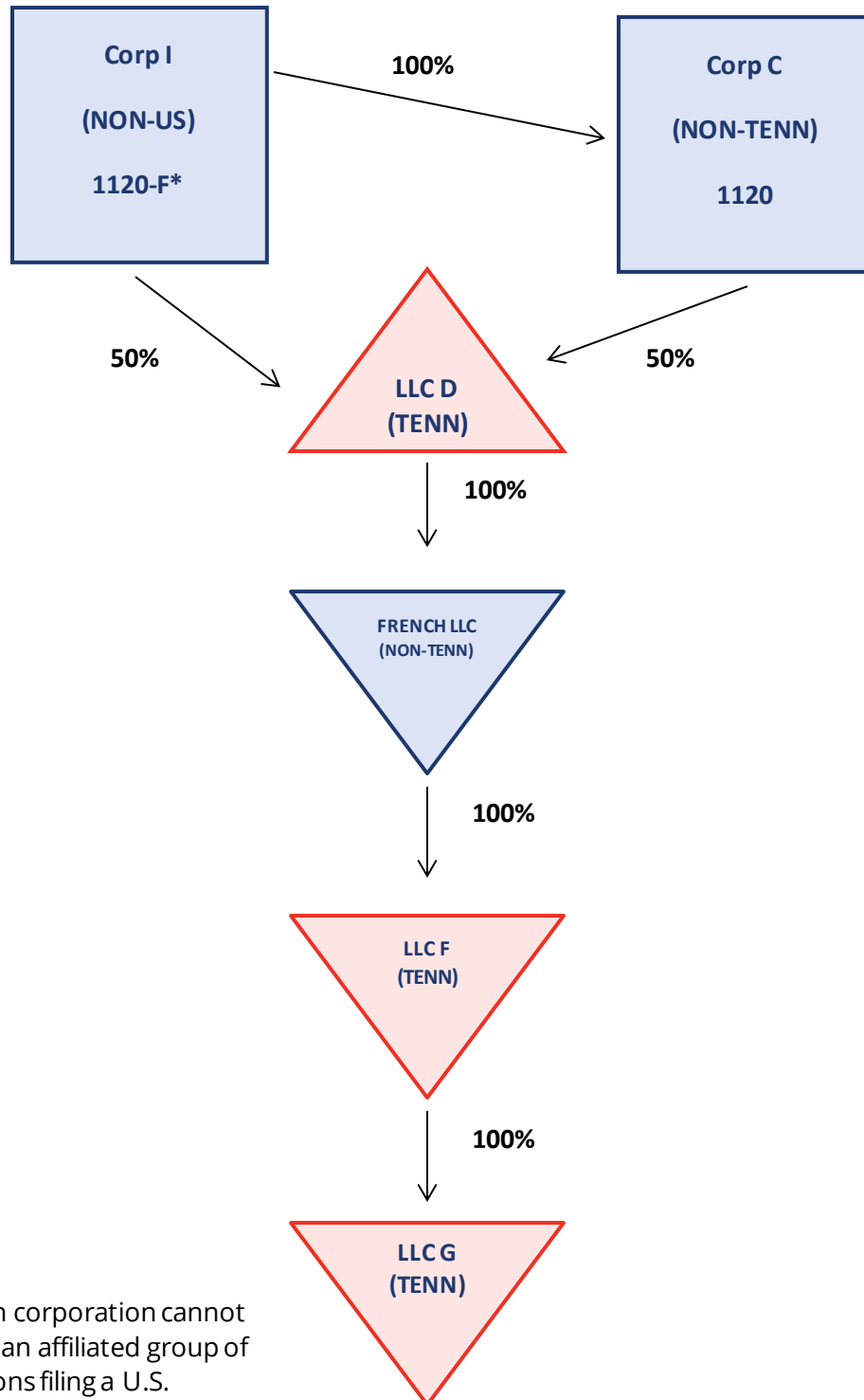
The scenario exhibited in Chart D shows that a corporation with no business activity in the state and no business registration with the Secretary of State may be subject to the state's franchise and excise tax if it is the sole owner of an SMLLC that has nexus in the state. Chart D reflects a reorganization of the Chart C structure. Corp. I cancels its ownership interest in LLC D, making LLC D an SMLLC solely owned by Corp C.

- *Federal return filing* – Only one federal return will be filed for Corp C and all SMLLCs.
- *Tennessee return filing* – One franchise and excise tax return would be filed for Corp C and all LLCs. Corp C and French LLC do not have Tennessee activity on their own but are included in the franchise and excise tax return because all LLCs disregard to Corp C and some have Tennessee nexus. The return would include the activities of Corp C, LLC D, French LLC, LLC F, and LLC G under a “top-down” analysis, as discussed earlier.



Chart C

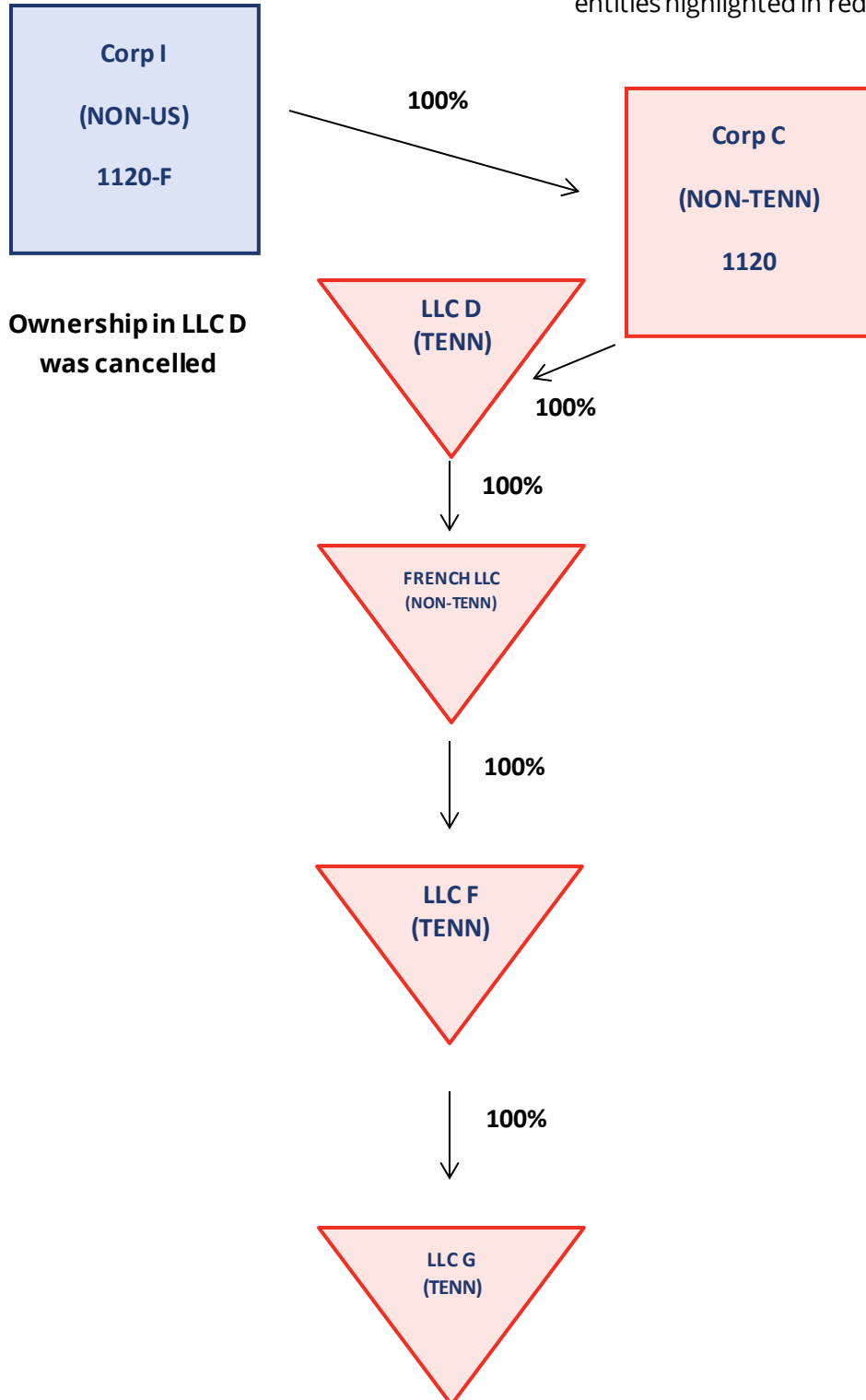
The three state return filers are highlighted in red.



\* A foreign corporation cannot be part of an affiliated group of corporations filing a U.S. consolidated federal return.

Chart D

One state return would be filed for the entities highlighted in red.



## Chapter 5: Filing Requirements

All for-profit, foreign, and domestic entities formed or qualified with the Tennessee Secretary of State must file a franchise and excise tax return and pay at least the minimum tax.<sup>95</sup>

Entities are subject to franchise and excise tax from their date of formation.<sup>96</sup> If an entity does not register with the Secretary of State, the entity is liable for the tax from the date it begins operations with substantial nexus in the state.<sup>97</sup>

Failure to file a franchise and excise tax return or pay required fees and taxes may result in the revocation of a business's charter or certificate.<sup>98</sup>

### Registration

Persons subject to the franchise and excise tax should register with the Department within 15 days from the date they become subject to the tax.<sup>99</sup> There is no registration fee.

Registration for sales tax, business tax, franchise and excise tax and more is accomplished on a single registration application. The Department requires a separate registration application for each business entity doing business in this state. In the case of financial institutions forming a unitary business, the entity filing the return on behalf of the unitary business should register with the Department, as should the other entities included in the unitary group.

### Electronic Filing

Businesses must submit franchise and excise tax registrations, returns, and associated payments electronically<sup>100</sup> through the [Tennessee Taxpayer Access Point](#) ("TNTAP") or through an approved software vendor.

The Department partners with the IRS in a program called IRS Modernized e-File ("MeF"). Through MeF, the IRS allows tax preparers to include the Tennessee tax return and any associated payment with its electronically filed federal return. The IRS forwards the Tennessee tax return directly to the state. Please see the IRS MeF webpage for more information on how to enroll. It can be found at <https://www.irs.gov/e-file-providers/modernized-e-file-program-information>

### Filing Period

A franchise and excise tax return is required for every closing of the books and records of the taxpayer. The reporting period for the state return will match the reporting period the entity

uses for federal income tax purposes.<sup>101</sup> As such, the period dates at the top of the franchise and excise tax returns, Forms FAE170 and FAE174, should correspond with federal income tax return period dates.

Taxable entities incorporated, domesticated, qualified, or otherwise registered to do business in Tennessee that are inactive in Tennessee for the entire taxable period must pay the minimum tax and may file only the first page of the franchise and excise tax return. Such taxpayers may omit the remaining pages.

Information concerning the requirements and details of federal tax periods can be found in IRS Publication 538 at <http://www.irs.gov/publications/p538/ar02.html>.

## 1. Annual Returns

### *Calendar Year and Fiscal Year*

A calendar year return covers 12 consecutive months, beginning on January 1<sup>st</sup> and ending on December 31<sup>st</sup>.

A fiscal year return also covers 12 consecutive months, but it begins on the first day of any month other than January and ends on the last day of the 12<sup>th</sup> month following (e.g., July 1<sup>st</sup> through June 30<sup>th</sup> of the next calendar year).

### *52-53 Week Fiscal Year*

The IRS allows businesses to file their federal income tax return using a 52-53 week fiscal tax year. The Department accepts the federal 52-53 week return and considers it an annual return for the purpose of prorating the franchise tax.<sup>102</sup> The 52-53 week reporting period will not be considered a short-period return even if the period covers less than 365 days.

A 52-53 week fiscal year is one that varies from 52 to 53 weeks during any particular year.

The 52-53 week year allows businesses to end their tax year on the same day of the week every year. Any day of the week may be used. The 52-53 week tax year ends either on the date on which that same weekday last occurs in a calendar month or on the date on which that same day of the week falls that is nearest to the last day of the calendar month. Some tax years will end in December, and some will end in January.

## 2. Short-Period Returns

Short-period returns are filed for tax filing periods covering less than 12 months. Initial returns, final returns, and returns involving reorganizations are often short-period returns. Short-period returns are filed if the person filed a short-period return for federal income tax purposes.

Because the filing period of the franchise and excise tax return must coincide with the accounting period of the federal return, short-period franchise and excise tax returns must match federal short-period returns. However, a business included in two annual consolidated federal returns in a single year may file two franchise and excise tax returns. See an example in the section “Change in Ownership – Filing Period and Due Dates.”

### *Examples of Short-Period Returns*

The following are examples of when businesses file short-period returns.

- Business files an initial return in its first year of existence.
- Business is not in existence for the entire tax year due to a merger, termination, or liquidation.
- Business conversion results in a liquidation of the old entity, such as one converting from a corporation to an SMLLC.
- Business elects to change its reporting period for business reasons on federal Form 1128.

The Department will accept two short-period returns if:

- A business is sold prior to the end of the year;
- Its presale activity is included in the federal consolidated return of the presale parent;  
and
- Its post-sale activity is included in the federal consolidated return of the new parent.

## Tax Year Adjustment

To adjust its tax year, an entity must request federal approval by filing federal Form 1128. The filing period reported for the franchise and excise tax return must match the period reported for federal income tax purposes.

**⚠ Computational information related to short-period returns can be found later in this manual in the sections “Annualizing Rent” and “Final Returns and Proration.”**

### 3. Foreign Entities Newly Subject to Franchise and Excise Tax

If an out-of-state foreign entity conducts any activity that gives it Tennessee nexus in a given year, it is taxable based on its federal tax year or reporting period. The franchise and excise tax computation begins with the date on the entity's federal income tax return, regardless of the start date of its in-state activity. For example:

- A foreign entity that files a calendar year return and begins doing business in Tennessee on July 1<sup>st</sup> would file a state return based on the entity's full calendar year federal return. The denominator apportionment ratios would be based on the entity's full calendar year activity. Franchise tax for this entity would be prorated for the short period, July 1<sup>st</sup> to December 31<sup>st</sup>.<sup>103</sup>

## Filing Due Dates

### 1. Calendar Year, Fiscal Year, and Short-Period Filers

Full-year and short-period returns that end on the final day of a month are due on the 15<sup>th</sup> day of the fourth month after the period ends.<sup>104</sup> Businesses that are sold or going through a reorganization may file a return with a period end date other than the last day of the month. Returns that end before the last day of the month are due on the 15<sup>th</sup> day of the fourth month following the month that included the final day. For example, a return filed with a period end date of February 8<sup>th</sup> would be due June 15<sup>th</sup> and one filed with a period end date of February 25<sup>th</sup> would also be due June 15<sup>th</sup>.

An electronic return is considered timely filed if it was:<sup>105</sup>

- Transmitted on or before the due date;
- Transmitted on or before the due date and subsequently accepted; or

- Rejected by the Department because of a validation rule, corrected by the taxpayer, and retransmitted within a 10-day grace period or “perfection period.”

The perfection period is a period of 10 calendar days. The perfection period begins on the day after the date of first transmission of an electronic return that is rejected by the Commissioner. Another perfection period occurs after the rejection of a return for failure to meet a validation test.<sup>106</sup>

## 2. 52-53 Week Filers

Returns based on a 52-53 week year are due on or before the 15<sup>th</sup> day of the fourth month following the end of the month closest to the 52-53 week year end.<sup>107</sup> As such, the franchise and excise tax return should be filed no later than the 15<sup>th</sup> day of the fourth month following the close of the taxpayer’s tax year.

- If a 52-53-week filer reports an end date of December 28<sup>th</sup>, the end of the month closest to December 28<sup>th</sup> is December 31<sup>st</sup>. The return would be due April 15<sup>th</sup>.
- If a 52-53-week filer reports an end date of January 2<sup>nd</sup>, the end of the month closest to January 2<sup>nd</sup> is December 31<sup>st</sup>. In this case, the return would also be due April 15<sup>th</sup>.

## 3. Filing Extension

The Department will grant an extension of seven months to file the franchise and excise tax return,<sup>108</sup> provided that by the original due date of the return, the taxpayer has made an extension request and remitted franchise and excise tax payments for the current tax year equal to the *lesser* of:

- 90% of the tax liability for the tax year for which the extension is being requested (as determined by the filed return); or
- 100% of the tax liability for the prior tax year (for the purpose of determining the required extension payment, the prior year tax liability must be annualized<sup>109</sup> if the prior tax year is a short period).
- If the taxpayer had a zero tax liability for the prior tax year, then the required extension payment is \$100.<sup>110</sup>

- If the taxpayer anticipates that it will be due a credit or refund of tax with the return for which it is requesting an extension (due to having made sufficient tax payments as of the original return due date), the taxpayer does not need to file an extension application or make an extension payment. In this case, the extension will automatically be granted.<sup>111</sup>

If a taxpayer who makes a timely extension request does not meet the extension payment requirements indicated above, or if the taxpayer does not file the return by the extended due date, penalties and interest will be calculated as though no extension had been granted.<sup>112</sup> Note that the payment requirements mentioned above pertain only to obtaining an extension of time in which to file the return, *not an extension of time in which to pay the tax*. For example:

- A calendar year taxpayer is unable to file by April 15 and is unsure what its current year tax liability will be. On April 15, the taxpayer remits a payment equal to 100% of the prior year tax liability, thus meeting the payment requirement for a filing extension. The taxpayer files its franchise and excise tax return and remits a payment for the remaining balance of tax due on November 15.<sup>113</sup> The taxpayer is not assessed a filing delinquency penalty because there is a valid extension in effect, but the taxpayer *is* assessed interest on the balance of tax paid after the original due date of the return.

If the taxpayer must make a payment to meet the extension payment requirement, the payment should be made electronically on or before the original due date of the return. Taxpayers who need to make an extension payment must file [Form FAE173](#) with the Department. Please note, the extension request and payment should be made online via [TNTAP](#).

**⚠ The filing extension is not a payment extension. Any tax unpaid as of the original due date of the return will be assessed interest. Taxpayers with a valid filing extension will not be assessed a delinquency penalty for late filing but may be assessed an estimated tax payment penalty or other type of tax penalty. (See the section in this chapter on penalties.)**

#### 4. Estimated Assessment

If a taxpayer does not file a return:

- An estimated assessment of tax will be posted to the taxpayer's TNTAP account; and



- A Notice of Proposed Assessment will be sent to the taxpayer.

The estimated tax assessment is based on the best information available to the Department, and the taxpayer bears the burden of showing by clear and cogent evidence that the assessment is incorrect.<sup>114</sup> If unresolved, the assessment will go to the Collection Services Division for collection.

## Change in Ownership - Filing Periods and Due Dates

For federal income tax purposes, businesses file short-period returns when a majority of an entity's ownership changes. A short-period return is required at the date of ownership change so that each respective owner only pays tax on income from the period in which they owned the entity.

Ongoing businesses sold mid-year may be included in the annual consolidated federal returns of two parent corporations in a given year. These consolidated federal returns could each report a full 12-month filing period. Generally, the franchise and excise tax return filing period of entities included in a consolidated federal return, or entities disregarded for federal income tax purposes, should match the federal return of which the entity is a part. However, in cases where an ongoing business closes its books before year end because it is sold to a new parent corporation, its franchise and excise tax filing period will differ from that of the federal consolidated return reporting a full-year filing period. The change in the ongoing entity's ownership causes the entity to have two short-period closings within one year. Franchise and excise tax returns should be filed for each short-period closing, with one representing the activity under the original owner and the second representing the activity under the new owner. For example:

- Parent Co. ABC sold Subsidiary Z to DEF Corporation on May 31<sup>st</sup>. Both ABC and DEF file consolidated Form 1120 tax returns with a filing period of January 1 to December 31. Subsidiary Z's activity from January 1<sup>st</sup> to May 31<sup>st</sup> would be included in ABC's consolidated calendar year return. Z would file a franchise and excise tax return for the short-period January 1<sup>st</sup> to May 31<sup>st</sup>. Then, Z's activity from June 1<sup>st</sup> to December 31<sup>st</sup> would be included in DEF's consolidated calendar year return. Z would file a franchise and excise tax return for the second short-period, June 1<sup>st</sup> to December 31<sup>st</sup>.
- Taxpayers may request that the state's computer system be adjusted so that the first short-period return would be due on the 15<sup>th</sup> day of the fourth month following the end

of the filing period reported on the corresponding consolidated federal return. In this case, April 15.

## Franchise Tax Proration and Annualizing Rents

### 1. Proration

- Short-period franchise and excise tax returns must coincide with federal short-period return accounting periods.
- All short-period returns should prorate the franchise tax.
- Franchise tax should never be prorated below the minimum \$100 tax.
- **There is no proration of the excise tax;** income and expenses are reported only for the period of time covered by the excise tax return.<sup>115</sup>

Businesses must prorate the franchise tax using the “number of days method.”<sup>116</sup> To prorate the tax, multiply the full-year franchise tax by the number of days in the tax period and then divide the product by 365.25.

- **Prorated Tax** = (Full Year Tax x Days in the Short Period) ÷ 365.25

The tax period start date is important for franchise tax proration on short period returns.

- Taxpayers incorporated or otherwise formed in Tennessee must prorate the franchise tax on the initial return from the date formed or the date on which Tennessee operations began, whichever occurs first.
- Taxpayers incorporated or otherwise formed outside Tennessee must prorate the franchise tax on the initial return from the date Tennessee operations began. The Tennessee date is used for proration of the franchise tax, but the excise tax is computed from the information on the taxpayer’s federal income tax return.

### 2. Annualizing Rents

Taxpayers must annualize rents on all short period returns. As with proration, taxpayers must use the *number of days method* to annualize rents. To arrive at annualized rent, multiply the rent expense by 365.25 and then divide the product by the number of days in the short period.

- **Annualized Rent** = (Rent Expense x 365.25) ÷ # of Days in the Short Period

The rent expense value used in the above calculation comes from the taxpayer's books and records prepared in accordance with generally accepted accounting principles (GAAP). For the purpose of completing the franchise tax Schedule G, GAAP books and records should be used by the taxpayer. For the purpose of completing the property factor of the standard apportionment ratio on Schedule N, the taxpayer should use its tax basis books and records. Annualizing rents for the apportionment ratio is the only instance where a short-period return impacts the excise tax calculation.

**Additional information and examples:**<sup>117</sup>

- Rents are not annualized when the rental term is on a month-to-month basis, because of the uncertain duration.
- When a taxpayer has rented property for a *term of 12 or more months* and the current tax period covers a period of less than 12 months (due, for example, to a reorganization or change of accounting period), the rent paid for the short tax period is annualized.
- When a taxpayer has rented property for a *term of less than 12 months* and the current tax period covers a period of less than 12 months (due, for example, to a reorganization or change of accounting period), the rent is not annualized beyond its term.
- Examples:
  - Taxpayer A, which ordinarily files its returns based on a calendar year, is merged into Taxpayer B on April 30. The net rent paid under a lease with five years remaining is \$2,500 per month. The rent for the tax period January 1 to April 30 is \$10,000. After the rent is annualized, the net rent is \$30,000 (\$2,500 X 12).
  - *Same facts as above*, except that the lease would have terminated on August 31. In this case, the annualized net rent is \$20,000 (\$2,500 X 8). Because the rental term is for less than 12 months, the rent was not annualized beyond its term.

## Final Returns

### 1. “True” Final Return

A “true” final return is the last return filed by an entity that no longer has business or financial activity in the state.<sup>118</sup> Taxpayers sometimes erroneously mark returns as final, but they might not be “true” final returns. A change in ownership that changes a taxpayer’s designation as to whether the taxpayer is a disregarded entity *never* constitutes a final return because the taxpayer’s business is ongoing.

**⚠ Please note: An initial audit step is determining whether an entity has truly liquidated and all financial and business operations have ceased. In the case of a foreign entity, determining if all Tennessee operations have ceased, and the entity is requesting tax clearance to withdraw its certificate of authority from the Secretary of State.**

#### *Final Return Status*

A taxpayer in the process of liquidating and ceasing business operations will be considered to be in “final return status” from the first liquidating event until it ceases to exist or is no longer subject to tax.<sup>119</sup> A taxpayer can be in final return status for more than one year and should file a tax return for each tax period while it is in this status. Taxpayers in final return status should *not* check the “final return” box on their return unless it is truly the last return to be filed.

#### *Filing Requirements*

There is a filing requirement for taxpayers with any remaining assets, activity, equity, or proceeds, or with installment sales attributable to Tennessee, regardless of whether the entity has remaining in-state activity.<sup>120</sup>

Taxpayers must attach a statement of liquidation, distribution, or disposition of all assets to the franchise and excise tax return when the “final return” box has been checked. This statement should include the date of sale or liquidation and balance sheets for the final and preceding tax periods. Upon review of the final return, the Audit Division may request additional information.

## 2. Liquidation and Tax Base Calculation

### *Liquidation Completed in a Single Day*

If the liquidation occurs all on one day, the franchise tax will be determined by reference to the balance sheet values for net worth and real and tangible property immediately preceding the liquidating event.<sup>121</sup> The net worth and property amounts should **not** be zero but should reflect *pre-liquidation values*.<sup>122</sup>

### *Example 1: Single Day Liquidation*

Assume all assets are sold and the proceeds are distributed on June 30.

	Schedule F	Schedule G
Tax Base (pre-liquidation values)	\$500,000	\$2,000,000
Annual Franchise Tax (\$2,000,000 x .0025)		\$5,000
Prorate		181/365.25
Franchise Tax		\$2,478

In this case, the pre-liquidation values of net worth and property were used to arrive at the tax base because all assets and equity were merged, sold, or distributed on a single date. Because the return is a short-period return (January 1 – June 30), the franchise tax is prorated. If there were any rental expenses, they would have been annualized for the purpose of arriving at the franchise tax property base on Schedule G.

### *Liquidation Occurring Over More Than One Day*

If the liquidation occurs over multiple days, the taxpayer will use *average monthly values* to compute the net worth and property bases for the purpose of computing the franchise tax on any return in final return status.

The *average monthly values* are determined by totaling:

- the value of net worth as of the final day of each month of the tax period, and the book value of the real and tangible property owned in Tennessee as of the final day of each month of the tax period; and
- dividing these totals by the number of months in the tax period, excluding the month when total liquidation occurred.<sup>123</sup> The divisor will be the same for both the net worth and owned property calculations.

The month-end balances for “indebtedness to or guaranteed by an affiliate” are averaged and are included in the average monthly value for Schedule F1.<sup>124</sup>

Rents are entered on Form FAE170, Schedule G, Lines 11-14 and annualized if the tax return covers less than 12 months. They are not averaged like owned property.

**⚠ The Department has made available a [Franchise Tax Worksheet for Accounts in Final Return Status](#). This worksheet includes sections to assist the taxpayer in computing the average monthly values for net worth reported on Schedule F1 or Schedule F2 and the book value of owned tangible property reported on Schedule G.**

### *Example 2: Average Monthly Values*

A calendar year taxpayer sold all its tangible property on July 1 of Year One with the intent to completely liquidate. A final distribution of all assets was made on March 9 of Year Two, and the taxpayer’s balance sheet reflected all zeroes after the distribution. Because the taxpayer is in final return status and the liquidation did not occur in a single day, the taxpayer will compute its franchise tax base using average monthly values. On the following page is a schedule detailing how the taxpayer will calculate the average monthly values of its net worth and real and tangible property franchise tax bases.

	<b>Schedule F1</b> Net Worth Base	<b>Schedule G</b> Property Base
<b>Year One</b>	<b>Month End Values</b>	
January 31	\$500,000	\$2,000,000
February 28	\$550,000	\$2,000,000
March 31	\$450,000	\$2,000,000
April 30	\$500,000	\$2,000,000
May 31	\$600,000	\$2,000,000
June 30	\$550,000	\$2,000,000
July 31	\$750,000	\$0
August 31	\$800,000	\$0
September 30	\$700,000	\$0
October 31	\$700,000	\$0
November 30	\$650,000	\$0
December 31	\$100,000	\$0
<i>Total</i>	<i>\$6,850,000</i>	<i>\$12,000,000</i>
Number of Months	12	12
Average Monthly Value	\$570,833	\$1,000,000
Tax rate		.0025
Annual Franchise Tax		\$2,500
Prorate - days		N/A
Franchise Tax		\$2,500
<b>Year Two</b>	<b>Schedule F1</b>	<b>Schedule G</b>
January 31	\$100,000	\$0
February 28	\$100,000	\$0
March 9	\$0	\$0
<i>Total</i>	<i>\$200,000</i>	<i>\$0</i>
Number of Months	2	2
Average Monthly Value	\$100,000	\$0
Tax rate	.0025	
Annual Franchise Tax	\$250	
Prorate - days	68/365.25	
Franchise Tax -minimum	\$100	

In Example 2, average monthly values were used to calculate the franchise tax in both Year One and Two because the taxpayer was in final return status starting with the first liquidating event (July 1<sup>st</sup> of Year One) and remained in that status for all future returns.

- The average monthly values listed for net worth and property are the respective values as of the final day of each month in the tax period.
- Zeroes were entered for March 9 of Year Two because all liabilities had been paid and all assets had been distributed to the owners at that time.

The average monthly values were calculated by dividing the sum of the month end values by the number of months in the tax period, excluding the month in which total liquidation occurred.

- The divisor in this example is two.
- March of Year Two was not counted for the divisor because total liquidation occurred in this month, meaning the month end balance sheet values were zero.
- The \$250 “annual tax” in Year Two was prorated because it was for the 68-day short-period of January 1 through March 9.
- The prorated amount ( $\$250 \times 68/365.25 = \$46.58$ ) is less than the \$100 minimum tax, so the assessed tax would be \$100.

### *Consolidated Net Worth Election*

If the taxpayer is part of an affiliated group that has made a consolidated net worth election, the election will *not* apply to the taxpayer while it is in final return status, unless the entire affiliated group is in final return status during the same tax period.<sup>125</sup>

A taxpayer in final return status may not file Schedule F2 using consolidated net worth unless the entire affiliated group is in final return status for the same tax period.

### **3. Tax Clearance**

Taxpayers are subject to franchise and excise tax until they are “actually and legally dissolved or withdrawn” with the Secretary of State.<sup>126</sup> Before a taxpayer can terminate its Charter, Articles of Organization, Certificate of Limited Partnership, or withdraw its Certificate of Authority or similar



document with the Secretary of State, a tax clearance certificate must be issued by the Department.

### *Certificate of Tax Clearance*

A Certificate of Tax Clearance declares that all tax returns administered by the Department have been filed and all liabilities have been paid. Certificates of Tax Clearance are issued to both terminating and ongoing businesses.

Certificates of Tax Clearance may be granted for terminations, withdrawals, reinstatements, rescissions, authorization, and good standing. Businesses often request a tax clearance certificate to confirm that they are in good standing with the Department to complete a large business transaction involving another entity.

To receive a tax clearance certificate when shutting down a business, a business must file all returns to date and a final franchise and excise tax return through the date of liquidation or the date on which the business ceased operations in Tennessee. Furthermore, all outstanding franchise and excise tax payments must be made.

A checked “final return” box on a franchise and excise tax return is deemed a request for tax clearance for termination or withdrawal. When the Department receives a return marked “final,” the Department may:

- Position the taxpayer for an audit;
- Automatically issue a tax clearance certificate; or
- Automatically issue a tax clearance denial letter that explains any shortcomings that need to be met and instructs the business to call the Department’s Taxpayer Services Division to get the matter resolved so the tax clearance can be issued.

The Department’s Taxpayer Services Division issues the certificate after the Department reviews the account and determines that all tax liabilities are satisfied. The Department mails the certificate to the business’ mailing address, unless otherwise specified. The clearance is valid for 45 days from the date of issuance.

The Secretary of State will deny the dissolution or withdrawal documents if the taxpayer has not been issued a tax clearance certificate. The same Certificate of Tax Clearance may be issued for a number of reasons and does not automatically signify that the business has terminated.

#### **4. Tax Collection**

The Commissioner of Revenue may collect franchise and excise taxes due, plus any penalties and interest from any officer, stockholder, partner, member, principal, or employee of a taxpayer that has ceased business without paying the tax, if the person has received property of the defunct business.

The amount of tax that may be collected in this situation may not exceed the value of the property received by the person from whom collection is sought.<sup>127</sup>

#### **5. Events Not Resulting in a Final Return**

##### *Short-Period Returns*

Although short-period returns are filed to segregate the earnings of the new owners from the old owners, these returns are not “final” if the business is ongoing. Returns should not be marked “final” unless all business activities and transactions have ceased, including the collection of all receipts from an installment sale.

##### *Conversion*

Conversion occurs when a single business changes its entity type. Conversion does not constitute dissolution of the converting entity; converting businesses are not required to wind up affairs, pay liabilities, or distribute assets. A business, therefore, is not required to submit a final franchise and excise tax return when it converts. Converting entities, however, should update the Department as to their change in entity type upon filing with the Secretary of State.

The Secretary of State recognizes the following conversions:

- Foreign entities that convert to domestic entities;
- Domestic unincorporated entities that convert to domestic corporations; and
- Domestic corporations that convert to domestic unincorporated entities.

Conversion of a domestic corporation to a domestic unincorporated entity could change an entity’s franchise and excise tax status from a regarded entity to a disregarded entity or vice versa. A newly-converted entity is deemed to have commenced business on the date on which the original entity was first formed. For example:

- A corporation owns 100% of another corporation, and both file separate franchise and excise tax returns. If the subsidiary corporation converts to an LLC, then that entity would be a disregarded entity (an SMLLC) owned by a corporation.
  - As a disregarded entity, the SMLLC's business activities will be included in its parent's state and federal income tax returns.
  - The subsidiary's franchise and excise tax return filed immediately before the conversion should *not* be marked final.<sup>128</sup>
  - If, at some point in the future, the disregarded SMLLC becomes a regarded entity again, the carryovers it originally generated as a regarded entity would be available to it again.

**⚠ Please Note: Any credit or loss carryovers generated by the domestic corporation before it became a disregarded entity would *not* be available to the franchise and excise taxpayer, which includes the disregarded entity and its corporate parent. This also includes job tax credits.**

A conversion may also result in a disregarded taxpayer losing its disregarded status for franchise and excise tax purposes. For example:

- An SMLLC that is owned by a corporation, which subsequently converts to a corporation, would no longer be disregarded and would need to begin filing its own franchise and excise tax return.
  - Any credit or loss carryovers generated by the SMLLC (prior to conversion) would stay with the SMLLC's corporate parent.
  - In general, carryovers will only be available to the entity that generated them, as evidenced by the entity's FEIN.<sup>129</sup>
  - If the corporate owner of an SMLLC converts to an unincorporated entity, the SMLLC would lose its disregarded status and any loss or credit carryovers would stay with the parent.

### *Federal Entity Classification Changes*

As previously discussed in Chapter 4 of this manual, eligible entities may use federal Form 8832 to elect how they will be classified for federal income tax purposes. The Department recognizes this election for franchise and excise tax purposes.

The change in entity type on federal Form 8832 does not require the filing of a final return because the same business will continue after the election but with a different entity designation. All credit and loss carryovers will be available to the business after the election, unless the business becomes a disregarded entity. For example:

- An LLC that elects to be treated as a corporation instead of a partnership for federal income tax purposes would be treated as a corporation for franchise and excise tax purposes, and any SMLLCs it owns would be disregarded.<sup>130</sup>

### *Technical Terminations*

For tax years prior to December 31, 2017, “Technical Termination” occurs when there is a “sale or exchange of 50% or more of the total interests in a partnership’s capital and profits” within a 12-month period.<sup>131</sup> Taxpayers filing for technical termination file federal Form 1065 for the period prior to the change in partnership interests and for the period subsequent to the change to reflect the “initial” return of the new partners’ interests.

- For franchise and excise tax purposes, a technical termination is considered a fictitious termination because the partnership’s business activities are ongoing.
- Taxpayers may file two short-period returns, but neither return should be considered final for franchise and excise tax purposes unless there is a complete liquidation of the business.

The Tax Cuts and Jobs Act of 2017, P.L. 115-97, however, eliminated technical terminations. With the repeal of technical terminations, partnerships can only terminate for federal tax purposes if the business, operation, or venture is completely terminated. In this case, the partnership would be in final return status.

### *Administrative Terminations*

Businesses registered with the Secretary of State may be *administratively revoked or dissolved* for a variety of reasons, including failure to file an Annual Report.<sup>132</sup>

- Administrative dissolutions or revocations should not trigger final franchise and excise tax returns because administrative terminations are not equal to legal terminations.
- Entities must continue to file returns until the business is “actually and legally” dissolved or withdrawn from the state.
- Any person doing business in Tennessee with a forfeited, revoked, or suspended registration or charter will not be relieved from filing a return and paying the tax for each tax year that it does business in Tennessee.<sup>133</sup>

### *Chapter 11 Bankruptcies*

Corporations and partnerships being reorganized through Chapter 11 of the United States Bankruptcy Code should not file final franchise and excise tax returns because the business is ongoing. However, businesses in Chapter 7 bankruptcy should file final returns because there is a complete liquidation of the business.

## **6. Corporate Reorganizations**

Corporate reorganizations may or may not result in a final return. Corporate reorganizations usually involve more than one entity and can be orchestrated to qualify as a “tax-free” exchange under one of the seven provisions of the IRC.<sup>134</sup>

Other reorganizations include:

- Statutory mergers or consolidations;
- Acquisitions of one corporation by another involving a stock exchange or asset transfer;
- Recapitalization transactions of a single corporation whereby stocks and/or securities are exchanged for new stocks and/or securities to reconfigure the company’s capital structure; and
- Transfers of all or part of a corporation’s assets to another corporation in bankruptcy.

Depending on the type of reorganization, a final franchise and excise tax return may or may not be required.

#### *“Type A” Reorganization*

- A “Type A” reorganization is a statutory merger or consolidation whereby one company is acquired by another.
- After the reorganization, only one company will remain in existence and the other will terminate.
- The terminating company will file a final return, and all its credit or loss carryovers will terminate.
- The surviving company will continue to file franchise and excise tax returns, and its credit and loss carryovers earned before the merger will be available after the merger.

#### *“Type B” Reorganization*

- A “Type B” reorganization is an acquisition of one corporation by another through the exchange of its own stock or a parent company’s stock.
- The acquired company becomes a subsidiary of the acquiring corporation.
- If these corporations were doing business in Tennessee, they would each file their own franchise and excise tax returns, both before and after the reorganization.
- This reorganization does not impact franchise and excise tax filings.

#### *“Type C” Reorganization*

- A “Type C” Reorganization occurs when a corporation acquires another corporation, the “target” corporation, in exchange for stock.
- The target company’s shareholders become shareholders of the acquiring company, and the target company is required to liquidate.

- As with the Type A reorganization, one corporation will survive and the other will liquidate or terminate.
- The terminating company will file a final return, and all its credit or loss carryovers will terminate.
- The surviving company will continue to file franchise and excise tax returns, and its credits and loss carryovers will survive the reorganization.

## Estimated Tax Payments

### 1. Estimated Payment Requirement

Taxpayers are required to make estimated tax payments when there is a combined franchise and excise tax liability of \$5,000 or more (after applicable tax credits) for *both* the prior tax year *and* the current tax year.

If the prior period's franchise and excise tax return was for a period of less than 12 months (short-period return), the actual liability from the prior short period must be annualized. Under these circumstances, the taxpayer is required to make estimated tax payments if both the annualized liability for the prior tax period and the projected liability for the current tax period are \$5,000 or more.<sup>135</sup> For example:

- A taxpayer filed a return for the tax period of January 1, 2018, through June 30, 2018, and plans to file a return for the period of July 1, 2018, through December 31, 2018.
- For the January 1, 2018, through June 30, 2018, period, the taxpayer owes \$3,000 in franchise and excise tax.
- The taxpayer estimates that the combined taxes, net of credits, for the second short period (July through December) will be \$5,000.
- To determine if both the current and preceding tax periods meet the \$5,000 threshold, the preceding tax period is annualized ( $\$3,000 \times 365.25/180 = \$6,088$ ).
- Here, *both* the preceding *and* current tax period exceed the \$5,000 threshold, so estimated tax payments are required for the tax period ended December 31, 2018.

- Note, the current year tax would not be annualized. If the estimated tax for the second short period return was \$4,000 instead of \$5,000, estimated payments would *not* be required.

## 2. Quarterly Estimated Payment Amount

Minimum quarterly estimated tax payments are computed using either the *standard method* or the *alternative annualized income installment method*.<sup>136</sup> Taxpayers may use either method but may not switch between methods during the tax year.

**⚠ The Department's [Estimated Franchise and Excise Tax Payments Worksheet](#) can be used to calculate payments under both methods.**

### *Standard Method*

Under the standard method, the amount of each quarterly installment is the same, regardless of that quarter's actual revenue. Both franchise and excise tax estimated payments are computed using the below formula under this method. The standard method computes the minimum quarterly payment amount as the *lesser* of:

- 25% of the prior year's total liability (annualized if the tax period was less than 12 months); or
- 25% of 80% of the projected current year's liability.

### *Annualized Income Installment Method*

The election to use the alternative annualized income installment method is an annual election made on the franchise and excise tax return Form FAE170 or FAE174. This method recognizes that income may be earned unevenly throughout the year and provides the estimate amounts that vary between quarters. Under this method, the payments more closely correlate to the income earned during the period. Franchise and excise tax components of the quarterly estimates are computed separately.

- The excise tax component is computed in accordance with Section 6655(e)(2) of the Internal Revenue Code.



- The franchise tax component of each installment is the lesser of 25% of the franchise tax shown on the tax return for the preceding tax year (annualized if less than 12 months) or 25% of 80% of the current year’s liability.

### 3. Remitting Payments

Taxpayers are required to remit their estimated tax payments electronically on TNTAP, through their bank or with approved tax preparation software through the IRS Modernized e-File Program. Penalty and interest charges may apply if the taxpayer fails to remit payments electronically.<sup>137</sup>

Tax payments are to be made by funds readily available to the state. Accepted forms of payment include ACH debit, ACH credit, and credit card (Visa, MasterCard, American Express, or Discover). A 2.35% service fee is added to payments made by credit card.

Any taxpayer owing \$2,500 or more in connection with any quarterly estimated tax payment must remit that tax payment to the state in funds that are immediately available to the state on the date the payment is made.<sup>138</sup>

### 4. Payment Due Dates

Quarterly payments of estimated franchise and excise tax are made according to the schedule below. The term “quarterly” is used because there are four payments due. The days between each quarter may vary.

Payment	Due Date
1 <sup>st</sup> Payment	The 15 <sup>th</sup> day of the <b>4<sup>th</sup></b> month of the current taxable year
2 <sup>nd</sup> Payment	The 15 <sup>th</sup> day of the <b>6<sup>th</sup></b> month of the current taxable year
3 <sup>rd</sup> Payment	The 15 <sup>th</sup> day of the <b>9<sup>th</sup></b> month of the current taxable year
4 <sup>th</sup> Payment	The 15 <sup>th</sup> day of the <b>1<sup>st</sup></b> month of the <b>subsequent</b> taxable year

### Penalties

Penalties may be assessed for several reasons, including but not limited to, late filing, late payment, delinquent or deficient estimated tax payments, failure to make a reasonable attempt to comply with the law, failure to make required disclosures, or fraud.

## 1. Penalties and Penalty Rates

### *Delinquent and Deficient Estimated Quarterly Tax Payments*

The penalty rate for delinquent and deficient estimated tax payments is 2% per month, up to a maximum of 24%, plus interest at the current rate per year.<sup>139</sup> Penalty and interest are computed from the due date of the installment to the date paid or until the 15<sup>th</sup> day of the fourth month following the close of the taxable year.

In order to avoid incurring a deficiency penalty, a taxpayer must make timely quarterly estimated franchise and excise tax payments, each consisting of at least:

- 25% of 80% of the current year's franchise and excise tax liability; or
- 25% of the prior year's liability.<sup>140</sup>

If a taxpayer has timely filed estimated tax payments for at least two years, but the estimated tax payments resulted in an underpayment of tax on which penalties and interest accrued (i.e., were deficient), such estimated payments may still be considered timely for the purpose of establishing good and reasonable cause for the waiver of a delinquency penalty.<sup>141</sup>

### *Delinquency Penalty – Filing or Paying Late*

If a taxpayer does not file its return or files late, or if a taxpayer does not timely pay the tax due, a delinquency penalty will be assessed. The penalty is computed at a rate of 5% per month, or any portion of a month, from the due date until the date the taxes are paid.

- The *maximum* penalty is 25% of the tax amount due.
- The *minimum* penalty is \$15, regardless of the amount of tax due.

### *Negligence Penalty*

Taxpayers are expected to file tax returns with all required schedules and disclosures and to pay the applicable tax due, based on Tennessee law. Failure to do so could result in the Department assessing a penalty if the Department determines that such failure is due to negligence. Negligence includes, but is not limited to, any failure to make a reasonable attempt to comply with the law.

A taxpayer's failure to report and pay the total amount of taxes due may result in the imposition of a penalty in the amount of 10% of the underpayment, if the Department determines that such failure is due to negligence. The penalty may be assessed on the franchise and/or excise tax. For example:

- If a taxpayer makes the same mistake with respect to the franchise tax reporting of a particular item/transaction for two consecutive audits, but correctly reports the excise tax due under both audits, the negligence penalty is only assessed on the franchise tax.<sup>142</sup>

This can also apply to specific mistakes made with respect to franchise or excise taxes. For example, if a taxpayer incorrectly deducts a non-deductible expense for two consecutive audits, the Department can assess a negligence penalty as it relates to that specific line item.

### *Intangible Expense Disclosure*

A taxpayer who deducts intangible expenses paid to an affiliate and fails to make the required disclosure or fails to add back the intangible expenses to net earnings/losses may be assessed a penalty equal to the greater of \$10,000 or 50% of any excise tax adjustment to the initially filed return.

The penalty is calculated when it is determined that the taxpayer:

- Deducted an intangible expense (e.g., royalties/licenses) paid to an affiliate and the taxpayer computed its excise tax based on its federal taxable income or loss without adding back the intangible expense on Schedule J, Line 2; or
- Added back the intangible expense on Schedule J, Line 2 and deducted the expense on Schedule J, Line 23 but did not attach the Intangible Expense Disclosure form.

Even if the Intangible Expense Disclosure form is not attached to the excise tax return, and the excise tax is computed *without* taking the deduction, a nondisclosure penalty is *still* calculated.

The Department calculates nondisclosure penalties by determining the difference between the excise tax calculated with the deduction and without the deduction. Then, the difference is multiplied by 50% to arrive at the penalty that may be assessed.

### *Captive REIT Disclosure*

Any financial institution that receives dividends, directly or indirectly, from a captive REIT must disclose the dividends and the name of the REIT on the [Captive REIT Disclosure Form](#). If a financial institution fails to make the required disclosure, the dividends received deduction is not allowed on Schedule J, even if the taxpayer owns 80% or more of the stock.

If the disclosure is not made, the taxpayer is also subject to a negligence penalty equal to the greater of \$10,000 or 50% of any adjustment to the initially filed return.<sup>143</sup>

### *Sale of Distributed Assets*

An entity or individual not normally subject to the excise tax may be assessed a penalty if it receives an asset from a taxpayer and later disposes of it for a gain without paying the required tax.<sup>144</sup> If the Department determines that this failure was due to negligence, a 50% penalty will be assessed on the underpayment.<sup>145</sup>

### *Fraud Penalty*

Fraud includes any deceitful practice or willful device resorted to with the intent to evade the tax.<sup>146</sup> If the Department determines that a failure to report and pay tax is due to fraud, a penalty of 100% of the underpayment will be imposed against the taxpayer. Imposition of this penalty is in lieu of all other penalties imposed by the Department, except penalties for dishonored checks or money order payments and penalties imposed in accordance with the Tax Enforcement Procedures Act.<sup>147</sup>

## **2. Penalty Waiver**

The Commissioner is authorized to waive, in whole or in part, penalties that are not the result of gross negligence or willful disregard of the law, if such penalties fall within any of the good and reasonable causes for waiver set forth in the law.<sup>148</sup> Thus, the Commissioner does not have the authority to waive properly imposed fraud penalties. Interest may not be waived under any circumstances.<sup>149</sup>

If a taxpayer fails to pay the full amount of tax due, the following circumstances would be good and reasonable causes for the waiver of penalty:<sup>150</sup>

- The taxpayer incurred a deficiency because of the taxpayer's good faith reliance on the incorrect interpretation of a law or regulation that was, at the time, unclear and misleading.
- The taxpayer incurred a deficiency because the taxpayer relied on factual, but not legal, misrepresentations made by business associates of the taxpayer, of which the taxpayer had no reason to doubt or question.
- The taxpayer incurred a deficiency because the taxpayer made a factual mistake, but after discovering the mistake, voluntarily and without demand from the Department, remitted the amount of the deficiency plus accrued interest.

If the taxpayer's late filing and payment of tax is no more than 30 days after the due date, the following circumstances would be good and reasonable causes for the waiver of the penalty:<sup>151</sup>

- The return was timely mailed but was not timely received or not received at all, and the taxpayer provides evidence that it was mailed as required.<sup>152</sup>
- The delinquency was caused by an intervening providential cause that occurred before the filing and payment due date, such as a disabling injury, illness, or death of the taxpayer, a member of the taxpayer's immediate family, or the exclusive preparer of the taxpayer's returns.
- The delinquency was caused by the unavoidable absence of the taxpayer or the exclusive preparer of the taxpayer's returns.
- The delinquency was caused by the destruction by fire or other casualty of the taxpayer's place of business or business records.
- The taxpayer proves that it requested the proper tax forms from the Department in a timely manner, but they were not sent to the taxpayer in time for the taxpayer to complete and file the return by the due date.
- The taxpayer proves that the taxpayer personally visited an office of the Department before the filing due date to get information or assistance to properly complete a tax return, but through no fault of the taxpayer, was unable to get information or help.

- The delinquency was caused by the taxpayer's failure to include payment with its timely filed return, if the taxpayer promptly provides payment when notified by the Department and satisfactorily demonstrates that the payment omission was due to an inadvertent oversight or error.
- The delinquency is discovered only when the taxpayer voluntarily pays the tax, but the Department is legally unable to enforce collection (e.g., the collection would be barred by the statute of limitations or the lack of jurisdiction).
- The taxpayer timely filed and paid the tax for at least the two-year period preceding the due date of the delinquent return and payment, and the delinquency was not caused by a willful disregard of the law or gross negligence.

The Department may also waive a penalty for good and reasonable cause, even if the cause for the deficiency/delinquency does not match one of the above circumstances, if the taxpayer can show that it has done everything it could reasonably be expected to do as an ordinarily intelligent and reasonably prudent business person. The taxpayer must also show that the deficiency/delinquency was not caused by a willful disregard of the law or gross negligence.<sup>153</sup>

Any taxpayer that believes it has good and reasonable cause for waiver of any penalty assessed should petition the Commissioner in writing by selecting the "Petition for Penalty Waiver" on their TNTAP account. A Petition for Waiver of Penalty Form is also available on the Department's website under the General Forms section.

## Interest

Interest applies to any taxes not paid by the date required by law, even if the Department grants a filing extension. The Department determines the interest rate on July 1<sup>st</sup> of each year using a statutorily imposed formula.<sup>154</sup>

**⚠ The Department is prohibited by law to waive interest. Tenn. Code Ann. § 67-1-803(a)(2)(B). (Under no circumstances shall the Commissioner's authority to waive penalties extend to interest.)**

All delinquent or deficient tax payments, either administered or collected by the Commissioner, begin accruing interest from the date delinquent or deficient until paid.<sup>155</sup>

- For tax periods prior to the date of assessment, interest accrues at the prevailing rate in effect on the date of the tax assessment, regardless of the tax period involved.
- For periods after the date of assessment, interest accrues at the prevailing rate in effect on the date of the accrual of such interest.

## Delinquent Accounts

The Commissioner will “certify” to the Secretary of State the name of any taxpayer having a payment delinquency exceeding 90 days. Upon certification, following notification to the taxpayer, the taxpayer’s charter or certificate to do business in Tennessee will automatically be revoked. If the taxpayer subsequently pays all taxes, fees, interest, and penalties, the charter or certificate may be reinstated, unless another taxpayer has taken title.<sup>156</sup>

## Statute of Limitations

### 1. Assessments

The statute of limitations for a franchise and excise tax assessment is three years from December 31<sup>st</sup> of the year in which the **return was filed**. Adjustments may be made to carryover schedules beyond this three-year period, but additional tax may only be assessed in periods open under the statute. Assessments may be made at any time if a return is not filed, or if a false or fraudulent return is filed with the intent to evade taxation.<sup>157</sup>

### 2. Refunds

The statute of limitations for refund claims is three years from December 31<sup>st</sup> of the year in which the **payment was made**. If a taxpayer makes franchise and excise tax payments and fails to claim the payments on its franchise and excise tax return (Schedule E), the taxpayer will lose the right to claim these payments after three years from December 31<sup>st</sup> of the year in which the tax return was filed.<sup>158</sup>

### *Refund Determinations*

The Department must decide on a refund claim within six months of receipt of the claim. If a refund claim is not approved or denied within six months following receipt of the claim, the refund claim is deemed denied for the purpose of filing suit in chancery court. If the claim for

refund is denied, the taxpayer may file a suit for refund in chancery court within one year from the date on which the claim for refund was filed.<sup>159</sup>

The following are examples of barred refund claims:

- A taxpayer filed its 2014 franchise and excise tax return with payment of \$3,000 on April 15, 2015. The payment resulted in an overpayment of tax that the taxpayer did not claim on subsequent returns filed. The remaining overpayment resulting from the 2014 tax payment became barred from refund on January 1, 2019.
- A taxpayer computed a tax liability of \$7,000 for the period ended December 31, 2013. The payment was made on April 15, 2014, and the return was filed on October 15, 2014. The taxpayer failed to claim an NOL carryover from the prior tax year.
  - This resulted in the Department’s tax system generating a Notice of Overpayment of \$2,000.
  - The taxpayer never claimed the \$2,000 overpayment credit on subsequent tax returns filed. The overpayment credit carried over to the period ended December 31, 2017. The taxpayer filed a claim for refund on January 20, 2018, and requested a refund of the \$2,000 overpayment. The refund claim was denied because the overpayment was barred from refund as of January 1, 2018.
- On March 20, 2011, a taxpayer made a payment of \$10,000 for the 2010 tax period. However, the 2010 return was not filed until April 15, 2014. On the return, the taxpayer computed a tax liability of \$100 and requested a refund of \$9,900. The overpayment of \$9,900 is eligible for refund because the return/refund claim was filed within three years of December 31 of the year in which the payment was made.
- Assume the same facts as the previous example, except the taxpayer does not file the 2010 return on April 15, 2014; instead, it files the return and requests the refund on April 15, 2015. In this case, the refund *would* be barred because the return on which the refund is requested was filed beyond the three-year period.

For the purpose of applying the statute of limitations, the Department considers estimated tax payments and extension payments to have been made as of the statutory due date or



extended due date of the return. For example:

- A taxpayer made four equal quarterly estimated tax payments of \$6,000 on April 15, 2013, June 15, 2013, September 15, 2013, and January 15, 2014, for the 2013 tax year. On October 15, 2014, the taxpayer filed its tax return with a computed tax liability of \$31,000 and remitted a payment of \$7,000 with the return.
  - With the assumption that all tax payments were made on October 15, 2014, the statute of limitations in which to request a refund would be December 31, 2017. If, however, on November 20, 2017, the taxpayer amended the return and requested a refund of \$30,000, the taxpayer would be entitled to the entire amount of the refund.

### 3. Statute Waivers

The Department may enter into a written agreement with the taxpayer to extend the statutory period of limitations upon the assessment of taxes payable to, or refundable by, the Department. The Department will provide the taxpayer with a standardized form when extending the statute of limitations during an audit. The waiver form extends both the period for making assessments and the period for requesting refunds.

The taxpayer and the appropriate Department official must sign the waiver agreement before it will be considered a fully executed agreement. Both parties must sign the extension form before the statute of limitations period has expired. The form cannot be backdated and signed after the expiration of the statute by either party. Audits will have to be adjusted for expired periods if the waiver is not signed by both parties before the expiration of the statute of limitations. Taxpayers should make a copy of the signed form before returning the form to the auditor.<sup>160</sup>

### Records Maintenance

Any tax return open under the statute of limitations is subject to either a field audit or an office audit. Taxpayers must maintain records that can be used to determine their franchise and excise tax liability. The Department has the authority to request the appropriate federal information to audit franchise and excise tax returns.<sup>161</sup>

If a taxpayer keeps electronic records, it must provide the records to the Department in a standard record format upon request. The Department will use the best information available if a taxpayer does not maintain appropriate records.<sup>162</sup>

## Assessment

The Audit Division will issue the taxpayer a Notice of Proposed Assessment if an audit results in an assessment. Taxpayers can work with the Audit Division to resolve issues regarding the assessment even after a Notice is issued. Taxpayers also have the right to request an informal conference with the Commissioner, or the Commissioner's designee, to discuss proposed assessments.<sup>163</sup> The Notice of Proposed Assessment becomes a Final Assessment on the 31<sup>st</sup> day after the date on which the assessment is issued, unless the taxpayer timely requests an informal conference. A taxpayer wishing to contest a Final Assessment without making payment must file suit in chancery court within 90 days of the date on which the assessment becomes final.

## Chapter 6: Federal Income Tax Returns and Filings

Entities subject to franchise and excise tax file on a variety of different federal income tax forms, as discussed previously. For example:

- Corporations, including business trusts classified as corporations, file on Form 1120.
- S-corporations file on Form 1120-S.
- REITs file on Form 1120-REIT.
- LLCs generally file on Form 1065.
- SMLLCs owned by individuals file on Form 1040, GPs and LPs file on Form 1065.
- Foreign corporations file on Form 1120-F.

The discussion in this chapter is limited to federal forms and does not address state tax issues, but it may be especially helpful to auditors reviewing federal tax returns and forms. *Although this information may also be helpful to franchise and excise tax filers (because federal taxable income is generally the starting point for calculating the franchise and excise tax liability), this information is not intended as an interpretation of federal tax law.*

All IRS forms and related instructions can be accessed at <http://www.irs.gov/Forms-&-Pubs>. REITs filing Form 1120-REIT are discussed in Addendum 2.

### Corporations

#### 1. Consolidated Group Election, Form 851 & Subsidiary Statements

Corporations filing on Form 1120 must file individually unless they have made a federal election to file as a consolidated group. Many large corporations with subsidiaries make this election. One advantage in making the election is that the losses of certain subsidiaries will offset the gains of others. Taxpayers attach Form 1122 – Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return – to the parent’s consolidated return the first year a subsidiary corporation is included in a consolidated return. The taxpayer will check a box on the first page of the consolidated Form 1120 to indicate that the return was

prepared on a consolidated basis. Also, Form 851 – Affiliations Schedule – must be attached to the consolidated federal return.

A consolidated federal return includes a parent corporation and an affiliated group of corporations that have at least 80% direct or indirect common ownership with a common parent corporation. Affiliated groups may include numerous subsidiaries. They are identified on federal Form 851. Note that federally disregarded LPs or LLCs are not listed on Form 851, as this form only lists corporations.

Information found on the federal Form 851 includes:

- The names and addresses of each of the filing group members;
- The federal identification numbers of all members of the filing group;
- Corporate organization/ownership structure;
- The principal business activity (PBA) code of each entity; and
- Group members who left the group during the tax year (sold, etc.).

The common parent corporation listed on Form 851 must directly own stock that represents at least 80% of the total voting power and at least 80% of the total value of the stock of at least one of the other corporations. 80% of each of the other corporations (except for the common parent corporation) must be owned directly by one or more of the other includible corporations.

Consolidated returns must include statements for each corporation included in the return. The supporting statements will have *columns for each corporation* that show the following, both before and after adjustments:

- Items of gross income, gain, loss, and deductions;
- A computation of taxable income;
- Balance sheets as of the beginning and end of the tax year;
- A reconciliation of income per books with income per return; and
- A reconciliation of retained earnings

The supporting statement will have eliminating entries so that intercompany transactions between corporations within the consolidated group are eliminated. The sum of each item of income and deduction, net of eliminations, is entered on the consolidated Form 1120. Note, the last three items listed above are not required if the group's total receipts and its total assets at the end of the tax year are less than \$250,000.

## 2. Capital Loss

A capital loss occurs when a capital asset is sold or disposed of at a loss. Property held by a corporation (whether or not connected with its trade or business) is generally a capital asset except for the following:

- Stock in trade or other property included in inventory or held mainly for sale to customers.
- Accounts or notes receivable acquired in the ordinary course of the trade or business for services rendered or from the sale of stock in trade or other property included in inventory or held mainly for sale to customers.
- Depreciable or real property used in the trade or business, even if it is fully depreciated.
- For dispositions after December 31, 2017, certain patents, inventions, models or designs (whether or not patented), secret formulas or processes, or similar property.
- Supplies regularly used in the trade or business.

For a corporation, capital losses are allowed in the current tax year *only to the extent of capital gains*. A net capital loss may be carried back 3 years and forward up to 5 years as a short-term capital loss. A capital loss may be carried back to the extent it does not increase or produce a net operating loss in the tax year to which it is carried.<sup>164</sup> Capital gains and losses are reported on Schedule D (Form 1120). This schedule is necessary because capital losses may not offset ordinary business income.

## 3. Capital Gain Net Income

Form 1120, Line 8 "Capital gain net income" reflects *net* capital gain income. It is the current year capital gains less current and/or prior year capital losses. The gain and loss amounts, before being netted, are reported on Schedule D (Form 1120) and the *net* gain is carried to Form 1120.

#### **4. Dividends and Inclusions**

Dividends and inclusions are reported on Form 1120, Line 4; the total comes from Schedule C (page 2 of Form 1120). Dividends from corporations more than 20% owned and less than 20% owned are segregated on Schedule C, but the specific percentage of ownership is not reported on this schedule. Corporations filing a consolidated return do not report as dividends on Schedule C any amounts received from corporations within the consolidated group because such dividends are eliminated in consolidation.

#### **5. Exempt Interest Income**

Interest earned on tax-exempt state or municipal bonds is federally exempt from taxation. It is disclosed on Form 1120, Schedule K and Schedule M-1 or M-3.

#### **6. Other Income**

Corporations with an ownership interest in a partnership report their share of the partnership's ordinary income from trade or business activities on Form 1120, Line 10, "Other income." Note that ordinary partnership losses passed through to a corporation are not reported as a negative on the "Other income" line, but are reported on Form 1120, Line 26, "Other deductions." A statement is attached to the federal return that shows the name, address, and EIN of each partnership that is owned by the corporation, along with the related pass-through amounts.

#### **7. Charitable Contributions**

The charitable contribution deduction amount claimed on a corporate return cannot be more than 10% of taxable income computed without regard to any deduction for charitable contributions and certain other deductions and losses. Charitable contributions over the 10% limitation can be carried over to the next 5 tax years.

In addition, if contributions of property (not cash) are made, the corporation will attach a statement to the return describing the kind of property contributed and the method used to determine its fair market value on Form 8283 – Noncash Charitable Contributions.

#### **8. Balance Sheet**

The Form 1120, Schedule L – Balance Sheet per Books – should agree with the corporation's books and records. Generally, the accounting method used is accrual, but it could be cash or another method. Some corporations are not required to complete Schedule L; for example, corporations that have total receipts and total assets at the end of the tax year of less than

\$250,000 are not required to complete Schedule L. Consolidated returns report on Schedule L the total consolidated assets, liabilities, and shareholders' equity for all affiliates in the consolidated group. Also, the balance sheets of each corporate affiliate are attached to the return unless the \$250,000 receipts/assets exception is met.

## 9. Reconciliation of Income (Loss) per Books with Income per Return

All corporations reconcile net income (loss) per books with income (loss) per return by completing either Schedule M-1 (for smaller corporations) or M-3 (for larger corporations). All items of income and expense are reconciled on these schedules. On the expanded Schedule M-3, there are specific lines for many types of income and expense, such as dividends, Subpart F, sale versus lease, gain or loss on sale, capital loss limitation, interest expense, charitable contributions, depletion, depreciation, and more. The "Other income" and "Other expense" lines are used to report items not specifically listed; amounts reported on these lines must be supported by detailed statements that show the book to tax reconciliation.

Multiple Schedule M-3s may be completed (consolidated group, parent, consolidated eliminations, subsidiary corporations, mixed 1120/L/PC group). If a taxpayer files a consolidated Form 1120 and Schedule M-3, then the book to tax reconciliation is completed for each member of the consolidated group. The first page of Schedule M-3 discloses whether audited financial statements exist, if the corporation filed SEC Form 10-K, and if the income statement has been restated in the last five years or more.

## S-corporations

Subchapter S-corporations and qualified subsidiaries file a single Form 1120-S. An S-corporation is a corporation that has made the federal election to be an S-corporation on Form 2553 – Election by a Small Business Corporation. A non-corporate entity, such as an LP or LLC, may also use this form to make an election to be taxed as an S-corporation.<sup>165</sup> S-corporation shareholders are limited to individuals, certain estates and trust, and other S-corporations.

S-corporation income is not taxed at the corporate level. Income, gains, losses, deductions, credits, and other items are passed through to the S-corporation shareholders to report on their individual income tax returns. Shareholders are liable for tax based on their share of the corporation's earnings, regardless of the amount actually distributed to the shareholders in cash or property. Form 1120-S, Schedule K is a summary schedule of the corporation's income, deductions, credits, etc. In addition, Schedule K-1 is prepared for each shareholder and shows each shareholder's portion of the items listed on Schedule K.

**⚠ Page 1 of Form 1120-S does not report the entity's total net income/loss. The tax basis net income/loss is found on the last line of Form 1120-S, Schedule K. The book basis income is found on Schedule M-3, Part 1, Line 11.**

S-corporations are pass-through entities, but they differ from partnerships in the following ways:

- S-corporations are true corporations and corporate rules regarding disregarded entities apply.
- S-corporation income is not subject to federal self-employment tax.
- S-corporations cannot have more than 100 shareholders and may not be owned by a corporation.
- S-corporations pay salaries and wages to shareholders and not guaranteed payments.
- S-corporations with 100% owned corporate subsidiaries may use Form 8869 to elect to treat one or more of its eligible subsidiaries as a qualified subchapter S subsidiary (QSub).<sup>166</sup>
  - An S-corporation and its QSubs file together on one Form 1120-S. They do not file Form 851 Affiliations Schedule, so the inclusion of QSubs is not readily apparent on the face of the return.

S-corporations are true corporations, but they differ from C-corporations in the following ways:

- S-corporations segregate income by type (ordinary, passive, capital gain/loss) whereas C-corporations net all types of earnings to arrive at one "taxable income" amount.
- S-corporations pass through to shareholders certain expense items that may be limited at the shareholder level. Each shareholder calculates their own limitation. For example, charitable contributions, Section 179 depreciation, capital losses, and items subject to passive activity limitations may be limited on the shareholder's return.
- S-corporations cannot have more than 100 members.
- S-corporations file Schedule M-3 (Form 1120-S), not Schedule M-3 (Form 1120).



**⚠ The Form 1120-S may include subsidiaries, but these inclusions may not be apparent. Franchise and excise tax audits begin by determining if any QSubs were erroneously included in the franchise and excise tax return of the parent.**

## Corporations Chartered Outside the United States

Corporations chartered outside of the United States file Form 1120-F – U.S. Income Tax Return of a Foreign Corporation – in which they report their income, gains, losses, deductions, and credits and compute their United States income tax liability. Form 1120-F is filed:

- If the corporation was engaged in a trade or business in the United States, regardless of whether it had United States source income from that trade or business or if income from such trade or business is exempt from United States tax under a tax treaty.
  - If the corporation does not have any gross income for the tax year because it is claiming a treaty or Code exemption, it must still file Form 1120-F to show that the income was exempted by a treaty.
- As a *protective return* when the foreign corporation conducts limited activities in the United States that the foreign corporation determines do not give rise to gross income that is effectively connected with the conduct of a trade or business within the United States. It files the return as a protective measure to safeguard its right to receive certain IRC deductions and credits if its original tax liability determination was incorrect.
- If the corporation was not engaged in a trade or business in the United States, but had income from any United States source, if its tax liability has not been fully satisfied by the withholding of tax at source.<sup>167</sup>
- If the corporation was, or had a branch that was, a Qualified Derivatives Dealer.

A foreign corporation may not belong to an affiliated group of corporations that files a consolidated return.<sup>168</sup>

## Partnerships

In their default classification, LLCs, LPs, and GPs file Form 1065 – U.S. Return of Partnership Income. Owners of a partnership are called partners, whereas owners of an LLC are called members. Like the Form 1120-S, Form 1065 reports ordinary business income (or loss) on page

1 and distributive share items on Schedule K (page 4 of Form 1065). Each partner's share of the partnership's tax attributes is reported on Schedule K-1s that the partnership issues to each partner, so that all items of income, deductions, credits, and other items pass through to the partners, who then report these tax attributes on their individual income tax returns (subject to any loss limitations at the individual level).

Pass-through entities filing on Form 1065 do not net short-term capital gains and losses with long-term capital gains and losses, but report each on a separate line on Form 1065, Schedule K to maintain their character when included in the owner's individual income tax return. The capital loss limitation (capital losses can only offset capital gains) is applied at the owner level. Income and expense items reported on Form 1065 do not lose their character when distributed to owners via Schedule K-1. For example, tax-exempt income is not netted with other types of income and expense but retains its character as tax-exempt income when reported on the owner's K-1, and eventually, the owner's tax return.

There are limits to the amount of losses, deductions, and credits that partners can claim from "passive activities." This limitation does not apply to the partnership, but instead applies to each partner's share of any income or losses and credits attributable to a passive activity. Because the treatment of pass-through items depends on the nature of the activity that generated them, the partnership must report income or loss and credits separately for each activity. Generally, passive activities include activities that involve the conduct of a trade or business if the partner does not materially participate in the activity, and all rental activities regardless of the partner's level of participation.

The passive activity rules provide that losses and credits from passive activities can generally be applied only against income and tax resulting from passive activities. In reporting the partnership's income or losses and credits from rental activities, the partnership separately reports rental real estate activities and rental activities other than rental real estate activities. Rental real estate activity income (loss) is reported on Form 8825 – Rental Real Estate Income and Expenses of a Partnership or an S Corporation – and the total from this form is carried to Line 2 of Schedule K and Box 2 of Schedule K-1, rather than to page 1 of Form 1065. Each real estate property rented by the entity is listed on Form 8825 along with the gross rents and expense items (such as depreciation, wages, utilities, repairs, etc.) that are attributable to each rental property listed.

A partnership could be disregarded for federal income tax purposes if it has common ownership (i.e., it is owned by two affiliated corporations that file a consolidated Form 1120). In this case, there would be no reason to file Form 1065 and issue Schedule K-1s because the distributed

items all ultimately flow to the same consolidated Form 1120. Instead, such partnership would be disregarded and included in the consolidated Form 1120. However, if the partnership's owners file different federal returns, then the partnership would file a Form 1065 and issue Schedule K-1s to the respective owners to include the tax attributes in their federal returns.

## Limited Liability Company (LLC)

An LLC is a type of entity created by state statute. They became common starting in 1990. The IRS did not create a new tax classification for the LLC when it was created by the states. Instead, the IRS will classify an LLC either as a corporation, partnership, or disregarded entity. Generally, an LLC will file a partnership return on Form 1065 unless it has made an election to be treated as a corporation.

## Single Member LLC

By default, an LLC that has two or more members will be classified as a partnership for federal income tax purposes. An LLC with only one member is known as a single-member limited liability company (SMLLC). By default, an SMLLC is disregarded to its owner for federal income tax purposes. However, an SMLLC can elect on Form 8832 to be recognized as a taxpaying entity, such as a corporation. An SMLLC that is owned by an individual is a disregarded entity and its activity is reported on Schedule C of the individual's Form 1040. Similarly, an SMLLC owned by a corporation is treated as a branch (or division) of its corporate owner and is included in the corporation's Form 1120.

## Other Federal Forms

There are numerous federal forms and schedules that are required for the purpose of making various federal tax elections or to show in greater detail how a particular taxable income or deduction amount was calculated. Thus far, we have discussed federal Forms 851, 1122, 2553, 8283, 8825, 8832, 8869, and federal Schedules C, D, K, K-1, M-1, and M-3. This section provides a brief overview of additional forms that support the various federal income tax returns (Forms 1120, 1120-S, 1065, and 1040).

### 1. Form 940

Employers file the federal unemployment Form 940 annually. This return reports the total wage payments to all employees and calculates the federal unemployment tax. Also, this form indicates on Schedule A the states in which the employer paid state unemployment tax.

## 2. Form 1125-A

The first section of Forms 1065, 1120, and 1120-S is where income is reported by type and totaled. Note that the total is reduced by cost of goods sold (CGS) items like depreciation, labor expense, rent expense, intangible expense, etc. CGS is reported on Form 1125-A and the total is carried, as a reduction, to the income section of the first page of the corporate and partnership tax returns. CGS is any direct cost related to the production of goods that are sold or the cost of inventory that an entity acquires to sell to consumers.

The second section of Forms 1065, 1120, and 1120-S is where overhead expenses related to the general operation of the business are reported. The same *type* of expense may be reported as CGS in the income section of the form and as a general operating expense in the deduction section. For example, wages, rent, and intangible expenses could be CGS or they could be general, operating expenses.

## 3. Form 4562

Most entities file Form 4562 – Depreciation and Amortization – to report:

- Section 179 expense currently deducted and any related carryover;
- Special (bonus) depreciation;
- MACRS depreciation for assets added in the current year and in previous years;
- Depreciation on listed property; and
- Amortization of intangible expenses.

The *Section 179* election to expense certain property is made by many taxpayers. For tax years beginning in 2018, the maximum section 179 expense deduction was \$1,000,000. This limit is reduced by the amount by which the cost of section 179 property placed in service during the tax year exceeds \$2,500,000.

*Special (bonus)* depreciation is also claimed by many taxpayers because of the ability to accelerate their depreciation expense. The rate of special (bonus) depreciation depends on when the qualified property was placed into service. Certain qualified property acquired after September 27, 2017, and before January 1, 2023, is eligible for a special depreciation allowance of 100% of the depreciable basis of the property. Qualified property includes tangible property depreciated under MACRS with a recovery period of 20 years or less.

The last section of Form 4562 is where *amortization* is reported. Even though amortization is reported on this form, it is not carried to a depreciation expense line on Forms 1120, 1120-S, or 1065. Instead, amortization expense generally will be included in the amount reported on the “Other deductions” line of the return. A schedule must be attached to the return to list the type and amount of expenses that make up this deduction.

#### **4. Form 4797**

Form 4797 provides details regarding sales of business property. This form lists the gross sales price, cost basis, depreciation allowed, dates of acquisition and sale, and the resulting gain or loss on the sale. The net gain or loss from Form 4797 is reported on page 1 of Forms 1120, 1065, and 1120-S. Note, the disposition of capital assets is not reported on this form, but instead are reported on Schedule D.

#### **5. Form 6252**

Form 6252 – Installment Sale Income – is used to report gains from an installment sale. An installment sale is a disposition of property where at least one payment is received after the end of the tax year in which the disposition occurs. The installment method taxes the gain in the periods in which proceeds are received, instead of when the contract was signed. For example:

- A building is sold under an agreement in which payments are to be received in installments over the next three years.
- Form 6252 is filed in the year of sale and each year thereafter until all proceeds have been received.
- Form 6252 reports the selling price, acquisition and sale dates, calculation of the gain, gross profit percentage, and payments received.

This form calculates the gain subject to income tax each year; the gain is transferred to Schedule D or Form 4797. Taxpayers are not required to use the installment method. They may elect out by not filing Form 6252, but instead reporting the full amount of the gain on Form 4797 or Schedule D.

#### **6. Form 7004**

Form 7004 – Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns – must be filed on or before the due date of the applicable tax

return. This form shows the taxpayer's identifying information, the form number of the tax return (Form 1041, 1065, 1120, 1120-S, etc.), and the beginning and end dates of the applicable tax year or short tax year. Generally, all members of a consolidated group must use the same taxable year as the common parent corporation. If, however, a member of a consolidated group is required to file a separate income tax return for a short period and seeks an extension of time in which to file the return, that member must file a separate Form 7004 for that period.

### **7. Form 8594**

When a group of assets that makes up a trade or business is sold, Form 8594 – Asset Acquisition Statement – is completed by both the seller and purchaser if there is goodwill or a going concern value relating to the assets and the purchaser's basis in the assets is determined solely by the amount paid for the assets. This form reports the names of the parties, date of sale, total sale price, allocation of sale price, including any amount allocated to goodwill. Also, the form discloses if there are any contractual agreements associated with the sale such as, covenants not to compete, lease agreements, management contracts, employment contracts, and similar arrangements.

## Chapter 7: Federal Income Revisions

### General Discussion

The Internal Revenue Service (“IRS”) will occasionally revise a business’ federal tax return (most frequently during an audit) that in turn affects the Tennessee franchise and excise tax calculations. Because federal income revisions (“FIR”) generally affect franchise and excise tax liabilities, taxpayers are required to report the revisions to the Department of Revenue (the “Department”). In such circumstances, the taxpayer does not file an amended franchise and excise tax return, but instead the taxpayer must complete the [Franchise and Excise Tax Federal Income Revision](#) form, which can be found on the Department’s website.<sup>169</sup>

**⚠ Please Note: The amount entered on Line 1 on the first column of the FIR form should be the taxpayer’s net income on a separate entity basis and should equal Schedule J, Line 1 of the last franchise and excise tax return as filed by the taxpayer, or as audited by the Department, for the period being revised.**

**⚠ The FIR form should be filed in lieu of an amended return (Form FAE170/174). The Taxpayer SHOULD NOT file an amended return to report FIRs to the Department.**

When reporting FIRs, the taxpayer must also provide the Department with the following supplemental information:

- A letter of explanation regarding the adjustments made to federal taxable income.
- Supporting documentation, including federal Form 4549 (or any variation of this form) and any other pertinent pages from the federal Revenue Agent Report (“RAR”) concerning the examination changes.
- If the taxpayer files a consolidated federal return, provide either a schedule detailing the changes that apply only to the Tennessee taxpayer for which the revisions are being reported or a reconciliation reflecting all adjustments for each entity included in the consolidated federal return.
- If the taxpayer files an amended federal return in relation to an FIR, provide a copy of the Form 1120X or the first page of the amended federal return.

- If the taxpayer is requesting a refund, the completion date of the federal revisions must be shown on the RAR, and if a Form 1120X was filed, a statement of adjustments and/or a copy of the refund check from the IRS must be included.
  - If the amount of the refund request is \$200 or more, the taxpayer must also submit a completed [Report of Debts form](#).

The IRS uses several forms to report federal audit adjustments to the taxpayer. Federal Form 4549 – Income Tax Examination Changes – is the primary report that lists changes by type and calculates a tax amount due or overpaid. There are numerous variants of this form, including Forms 4549-A, 4549-B, and 4549-E. Additionally, federal Form 5278 has the same information as Form 4549, but it reports proposed changes that are not necessarily agreed to by the taxpayer.

When a FIR is reported, the auditor will likely request a copy of Form 4549 that is signed by both the federal examiner and the taxpayer. This form has lines for adjustments to income, taxable income per return or as previously adjusted, and the net federal tax due or overpaid net of credits and penalties.

- For corporations, the amount reported on Form 4549, Line 3, “Taxable Income Per Return or as Previously Adjusted,” comes from federal Form 1120, Line 30, “Taxable income” (after net operating loss and special deductions).
  - The first line of the Tennessee FIR form reads “Federal income or loss from Schedule J, Line 1.”
  - An auditor will be looking to reconcile the federal Form 4549, Line 3 amount with the Tennessee FIR form, Line 1 amount. Differences may exist because either the Tennessee form amount does not include federal net operating losses and special deductions, or previous FIRs were not reported.

The federal audit changes are reported on Form 4549, Line 1 as “Adjustments to income.” An adjustment that decreases an expense will be reported as a positive number, because it is effectively an increase to income. The “Total adjustments” reported on Form 4549 will be transferred to the Tennessee FIR form, Line 1, Column 2.

The taxpayer (and the auditor alike) must pay special attention to the various types of federal audit adjustments reported on Form 4549 because some adjustments may necessitate an additional adjustment for excise tax purposes due to certain modifications required under



excise tax law.<sup>170</sup> For example, Form 4549 may report a decrease in dividend income, but for excise tax purposes, the auditor needs to determine if there is a decrease in Schedule J, Line 1 net income as well as a decrease in the Schedule J, Line 18 dividends received deduction. There are various other federal audit adjustments that may require a “double adjustment.” Such adjustments include:

- contribution expenses
- capital losses
- expenses for which a federal credit was claimed
- bonus depreciation
- nonbusiness earnings

FIRs may affect the excise tax, interest, penalties (decrease only), credits, and net operating loss/tax credit carryovers for several tax years. Taxpayers especially need to contemplate changes in net operating loss and tax credit carryover utilizations that may result from the reporting of FIRs. For example:

- If a taxpayer has utilized a large Tennessee net operating loss carryover that originated in Year 1 in Year 5 but has now reported FIRs that affect Year 3, any net operating loss carryover that was available as of Year 3 (without regard to the amount utilized in subsequent tax years) will be applied first to Year 3 and then to Year 5 if any carryover amount remains.

After taking into consideration any tax effects resulting from net operating loss and tax credit carryovers, any tax years that reflect an overpayment of excise tax should be offset against any tax years reflecting an underpayment of excise tax (beginning with the earliest underpaid tax year). Interest is computed at the current rate<sup>171</sup> on any net underpayment of tax from the statutory due date of the return through the date on which the tax is paid.

## **Statute of Limitations - FIR**

The Department must assess any additional tax due within two years of the taxpayer notifying the Department of the changes made to its net income as the result of an IRS examination.<sup>172</sup> For example:

- A taxpayer files an F&E Federal Income Revision form on October 1, 2018, to report FIRs for the tax period ended December 31, 2015. The auditor determines that additional excise tax is due because of the revisions. The Department must assess the additional tax on or before September 30, 2020.<sup>173</sup>

If the IRS examination results in a decrease in net income, then an overpayment of excise tax will normally result. The taxpayer has three years, from the date of redetermination of the taxpayer's net income by the IRS, in which to file a Claim for Refund with the Department that is supported by proper proof.<sup>174</sup> For example:

- An IRS examination of the taxpayer's federal income tax return for the tax year ended December 31, 2014, has concluded and all adjustments are finalized and agreed to by both the taxpayer and the IRS. The result of this examination is a decrease in the taxpayer's net income that will result in an overpayment of excise tax. The Form 4549 detailing the examination changes was signed and dated by the IRS examiner on July 15, 2017, which is deemed to be the redetermination date. The taxpayer must file a Claim for Refund, supported by proper proof, with the Department on or before July 14, 2020.

If the IRS audit covers tax years that are outside the statute of limitations, the Department may only adjust the franchise or excise tax base to the extent that either is directly affected by the IRS examination changes. An amended return filed as the result of an FIR does not re-open the statute of limitations for the given tax year. However, if the IRS adjustments impact tax years that are open under the statute, then all changes affecting franchise and excise taxes can be made. For example:

- As the result of an IRS examination of a tax return that is still open under the statute of limitations, the taxpayer's depreciation expense is adjusted. In addition to the impact on the taxpayer's net earnings subject to excise tax, the change in depreciation expense may increase or decrease the book value of property reported on Schedule G of the franchise and excise tax return. Also, a change in Tennessee rent expense would affect Schedule G. If Schedule G is the franchise tax base for the given tax year, then the franchise tax could increase, or decrease based on these adjustments.<sup>175</sup>

## Audit Procedures

In the case of an FIR, a taxpayer may expect an auditor to request some, or all, of the following documents/information and perform some, or all, of the following procedures:

- Request the Department's FIR form.
- Request authoritative documentation of the IRS adjustments. This is generally the federal Form 4549 that has been signed by both the IRS examiner and the taxpayer. Please note, the federal Form 870<sup>176</sup> is not deemed to provide the redetermination date for refund claim purposes.
- If the Form 4549 adjustments are for a consolidated group, request a breakdown that shows each adjustment by entity.
  - For example, a columnar schedule that shows each entity's adjustment values in a separate column, with the final column reflecting the total of all adjustments that tie to Form 4549.
- Tie the information reported on the Tennessee FIR form to the federal form(s).
- Obtain an understanding of the adjustments and consider whether they increase or decrease Tennessee taxable income.
  - For example, if dividend income changes, would the Schedule J dividends received deduction also change? If gross sales change, would the apportionment ratio change? If net income increases, would the use of a tax credit increase?
- If a refund is requested, obtain additional documents as discussed above (i.e., Report of Debts form, completion date of revenue agent's examination, copy of IRS refund check, copy of federal amended return or Form 1120X).

**⚠ The taxpayer should ensure that the completion date (redetermination date) of the federal revisions is included on Form 4549 or other Revenue Agent's Report.**

- Prepare and assemble the standard audit workpapers, related forms, and taxpayer communications for inclusion in the electronic audit file.

## Chapter 8: Business and Nonbusiness Earnings

### Introduction

The classification of income, receipts, or earnings as “business earnings” or “nonbusiness earnings” is unique to state taxation. Generally, this classification is only important when a taxpayer has multi-state operations. If there are no out-of-state operations, all earnings are classified as business earnings and are fully taxable. However, if there are out-of-state operations (taxpayers with a “right to apportion”), income classified as business earnings is subject to apportionment and income classified as nonbusiness earnings is subject to direct allocation.<sup>177</sup> Directly allocated earnings are fully taxable to the state to which the nonbusiness earnings are attributed. (See Chapter 14 on Apportionment and the section below on allocation.)

Business earnings apportioned to Tennessee and nonbusiness earnings that are directly allocated to Tennessee are subject to the 6.5% excise tax. Nonbusiness earnings are reported on Schedule M – Nonbusiness Earnings Allocation – and are either designated as being directly allocated to Tennessee or not. All business and nonbusiness earnings are included in adjusted federal income (loss) reported on Schedule J, Line 1 – Computation of Net Earnings Subject to Excise Tax. Nonbusiness earnings that are not allocated to Tennessee are removed from the excise tax base by an entry on Schedule J, Line 22, which is derived from the taxpayer’s entry on Schedule M, Line 8.

It is incorrect to conclude that business earnings are always subject to the excise tax and nonbusiness earnings are not. Business earnings that are not unitary to a taxpayer’s business activity within the state are not subject to the excise tax. However, nonbusiness earnings could be allocated 100% to Tennessee and, thus, be fully subject to the excise tax. A brief definition of business and nonbusiness earnings follows, but also see the sections on “business,” “nonbusiness,” and “unitary.”

Business earnings are:

- Earned from an activity that is in the regular course of business (transactional test) or related to the acquisition, use, management, or disposition of property that is integral to the taxpayer’s regular trade or business (functional test); and
- Unitary to the taxpayer’s business activity within the state.

Nonbusiness earnings are:

- All earnings other than business earnings.

### 1. Allocation Methodology for Nonbusiness Earnings

Direct allocation is a multi-state taxation method that attempts to tax nonbusiness earnings in the appropriate state. For example, nonbusiness rental income less expenses would be directly allocated to the state where the property is located. Nonbusiness earnings are directly allocated to Tennessee or another state in their entirety.

Allocation is based on the nature of the item or asset generating the income. One should use the following guidance to properly allocate nonbusiness earnings when reported.

If the income is from real or tangible property, the nonbusiness earnings are allocated to the situs or location of that property.

- Rents and Royalties from Real Property Allocated to Tennessee<sup>178</sup>
  - Net rents and royalties from tangible personal property are allocable to Tennessee if and *to the extent that the property is utilized* in this state. If the taxpayer's commercial domicile is Tennessee and the taxpayer is not organized under the laws of or taxable in the state where the property is utilized, then the entire earnings are allocated to Tennessee.
  - The extent of utilization of tangible personal property in Tennessee is determined by multiplying the rents and royalties by a fraction.
    - The numerator is the number of days the property is physically located in the state during the rental or royalty period in the tax year.
    - The denominator is the number of days the property is physically located out of the state (everywhere) during all rental or royalty periods in the tax year.
  - If a taxpayer cannot substantiate or ascertain the physical location of the property during a rental or royalty period - the tangible personal property is considered utilized in Tennessee if the property was located in Tennessee at the time the rental or royalty payer obtained possession.
- Capital Gains and Losses Allocated to Tennessee<sup>179</sup>

- Capital gains and losses from sales of *real property* located in Tennessee are allocable to this state. Also, capital gains and losses from sales of *tangible personal property* are allocable to Tennessee, if:
  - o The property was located in this state at the time of the sale; or
  - o The taxpayer's commercial domicile is in Tennessee and the taxpayer is not taxable in the state in which the property had a situs.
- Capital gains and losses from sales of *intangible personal property* are allocable to Tennessee if the taxpayer's commercial domicile is in Tennessee.
  - o Commercial domicile<sup>180</sup> is the location where the main overall operations of the company are directed and managed, which is generally the headquarters location of the company.
- Interest and Dividends Allocated to Tennessee<sup>181</sup>
  - Interest and dividends are allocable to Tennessee if the taxpayer's commercial domicile is in Tennessee.
- Patent and Copyright Royalties Allocated to Tennessee<sup>182</sup>
  - Patent and copyright royalties are allocable to Tennessee if, and to the extent, the patent or copyright is *utilized* by the payer in Tennessee or in a state where the taxpayer is not subject to tax and the taxpayer's commercial domicile is in Tennessee.
    - o A patent is *utilized* in Tennessee to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states, or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state where the taxpayer is commercial domiciled.

- A copyright is *utilized* in Tennessee to the extent printing or other publications originate in Tennessee. If the basis of receipts from copyright royalties does not permit allocation to states, or if the accounting procedures do not reflect states of utilization, the copyright is utilized in Tennessee if the taxpayer is commercially domiciled in Tennessee.

## 2. Audit Adjustments when Nonbusiness Earnings are Reclassified

Nonbusiness receipts are reported and allocated on Schedule M and excluded from the standard apportionment schedule (Schedule N). Also, any property and payroll costs involved in the production of the nonbusiness earnings are properly excluded from Schedule N.

A common taxpayer error is reporting income as nonbusiness earnings when such income is unitary and meets the transactional or functional test. When this happens, audit adjustments are generally made to Schedules M, J, and N. This may result in a change to the franchise and excise tax liability for the tax year under examination. See the section Audit Procedures below for the specific audit adjustments when nonbusiness earnings are reclassified as business earnings.

**⚠ An audit reclassification of nonbusiness earnings to business earnings will generally cause a change in the apportionment ratio if the taxpayer has reported them as nonbusiness earnings for apportionment purposes. Changes to the ratio will impact both the franchise and excise tax.**

## Business Earnings

For Tennessee excise tax purposes, the term “business earnings” is defined as:<sup>183</sup>

- Earnings arising from transactions and activity in the regular course of the taxpayer’s trade or business or earnings from tangible and intangible property, if the acquisition, use, management, or disposition of the property constitutes an integral part of the taxpayer’s regular trade or business operations.

Essentially, earnings that arise from the conduct of the trade(s) or business operations of a taxpayer are business earnings and the taxpayer must show by clear and cogent evidence that particular earnings are classifiable as nonbusiness earnings. A taxpayer may have more than one regular trade or business in determining whether income is business earnings.

Because of this broad definition and because a taxpayer can have more than one trade or business, most income will be considered business earnings. The intent of the definition is that all earnings are considered business earnings unless clearly shown to be nonbusiness earnings.

**⚠ The default audit position is that all earnings are business earnings until proven otherwise.**

### 1. Transactional and Functional Tests

There are two different ways to determine if an item is business earnings.<sup>184</sup> The first way is commonly called the **transactional test**, which applies to:

- Earnings arising from transactions and activity in the regular course of the taxpayer's business. For example:
  - Earnings from the sale of inventory or interest earned on the business' checking account would fall into this category.
- A major consideration is whether the transaction is frequent in nature, as opposed to being a rare or extraordinary event.

A transaction that does not meet the transactional test may be business earnings if it meets the **functional test**. The functional test applies to:

- Earnings from tangible and intangible property, if the acquisition, management or disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.
- Under this test, the asset generating the income is evaluated to see if it functions as a business asset. If it does, then the sale of the asset produces business earnings. For example:
  - A retail store that is in the business of selling clothes sells all its old store furnishings and fixtures.
  - Because the furnishings functioned as a business asset, any gain from the sale of the furnishings would result in business earnings under the functional test.



- The functional test looks at the relationship between the underlying income-producing asset and the taxpayer's regular trade or business. If the underlying asset is integral, as opposed to incidental, to the taxpayer's business operations the functional test is met.

#### *Example – Transactional Test*

The taxpayer in this example is a large company based outside the state. It has interest income from the investment of working capital generated by business operations. The taxpayer is not in the business of investing, and the investments are not managed or connected to Tennessee.

The transactional test shows that the investment interest income *is business earnings*:

- The interest income came from business operations.
- The account was occasionally used to fund business operations.

This example emphasizes that under the transactional test the income from the investment of working capital would be considered business earnings.

#### *Example – Functional Test*

The taxpayer in this example was based and domiciled outside the state and sold intangible property to Tennessee customers (club memberships) before filing a final return. The corporation did not have any assets or employees based in the state. It sold its operations and assets to an unrelated entity and reported a gain for federal income tax purposes. The final franchise and excise tax return reported the gain as apportionable business earnings. This one-time sales transaction was not part of the taxpayer's regular business activities, but it met the functional test.

The functional test shows that the gain was business earnings because:

- The assets sold were used in the business.
  - Even though a partial or complete liquidation is a one-time event, if the asset being sold is considered a business asset, then the income from the sale is business earnings.

## 2. Rule 23 – Business and Nonbusiness Earnings

TENN. COMP. R. & REGS. 1320-06-01-.23 (“Rule 23”) emphasizes that labels (e.g., manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income) do not determine whether income is business or nonbusiness earnings. Income of any type or class and from any source is business earnings if it arises from transactions and activity occurring in the regular course of trade or business.

Accordingly, the critical element in classifying earnings is to identify the transactions and activities that are elemental to a trade or business. Generally, all a taxpayer’s transactions and activities that are dependent on, or contribute to, the operations of its economic enterprise will constitute the taxpayer’s trade or business. Furthermore, the transactions and activities will be arising in the regular course of a trade or business and will constitute integral parts of a trade or business.

The following examples of business earnings are grouped by type of income – rents, gains or losses from sales of assets, interest, dividends, and patent and copyright royalties. (See the Nonbusiness Earnings section in this manual for an example of nonbusiness earnings.)

### *Rental Income*

- Rental income is business income if the taxpayer used the rental property in its trade or business or if the rental income from the use or management of the property constitutes an integral part of the taxpayer’s regular trade or business operations. For example:
  - The taxpayer operates a multi-state car rental business. The income from car rentals is business earnings.
  - The taxpayer is engaged in the heavy construction business where it uses equipment such as cranes, tractors, and earthmoving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business earnings.
  - The taxpayer constructed a plant for use in its multi-state manufacturing business. 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it

was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business earnings.

### *Gain or Loss from Sale of Real, Tangible, or Intangible Property*

- Generally, gain or loss from the sale, exchange, or other disposition of real property or tangible or intangible personal property constitutes business earnings if the property, while owned by the taxpayer, was used in the taxpayer's trade or business operations, or if the income from the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. The gain from the sale of assets that functioned as business assets will result in business earnings under the functional test. For example:
  - In conducting its multi-state manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business earnings.
  - The taxpayer constructed a plant for use in its multi-state manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business earnings.
  - Same as the previous example, except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business earnings.
  - Same as the previous example, except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business earnings.

### *Interest Income*

- Interest income is derived from an intangible asset, such as a certificate of deposit or a note receivable. Interest is business earnings when the related intangible was created in the regular course of the taxpayer's trade or business operations or when income from the use or management of the intangible constitutes an integral part of the taxpayer's regular trade or business operations. For example:
  - The taxpayer operates a multi-state chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like

are received with respect to installment sales and revolving charge accounts. These amounts are business earnings.

- The taxpayer conducts a multi-state manufacturing business. During the year, the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bore interest. The interest income is business earnings.
- The taxpayer is engaged in a multi-state manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business earnings.
- The taxpayer is engaged in a multi-state money order and traveler's checks business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business earnings.

### *Dividends*

- Dividends from stock are business earnings if the stock arises out of or was acquired in the regular course of the taxpayer's trade or business operations or if the dividend income from the use or management of the stock constitutes an integral part of the taxpayer's regular trade or business operations. For example:
  - The taxpayer operates a multi-state chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock it owns. The dividends are business earnings.
  - The taxpayer is engaged in a multi-state manufacturing and wholesaling business. In connection with that business the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest bearing bonds. The

remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business earnings.

- The taxpayer and several unrelated corporations own all the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayers acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business earnings.
- The taxpayer is engaged in a multi-state heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. To maintain an adequate bonding capacity, the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business earnings.
- The taxpayer received dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business earnings.

### *Royalties*

- Patent and copyright royalties are business income if the patent or copyright arises out of or was created in the regular course of the taxpayer's trade or business operations or if the royalty income from the use or management of the patent or copyright constitutes an integral part of the taxpayer's regular trade or business operations. For example:
  - The taxpayer is engaged in the multi-state business of manufacturing and selling industrial chemicals. In connection with that business the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The taxpayer's royalties are business earnings.
  - The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter

used by the taxpayer in its business. Any royalties received on these copyrights are business earnings.

## Nonbusiness Earnings

Nonbusiness earnings are defined as all earnings other than business earnings.<sup>185</sup> In the case of an audit, the auditor will presume all income is business earnings. The auditor will, however, provide the taxpayer with ample opportunity to explain, using clear and cogent evidence, why certain income is properly classified as nonbusiness earnings.

Taxpayers, therefore, should strongly consider all earnings to be business earnings until they can establish otherwise.

**⚠ Taxpayers claiming nonbusiness earnings should maintain detailed records substantiating the salient facts in the event they are audited.**

See the Introduction section at the beginning of this chapter for a discussion on the allocation methodology used for nonbusiness earnings.

### 1. Nonbusiness Earnings Examples

#### *Rule 23 Provides One Example of Nonbusiness Earnings*

- The taxpayer is a heavy machinery manufacturer. It enters a multi-million-dollar deal to acquire the manufacturing assets of another similar business. As a result of the acquisition, the taxpayer becomes the owner of a small roadside market in Tennessee. The market is leased by a third-party lessee for \$1,000 per month. The taxpayer acquired the assets of the other company solely to expand its manufacturing operations. It had never operated the market and has no intent to engage in the business of leasing commercial real estate. The Taxpayer does not own any other similar property that it leases to others. The taxpayer intends to sell the market as soon as the current lease expires. The rental income from the market is *de minimis* in relation to the income derived from the taxpayer's manufacturing operations.
  - Under these circumstances, the rental income is nonbusiness earnings. The taxpayer would exclude the market from the property factor for purposes of the apportionment formula and would not claim the expenses relative to the market as business expenses.

There are many indicators in the above example evidencing that the rents did not rise to the level of a second line of business. Therefore, the earnings in this example fail the transactional test and cannot be classified as business earnings. If the rents are not business earnings, then by definition, they are classified as nonbusiness earnings and are reported on Schedule M.

## 2. Expenses Related to Nonbusiness Earnings

When nonbusiness earnings are properly reported on Schedule M, the related expenses must also be reported. For example, if a taxpayer has nonbusiness rental income, then all the expenses related to that property, such as insurance, depreciation, repairs, taxes, etc., would be nonbusiness-related expenses. Generally, in the absence of specifically identifiable expenses, it is assumed the related expenses are 5% of the nonbusiness earnings. However, in the case of nonbusiness *rental* earnings, in the absence of actual identifiable related expenses, it is assumed that related rental expenses are 50% of such nonbusiness earnings.<sup>186</sup>

Expenses related to nonbusiness income are netted against the income and in some instances, may exceed the income and result in a loss. For example, rental properties that become vacant and generate no rental income would still incur expenses. A nonbusiness loss would, in effect, be an add-back to the excise tax base, where nonbusiness earnings are a deduction. Both the income and expense items are first reported on Schedule M and then the net amounts are reported on Schedule J.

## Tax Impact of Earnings Classification

How earnings are classified (business/nonbusiness) may have a large impact on the excise tax computed. The example below demonstrates the difference between a gain being classified as business or nonbusiness earnings. Assume an out-of-state taxpayer sold a tangible asset for a gain of \$3,500,000. The following chart shows the tax impact of treating the gain as business versus nonbusiness when all of the gain was allocated to a state other than Tennessee.

Excise Tax Calculation	Business	Nonbusiness
Federal income or loss	\$5,000,000	\$5,000,000
<i>Less: Nonbusiness earnings</i>	-0-	(\$3,500,000)
Total Business Income – ( <i>sum of above</i> )	\$5,000,000	\$1,500,000
Apportionment Ratio (nonbusiness receipts are excluded from the apportionment factor)	45%	50%
Apportioned business income	\$2,250,000	\$750,000
<i>Add: nonbusiness earnings directly allocated to Tennessee</i>	n/a	-0-**
Excise tax base subject to tax	\$2,250,000	\$750,000
Excise tax 6.5% of tax base	\$146,250	\$48,750
** The nonbusiness earnings were allocated to a state other than Tennessee		

As demonstrated above, the excise tax is much greater if the out-of-state taxpayer classifies the gain as apportionable business earnings. There is less excise tax when the sale is classified as nonbusiness; the gain is removed from the apportionable excise tax base and allocated to a state other than Tennessee. No tax is computed on the nonbusiness gain because, in this example, it is allocated 100% to another state.

The apportionment ratio shown above is less when the \$3,500,000 gain is classified as business earnings. The apportionment ratio compares Tennessee receipts to everywhere receipts. In this case, the gain is included in the denominator of the receipts factor, but the numerator will reflect zero assuming the receipt is sourced to a state other than Tennessee. Nonbusiness earnings are allocated and not apportioned; so, they are never in the apportionment ratio.<sup>187</sup>

Multi-state taxpayers occasionally report nonbusiness earnings in error. Nonbusiness earnings are unusual, so taxpayers should be prepared to provide detailed documentation to support the nonbusiness classification. It is logical that if earnings were fully allocated to another state, the taxpayer would have paid an income tax in that other state. The other state's treatment of the income may support the taxpayer's classification choice, but it is not definitive in determining the classification for Tennessee excise tax purposes. See the section on Audit Procedures at the end of this chapter for more information.

**⚠ Business earnings are apportioned if a taxpayer is doing business and has substantial nexus both inside and outside of Tennessee.**



## Unitary Earnings

Business earnings, under the transactional and/or functional test, must also be unitary with operations in Tennessee to be subject to Tennessee excise tax. Earnings that are not unitary with the state can be removed or deducted from the tax base as nonbusiness earnings. The term “unitary,” as it is used in this context, is not defined in the code or rules.<sup>188</sup> However, a business is unitary when the operation of one of its components or divisions depends upon and contributes to the operation of its other components. A business’ activities and income would be unitary with its Tennessee operations if they have a sufficient connection to or relationship with the business activities within Tennessee to subject them to Tennessee’s tax.

The U.S. Constitutional argument is that Tennessee cannot tax earnings related to operations having no connection or relationship with the state. See the Commerce Clause and Due Process Clause discussion in Chapter 3 on Nexus.

Essentially, the Constitution prohibits a state from taxing income that cannot be attributed to the corporation’s activities within the state. Income is apportionable if the business’ operations within the state contribute to or benefit from the corporation’s unitary business.

Tennessee’s method of taxing interstate business does not isolate the intrastate income-producing activities from the rest of the business, but instead taxes an apportioned sum of the entity’s multistate business if the business is unitary. Tennessee’s apportionment method has been found to be constitutional. However, taxpayers may conclude that their intrastate and out-of-state activities (in whole or part) do not form part of a single unitary business that is apportionable for excise tax.

Earnings that are not unitary with the taxpayer’s Tennessee operations should be reported as nonbusiness earnings on Schedule M.

**⚠ Apportionable business income must be both: 1) business earnings (transactional or functional tests); and 2) unitary to in-state operations.**

### 1. Legal Analysis

Courts have ruled that there is no single controlling factor, but rather all factors should be examined in combination, to determine whether income is unitary with the activity of the taxpaying entity in the state. Any reasonable connection to in-state operations would establish a

unitary relationship of the income. The courts have used three methods to help make this determination:

- Three Unities Test;
- Contribution or Dependency Test; and
- Factors of Profitability Test.

### *Three Unities Test*

This test concludes that a unitary relationship is established if there is unity of ownership, unity of operation, and unity of use between in-state and out-of-state operations.

- *Unity of Ownership* – common control between entities.
  - Control is generally evidenced by ownership between entities in excess of 50%, but it also can be demonstrated through constructive or tiered ownership, whereby an entity has significant influence.
- *Unity of Operation* – the performance of certain functions by one entity on behalf of the entire group.
  - Unitary operations are evidenced by central purchasing, advertising, or management; common training; intercompany financing; common personnel such as attorneys, accountants, etc.; common insurance; common use of facilities, etc.
- *Unity of Use* – a centralized executive force and general system of operation.
  - Demonstrated by major policy decisions, central management, intercompany services, and overlapping officers and directors.

### *Contribution or Dependency Test*

This test focuses on whether business done within the state is dependent on or contributes to business outside the state.

- This test can be met under a concept known as flow-of-value through financial arrangements, exchange of materials or expertise, etc.

### *Factors of Profitability Test*

Under this test, the functional integration of assets, centralization of management, and economies of scale, and whether the business components under consideration contribute to each other and the business as a whole, would provide evidence of a unitary relationship.

- Indications that this test is met include product flow between affiliates, centralized functions of operation such as purchasing, manufacturing, and financing, and interaction of personnel at upper management levels and approval for major policy decisions.

**⚠ “Unitary business” or “unitary group,” as defined in the code, apply specifically to financial institutions filing a combined return (Form FAE174) with a unitary group. This definition does not apply to the taxation of income under the unitary principle. Tenn. Code Ann. § 67-4-2004(52) should not be cited in nonbusiness or nonunitary discussions.**

## **2. Example – Nonunitary Business**

An entity with an investment portfolio had unaffiliated money managers who manage its excess funds. These funds were not derived from working capital, and the proceeds were not used in the business to fund operations or as working capital. The independent investment managers had control to make investment decisions. None of the investment activity related to, or took place in, Tennessee. Under these circumstances, the investment income is considered nonbusiness earnings and is non-allocable to Tennessee.

Note, however, that this determination is based on a very specific fact pattern and auditors will gather and examine all the relevant facts each time they are confronted with a unitary vs. nonunitary decision. Note also, that courts have held one division or component of a taxpayer’s business may “add to the riches” of that entity and yet remain a “discrete business enterprise” whose earnings are nonunitary.<sup>189</sup>

## **Litigation – Unitary Business Principle**

Courts have frequently addressed both the nonunitary principle and the assertion that earnings are nonbusiness under the transactional and functional tests. Following are summaries of

several court cases decided on the unitary/nonunitary issue. These cases demonstrate the importance of making an evaluation based on all available documents and pertinent facts.

### 1. Finding: Nonunitary

Below are three Tennessee cases where the courts found that certain earnings were nonunitary.

- In the *Louis Dreyfus Corp.* case,<sup>190</sup> the taxpayer had a distinct division located outside of the state that earned interest income. This division had no operational connection to the taxpayer's regular agricultural commodity business in Tennessee. The court held that the interest income earned by the out-of-state division was not taxable in Tennessee, because there was no unitary connection of money, operations, and management to the commodity business. Therefore, even though under the functional test the interest income was business earnings, it was not taxable since it was nonunitary.
- In the *L.M. Berry & Co.* case,<sup>191</sup> the taxpayer had dividend income from less-than-80% owned foreign subsidiaries. Although the subsidiaries conducted a similar line of business as the taxpayer, the court held that there was not a unitary connection between the foreign subsidiaries and the Tennessee operations of the taxpayer. The court listed over 20 facts that indicated there was no operational or otherwise connection to the state or U.S. operations.
- In the *Siegel-Robert, Inc.* case,<sup>192</sup> the taxpayer had interest income earned on investment funds that was not needed for operational purposes. The investments were in Treasury securities that were either reinvested or held to potentially acquire other businesses. The taxpayer asserted that the investment income was nonbusiness, and that its investment activities were conducted entirely outside of the state and not unitary with Tennessee. The court agreed with the taxpayer. While it appeared that the use of the investment proceeds to acquire other businesses served an operational purpose, it was never established. For the years at issue, there was never any business acquisition or use of investment proceeds that had any relation or connection to the taxpayer's in-state operations.
  - Note, this case is very fact specific and does not set a specific precedent. Rarely will interest income be nonunitary. Auditors will evaluate very closely the facts of a taxpayer under audit when their facts are like the very specific facts of this case.

## 2. Finding: Unitary Business Earnings

Below are three Tennessee court cases that found earnings to be unitary.

- In the *Newell Window Furnishing, Inc.* case,<sup>193</sup> the taxpayer reported a gain as nonbusiness earnings and claimed it was nonunitary. As a corporation doing business in the state, the taxpayer was required to pay an excise tax on the amount of income it reported for federal income tax purposes. The corporation had made an election for federal purposes to treat the sale of its stock as an asset sale under IRC § 338(h)(10). Corporations typically make this election for federal purposes so that the purchaser of the business can apply the full purchase price as the new basis for assets and write-off the price with depreciation expense in future years. However, by making this election, the seller has a taxable gain on those assets. The court held that the gain was business earnings under the functional test and that the sale and income was unitary with Tennessee.
- In the case of *Blue Bell Creameries, LP*,<sup>194</sup> the taxpayer acquired and sold the stock of its holding company in the context of a reorganization of the business entities within the unitary business for a \$120,000,000 gain. The taxpayer claimed the gain as nonbusiness earnings because it was from a one-time extraordinary transaction, the sale of stock of the holding company. The Tennessee Supreme Court concluded that although the gain was not business earnings under the transactional test, it was business earnings based on the functional test from the statutory definition of business earnings. The court stated that the functional test does not look at whether the disposition is a regular part of the taxpayer's business, but whether the asset being disposed of constitutes an integral part of the taxpayer's regular business. The acquisition and sale of stock was a necessary step in the corporate reorganization of the business entities which all profit from the overall business. The stock transaction helped accomplish a reduction of expenses for the business and increased the net earnings of the overall business. Therefore, the stock sale helped contribute to the production of regular earnings from the sale of the taxpayer's normal business products.
  - The taxpayer also advanced a constitutional argument based on the unitary principle. The taxpayer did not prevail on that argument since the taxpayer's acquisition and disposition of stock was part of an overall plan of reorganization that the taxpayer helped accomplish by selling the stock. Therefore, the court concluded that the taxpayer and the holding company were not discrete separate business enterprises, but that they were connected, or unitary, as they

engaged in a stock transaction to reorganize the business to maximize its regular business profits.

- In the case of *H.J. Heinz Co., LP*,<sup>195</sup> the taxpayer deducted dividend income from a wholly-owned investment company, HJH One, LLC, as nonbusiness earnings. The investment company owned preferred shares of stock in the taxpayer. The taxpayer treated the dividends as nonbusiness because it was merely passive investment income. The court, citing *Blue Bell*, held that the dividend income was integral to the taxpayer's regular business because the stock served an operational rather than an investment function, which allowed the taxpayer's business operations to prosper.
  - The taxpayer also advanced a constitutional argument based on the unitary principle. The court noted that a 2001 reorganization was undertaken to benefit the entire Heinz group. HJH One, LLC came into existence as part of that reorganization and conducted no business except to receive dividends in the Heinz Co. stock. HJH One, LLC distributed this dividend income to the taxpayer in the form of partnership investment income. The court concluded that taxation of the dividend income that the taxpayer received from HJH One, LLC was constitutional because the taxpayer's ownership of HJH One, LLC served an operational function.

## Audit Procedures

Auditors will reclassify nonbusiness/nonunitary earnings reported by the taxpayer to business earnings unless the taxpayer can show by clear and cogent evidence that particular earnings should remain classified as nonbusiness earnings. Auditors will not reclassify business earnings to nonbusiness/nonunitary earnings unless clear and cogent evidence exists.

If income is reported as nonbusiness/nonunitary earnings, the auditors will request:

- A written, detailed explanation of the circumstances of the income that includes:
  - Source of the earnings
  - The nature of the income (interest, gain, etc.)
  - The nature of the asset that generated the earnings and its connection to the business
  - A description of pertinent activities, relationships, locations and dates

- The names and pertinent business activities of other entities that were a party to the transaction and their relationship with the taxpayer
  - Ownership percentages of affiliates (if applicable)
  - How the amount was calculated
  - If the income was segregated from the taxpayer's working capital
- Copies of documents that support the taxpayer's narrative.
    - Depending on the situation, this may include financial statements, detailed tax and accounting records, bank and brokerage statements, contracts, purchase/sale agreements, board minutes, state and federal tax returns and reports.

Auditors will evaluate the above information in relation to Tenn. Code Ann. §§ 67-4-2004(4) and (33), and TENN. COMP. R. & REGS. 1320-06-01-.23 (2016), and relevant court decisions. Based on the specific facts, they may adjust the return and reclassify nonbusiness earnings as apportionable business earnings. Audit adjustments may include:

- Removal of the reclassified amount from Schedule M.
- Removal of the amount reported on Schedule J, Line 22.
- An increase to the apportionment factors reported on Schedule N to include property, payroll, or sales amounts related to the reclassified earnings

All relevant documents reviewed or created during the audit will be retained in the Department's audit workpaper file.

## Chapter 9: Franchise Tax

### Overview

#### 1. Who Must File?

The franchise tax is a privilege tax imposed on entities for the privilege of doing business in Tennessee. All entities doing business in Tennessee and having a substantial nexus in Tennessee, except for not-for-profits and other exempt entities, are subject to the franchise tax.<sup>196</sup> This includes corporations, subchapter S corporations, limited liability companies, professional limited liability companies, registered limited liability partnerships, professional registered limited liability partnerships, limited partnerships, cooperatives, joint-stock associations, business trusts, regulated investment companies, REITs, state-chartered or national banks, or state-chartered or federally chartered savings and loan associations.<sup>197</sup>

#### *Public Law 86-272 Not Applicable to Franchise Tax*

As previously discussed in Chapter 3 of this manual, taxpayers whose only business activity is the solicitation of orders for tangible personal property, which are approved and delivered from locations outside the state, are exempt from the excise tax. However, such taxpayers are **not** exempt from the franchise tax. In an opinion published in 2004, the Tennessee Attorney General concluded that Public Law 86-272 applies only to taxes measured by net income, and therefore, does not apply to the franchise tax, which is based on a taxpayer's net worth.<sup>198</sup> A taxpayer claiming exemption from the excise tax under Public Law 86-272 should check the applicable box on the first page of the return and complete only the franchise tax portion of the return (Schedules F1 or F2, G).

#### 2. Minimum Franchise Tax

The minimum franchise tax payable each year is \$100. A taxpayer that is inactive or that has had its charter or other registration forfeited, revoked, or suspended without having been dissolved or otherwise properly terminated, is **not** relieved from filing a return and paying the minimum franchise tax.<sup>199</sup>

To properly terminate or withdraw a corporation's charter, the taxpayer must do the following:

- File a final franchise and excise tax return;



- Submit a schedule of liquidation, distribution, or disposition of assets with the final return;
- Pay all taxes owed to the Department;
- Obtain a tax clearance certificate from the Department; and
- Provide the tax clearance certificate, along with Articles of Dissolution, to the Tennessee Secretary of State.

When a taxpayer that has dissolved or liquidated owes franchise tax to the Department, and has failed to pay the tax, the Commissioner is authorized to collect the unpaid tax from any officer, stockholder, partner, member, principal, or employee of the taxpayer, who received property that belonged to the taxpayer. Such collection is limited to the value of the property received by any of these individuals.<sup>200</sup>

### **3. Franchise Tax Base**

The franchise tax base is the taxpayer's net worth (reported on Schedule F1 or F2), or the book value of the property owned and the rental value of property used in this state (reported on Schedule G), whichever is greater. The franchise tax rate is \$0.25 per \$100 (0.25%, or 0.0025) of the franchise tax base.<sup>201</sup>

### **4. Minimum Measure (Schedule G)**

The measure of the franchise tax cannot be less than the book value (cost less accumulated depreciation) of the property owned and the rental value (net annual rental paid) of property used in this state, excluding exempt inventory and exempt required capital investments made by a taxpayer claiming the job tax credit for higher level investments.<sup>202</sup> An in-depth discussion regarding exempt inventory and exempt required capital investments can be found in Chapter 10.

### **5. Cap on Manufacturer's Franchise Tax Base**

Manufacturers, whose principal business is fabricating or processing tangible personal property for resale and ultimate use or consumption off the premises, are subject to franchise tax only on the first \$2 billion of apportioned net worth or real and tangible personal property owned or used in this state. Thus, a manufacturer's franchise tax base is capped at \$2 billion.<sup>203</sup>

To determine whether a taxpayer is a “manufacturer” for purposes of the franchise tax cap, the taxpayer must compare its total annual revenues derived from fabricating or processing tangible personal property to its total annual revenues, and a resulting ratio of more than 50% indicates that the taxpayer may qualify for the franchise tax cap. For purposes of this test, the taxpayer’s manufacturing activities are not required to occur in Tennessee.

## 6. GAAP Books and Records

The net worth and property values reported on the franchise tax return should originate from the taxpayer’s books and records prepared under generally accepted accounting principles (GAAP). However, if the taxpayer does not maintain its books and records in accordance with GAAP, and is not otherwise required to file as a unitary group on a combined basis, the taxpayer may compute and report its net worth and property values in accordance with the accounting method used by the taxpayer for federal tax purposes, so long as the method fairly reflects such values.<sup>204</sup> If the taxpayer maintains both GAAP *and* tax basis books and records, the taxpayer **must** use its GAAP books and records to determine its franchise tax base.

**⚠ Audit Tip: Smaller taxpayers may only keep tax basis books and records to track their day-to-day business operations. However, they may also be required to have GAAP financial statements prepared by an independent accountant for various purposes, such as to obtain a loan or for bonding/licensing requirements. In this case, the taxpayer must use the GAAP financial statements to compute its franchise tax base.**

GAAP requires that an entity’s financial statements be prepared in accordance with the *liquidation basis of accounting* when liquidation of the entity is imminent.<sup>205</sup> Under this basis of accounting, assets and liabilities are presented at the amount the entity expects to collect or pay during the liquidation. For some assets, this may be fair value instead of book value. Liabilities will include estimated disposal costs and expenses related to the liquidation. It may be to a taxpayer’s disadvantage to use liquidation basis financial statements, but the use of such financial statements is required for franchise tax purposes when liquidation of the taxpayer is imminent. In short, the liquidation basis of accounting is a basis of accounting required by GAAP under the circumstances previously mentioned, and if GAAP financial statements are required to be prepared by the taxpayer using this basis of accounting, they **must** be used to compute the taxpayer’s franchise tax base.

## Non-Consolidated Net Worth – Schedule F1

### 1. Net Worth

Net worth is reported on Schedule F1, Line 1. Net worth is defined as a taxpayer's total assets less its total liabilities, computed in accordance with GAAP.<sup>206</sup> This method of determining net worth is used for all types of taxpayers. On the following page is an example of a net worth computation.

<b>Assets</b>	
Cash	\$ 10,000
Accounts receivable, net	20,000
Investment in TN corporation	10,000
Investment in TN LLC1	(2,000)
Investment in TN LLC2	5,000
Property, plant & equipment, net	37,000
Other assets	20,000
<b>Total assets</b>	<b>\$ 100,000</b>
<b>Liabilities</b>	
Accounts payable	\$ (5,000)
Mortgage payable	(10,000)
Warranty liability	(5,000)
<b>Total liabilities</b>	<b>\$ (20,000)</b>
<b>Equity (Net Worth)</b>	<b>\$ 80,000</b>

Many large, multistate taxpayers that have their financial statements prepared by an independent accountant will have their financial statements prepared in accordance with GAAP because GAAP financial statements are required for large, publicly-traded entities and by many creditors, such as banks and other lenders. Smaller taxpayers may not maintain GAAP financial statements, and thus, would be permitted to compute their net worth in accordance with the accounting method used by the taxpayer for federal tax purposes. However, as previously discussed, if the taxpayer maintains both GAAP and tax basis balance sheets, the taxpayer must use its GAAP balance sheet to compute its net worth for franchise tax purposes.

Taxpayers report their *balance sheet per books* on Schedule L of their federal income tax return (Forms 1065, 1120S, 1120). The amounts reported by a taxpayer on the federal return balance

sheet generally are derived from the taxpayer's GAAP books and records, and thus are appropriate to use in computing net worth for franchise tax purposes.

**⚠ Audit Tip: Auditors may compare the amounts reported in the taxpayer's audited financial statements prepared by an independent accountant with those reported on the federal return balance sheet (Schedule L). While the net worth computed from both sources should agree, if the amounts differ, the financial statements should be used to compute net worth.**

### *Appropriations of Retained Earnings*

Under GAAP, an entity may appropriate part of its retained earnings as a separate balance sheet account to earmark the funds for a given purpose, such as a future plant expansion. These types of accounts **do not** represent a liability under GAAP but rather a component of the entity's retained earnings (net worth). The appropriation must be shown in the shareholders' equity section of the entity's balance sheet.<sup>207</sup> In addition, an entity may not charge costs or losses to an appropriation of retained earnings.<sup>208</sup> The purpose of appropriated retained earnings is for entities to indicate to their shareholders that certain funds have been earmarked and are not available to be paid out as dividends.

An entity may erroneously include accounts that are similar in nature to appropriations of retained earnings in the liabilities section of their balance sheet. However, because these accounts do not represent a liability under GAAP, they should **not** be deducted from the entity's total assets in computing net worth; this would erroneously reduce the amount of the entity's net worth subject to the franchise tax, as illustrated on the following page.

<u>Correct</u>	
<b>Total assets</b>	<b>\$ 240,853,300</b>
<b>Liabilities and shareholders' equity</b>	
<b>Liabilities</b>	
Accounts payable	\$ 24,420,200
Current portion of long-term debt	12,000,000
Note payable - bank	108,050,000
<b>Total liabilities</b>	<b>\$ 144,470,200</b>
<b>Stockholders' equity</b>	
Preferred stock	\$ 1,000
Common stock	3,300
Additional paid-in capital	250,000
<b>Retained earnings appropriated for plant expansion</b>	<b>18,228,800</b>
Retained earnings (unappropriated)	78,000,000
Less: cost of treasury stock	(100,000)
<b>Total shareholders' equity (net worth)</b>	<b>\$ 96,383,100</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 240,853,300</b>
<u>Incorrect</u>	
<b>Total assets</b>	<b>\$ 240,853,300</b>
<b>Liabilities and shareholders' equity</b>	
<b>Liabilities</b>	
Accounts payable	\$ 24,420,200
Current portion of long-term debt	12,000,000
Note payable - bank	108,050,000
<b>Other liability - reserve for plant expansion</b>	<b>18,228,800</b>
<b>Total liabilities</b>	<b>\$ 162,699,000</b>
<b>Stockholders' equity</b>	
Preferred stock	\$ 1,000
Common stock	3,300
Additional paid-in capital	250,000
Retained earnings (unappropriated)	78,000,000
Less: cost of treasury stock	(100,000)
<b>Total shareholders' equity (net worth)</b>	<b>\$ 78,154,300</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 240,853,300</b>

**⚠ Audit Tip: Appropriations of retained earnings that are properly classified as part of the taxpayer's equity will not have a corresponding expense or loss journal entry in the taxpayer's books and records. Unless a book expense or loss was incurred by the taxpayer, the appropriated amount may not be deducted as a liability in computing the taxpayer's net worth for franchise tax purposes.**

## 2. Affiliated Indebtedness

Indebtedness to or guaranteed by a parent corporation or affiliated corporation is reported on Schedule F1, Line 2, and must be added back to the tax calculation if the taxpayer is also a corporation and it is determined that the taxpayer is undercapitalized. This add-back is required to prevent taxpayers from avoiding franchise tax by using excessive affiliated debt, rather than capital, to fund their ongoing business operations. In other words, if a corporation, whose capital stock is inadequate for its business needs, is extended credit by a parent or affiliated corporation, or has debt with a third-party lender and *that* debt is guaranteed by a parent or affiliated corporation, all or a portion of the indebtedness may potentially be added back in computing the corporation's net worth.<sup>209</sup> The indebtedness add-back cannot be a negative amount.

**⚠ Audit Tip: The indebtedness add-back applies only to indebtedness between affiliated corporations. Indebtedness between corporations and partnerships or individual stockholders is not includable in the net worth computation. If the taxpayer is not a corporation, or if a corporate taxpayer's lender/guarantor is not itself a corporation, then this add-back does not apply.**

**Affiliated debt** includes all loans, notes, payables, etc. owed to or guaranteed by any related corporation, as shown on the balance sheet, but does not include any account or trade payables that are current liabilities. Affiliated indebtedness *does*, however, include any current portion of a long-term affiliated debt that is reported as a current liability on the taxpayer's balance sheet.

**The indebtedness add-back is required only if the corporation is inadequately capitalized for its business needs.** To determine whether this is the case, two tests are performed; the indebtedness add-back, if any, is the **lesser** of the amount computed under the Rule 15 Method<sup>210</sup> or the 4:1 Debt-to-Equity Method. An in-depth discussion of these two methods follows.

### Rule 15 Method

The first test for determining the potential indebtedness add-back is the Rule 15 Method. Two subtests are performed under this method, and the **greater** result from the subtests is used:

- **First Subtest** – *Excess of indebtedness over quick assets.* **Quick assets** include any asset that can be converted to cash within the accounting period, such as cash, receivables, and marketable securities. Inventories are not included in this first test.
- **Second Subtest** – *Excess of book value of capital assets (including inventory) over net worth.*
- **The potential add-back cannot exceed the amount of the total affiliated indebtedness.** If quick assets exceed the affiliated indebtedness and net worth exceeds the book value of capital assets, the taxpayer is adequately capitalized, and no indebtedness add-back is required.

#### Rule 15 Method - Example

<u>ASSETS</u>		<u>LIABILITIES</u>	
Cash on hand	\$ 500	Accounts payable	\$ 1,500
Cash in bank	1,500	Accrued liabilities	800
6-mo. Certificate of deposit	5,000	Wages payable	1,300
Accounts receivable	3,000	Note payable - Parent, Inc.	20,000
Allowance for bad debts	(200)		
Inventory	4,800	<u>EQUITY</u>	
Machinery, net	10,000	Capital stock	\$ 500
Marketable securities	2,000	Retained earnings	2,500
Total assets	<u>\$ 26,600</u>	Total liabilities & equity	<u>\$ 26,600</u>

1) First Subtest - Excess of indebtedness over quick assets:

Affiliated indebtedness	\$ 20,000
Cash	\$ 7,000
Accounts receivable, net	2,800
Marketable securities	2,000
Total quick assets	<u>\$ 11,800</u>
Excess of indebtedness over quick assets	<u>\$ 8,200</u>

2) Second Subtest - Excess of book value of capital assets over net worth:

Inventory	\$ 4,800	
Fixed assets, net	10,000	
Total capital assets		\$ 14,800

Capital stock	\$ 500	
Retained earnings	2,500	
Total net worth		\$ 3,000

Excess of book value of capital assets over net worth		<u>\$ 11,800</u>
--	--	------------------

3) Compare results from two subtests:

1. First subtest	\$ 8,200	
2. Second subtest	\$ 11,800	
3. Greater of two subtests	\$ 11,800	
4. Total affiliated indebtedness	\$ 20,000	
<b>5. Lesser of # 3 or 4 above*</b>	<b>\$ 11,800</b>	<b>Result from Rule 15 Method</b>

\*Compare with the result from the 4:1 Debt-to-Equity Method and use the lesser amount.

#### 4:1 Debt-to-Equity Method

The following steps are used to compute the potential indebtedness add-back under the 4:1 Debt-to-Equity Method:

- Determine if the taxpayer has any affiliated or intercompany debt. Affiliated debt includes all loans, notes, payables, etc. owed to or guaranteed by any related corporation, as shown on the balance sheet, but does not include any account or trade payables that are current liabilities. Affiliated indebtedness *does*, however, include any current portion of a long-term affiliated debt that is reported as a current liability on the taxpayer's balance sheet.
- Net the affiliated indebtedness against corresponding receivables on long-term debt between the taxpayer and the same affiliated entity that issued the original debt.
  - It is important to note that a receivable can be netted against affiliated indebtedness **only** if it meets the same criteria for inclusion as the indebtedness.



In other words, any account or trade receivables classified as current assets on the balance sheet from the same affiliated entity **cannot** be netted against affiliated indebtedness, but the current portion of a loan or note receivable that is reported as a current asset on the affiliated entity's balance sheet *can* be netted against affiliated indebtedness.

- Determine the taxpayer's overall debt-to-equity ratio.
  - **Adequately Capitalized:** If the debt-to-equity ratio is 4:1 or less, the taxpayer is considered adequately capitalized, and no amount of affiliated indebtedness will be required to be added back in determining the taxpayer's net worth.
  - **Inadequately Capitalized:** If the taxpayer's debt-to-equity ratio is more than 4:1, the taxpayer is deemed to be inadequately capitalized, and the excess amount of affiliated indebtedness may potentially be added back in determining the taxpayer's net worth.
- Determine the actual amount of affiliated indebtedness that must be added back in determining the taxpayer's net worth, based on the results from both the Rule 15 and 4:1 Debt-to-Equity Methods. The amount of affiliated indebtedness that should be added back on Schedule F1, Line 2 equals the **lesser** result from these two tests. However, the affiliated indebtedness add-back **cannot** exceed the total amount of the affiliated indebtedness itself (net of any corresponding receivables, as discussed in the second step above).

On the following page are four independent examples of the potential affiliated indebtedness add-back computation under the 4:1 Debt-to-Equity Method. These are the definitions of the terms that are used in the examples that follow:

- *Assets* = All assets from the balance sheet
- *Liabilities* = All liabilities from the balance sheet
- *Equity* = *Assets* – *Liabilities* (may be a negative number)
- *Ratio* = 4
- *Value of Equity* = *Equity* x *Ratio* (may be a negative number)

- *Debt* = Total liabilities, excluding current liabilities except for any current portion of long-term affiliated indebtedness included in the current liabilities reported on the balance sheet (in other words, long-term affiliated debt plus the current portion of such debt).
- *Potential Add-Back* = *Debt* - *Value of Equity*

#### 4:1 Debt-to-Equity Method - Examples

Example 1	Example 2																				
<p>Intercompany indebtedness = \$ 30,000            Assets = \$ 100,000            Liabilities = \$ 90,000 (including \$ 15,000 current liability)</p>	<p>Intercompany indebtedness = \$ 30,000            Assets = \$ 100,000            Liabilities = \$ 70,000 (including \$ 40,000 current liability)</p>																				
<table style="width: 100%; border-collapse: collapse;"> <tr><td>Assets</td><td style="text-align: right;">\$ 100,000</td></tr> <tr><td>Less: Liabilities</td><td style="text-align: right;">(90,000)</td></tr> <tr><td>Equity</td><td style="text-align: right;"><u>\$ 10,000</u></td></tr> <tr><td>Ratio</td><td style="text-align: right;"><u>4</u></td></tr> <tr><td>Value of Equity</td><td style="text-align: right;">\$ 40,000</td></tr> </table>	Assets	\$ 100,000	Less: Liabilities	(90,000)	Equity	<u>\$ 10,000</u>	Ratio	<u>4</u>	Value of Equity	\$ 40,000	<table style="width: 100%; border-collapse: collapse;"> <tr><td>Assets</td><td style="text-align: right;">\$ 100,000</td></tr> <tr><td>Less: Liabilities</td><td style="text-align: right;">(70,000)</td></tr> <tr><td>Equity</td><td style="text-align: right;"><u>\$ 30,000</u></td></tr> <tr><td>Ratio</td><td style="text-align: right;"><u>4</u></td></tr> <tr><td>Value of Equity</td><td style="text-align: right;">\$ 120,000</td></tr> </table>	Assets	\$ 100,000	Less: Liabilities	(70,000)	Equity	<u>\$ 30,000</u>	Ratio	<u>4</u>	Value of Equity	\$ 120,000
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<table style="width: 100%; border-collapse: collapse;"> <tr><td>Debt</td><td style="text-align: right;">\$ 75,000</td></tr> <tr><td>Less: Value of Equity</td><td style="text-align: right;">(40,000)</td></tr> <tr><td>Potential add-back</td><td style="text-align: right;"><u>\$ 35,000</u></td></tr> </table>	Debt	\$ 75,000	Less: Value of Equity	(40,000)	Potential add-back	<u>\$ 35,000</u>	<table style="width: 100%; border-collapse: collapse;"> <tr><td>Debt</td><td style="text-align: right;">\$ 30,000</td></tr> <tr><td>Less: Value of Equity</td><td style="text-align: right;">(120,000)</td></tr> <tr><td>Potential add-back</td><td style="text-align: right;"><u>\$ (90,000)</u></td></tr> </table>	Debt	\$ 30,000	Less: Value of Equity	(120,000)	Potential add-back	<u>\$ (90,000)</u>								
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Less: Value of Equity	(120,000)																				
Potential add-back	<u>\$ (90,000)</u>																				
<p><b>Result from 4:1</b>  <b>Debt-to-Equity Method</b>      <b>\$ 30,000 *</b></p>	<p><b>Result from 4:1</b>  <b>Debt-to-Equity Method</b>      <b>\$0 *</b></p>																				
<b>*Intercompany indebtedness is less</b>	<b>*Equity exceeds total debt</b>																				
Example 3	Example 4																				
<p>Intercompany indebtedness = \$ 60,000            Assets = \$ 50,000            Liabilities = \$ 90,000 (including \$ 20,000 current liability)</p>	<p>Intercompany indebtedness = \$ 30,000            Assets = \$ 100,000            Liabilities = \$ 85,000 (including \$ 40,000 current liability)</p>																				
<table style="width: 100%; border-collapse: collapse;"> <tr><td>Assets</td><td style="text-align: right;">\$ 50,000</td></tr> <tr><td>Less: Liabilities</td><td style="text-align: right;">(90,000)</td></tr> <tr><td>Equity</td><td style="text-align: right;"><u>\$ (40,000)</u></td></tr> <tr><td>Ratio</td><td style="text-align: right;"><u>4</u></td></tr> <tr><td>Value of Equity</td><td style="text-align: right;">\$(160,000)</td></tr> </table>	Assets	\$ 50,000	Less: Liabilities	(90,000)	Equity	<u>\$ (40,000)</u>	Ratio	<u>4</u>	Value of Equity	\$(160,000)	<table style="width: 100%; border-collapse: collapse;"> <tr><td>Assets</td><td style="text-align: right;">\$ 100,000</td></tr> <tr><td>Less: Liabilities</td><td style="text-align: right;">(85,000)</td></tr> <tr><td>Equity</td><td style="text-align: right;"><u>\$ 15,000</u></td></tr> <tr><td>Ratio</td><td style="text-align: right;"><u>4</u></td></tr> <tr><td>Value of Equity</td><td style="text-align: right;">\$ 60,000</td></tr> </table>	Assets	\$ 100,000	Less: Liabilities	(85,000)	Equity	<u>\$ 15,000</u>	Ratio	<u>4</u>	Value of Equity	\$ 60,000
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<table style="width: 100%; border-collapse: collapse;"> <tr><td>Debt</td><td style="text-align: right;">\$ 70,000</td></tr> <tr><td>Less: Value of Equity</td><td style="text-align: right;">160,000</td></tr> <tr><td>Potential add-back</td><td style="text-align: right;"><u>\$ 230,000</u></td></tr> </table>	Debt	\$ 70,000	Less: Value of Equity	160,000	Potential add-back	<u>\$ 230,000</u>	<table style="width: 100%; border-collapse: collapse;"> <tr><td>Debt</td><td style="text-align: right;">\$ 45,000</td></tr> <tr><td>Less: Value of Equity</td><td style="text-align: right;">(60,000)</td></tr> <tr><td>Potential add-back</td><td style="text-align: right;"><u>\$ (15,000)</u></td></tr> </table>	Debt	\$ 45,000	Less: Value of Equity	(60,000)	Potential add-back	<u>\$ (15,000)</u>								
Debt	\$ 70,000																				
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<p><b>Result from 4:1</b>  <b>Debt-to-Equity Method</b>      <b>\$ 60,000 *</b></p>	<p><b>Result from 4:1</b>  <b>Debt-to-Equity Method</b>      <b>\$0 *</b></p>																				
<b>*Intercompany indebtedness is less</b>	<b>*Equity exceeds total debt</b>																				

### 3. Net Worth Apportionment

The net worth (including any required indebtedness add-back) of a taxpayer that is doing business only in this state will be 100% subject to the franchise tax. However, when a taxpayer does business both within and outside the state, the taxpayer will apportion its net worth (including any required indebtedness add-back) to this state based on its franchise tax apportionment ratio computed on the appropriate apportionment schedule<sup>211</sup> of the franchise and excise tax return.<sup>212</sup> The franchise tax apportionment ratio is reported on Schedule F1, Line 4. In-depth discussions regarding a taxpayer's right to apportion and the mechanics of apportionment can be found in Chapter 14 of this manual.

## Consolidated Net Worth – Schedule F2

### 1. Overview

A taxpayer may elect to compute its net worth on a consolidated basis **only** if it is a member of an affiliated group<sup>213</sup> that has made a group election to compute their net worth on a consolidated basis (“CNW election”). To make the CNW election, the affiliated group must file a [Consolidated Net Worth Election Registration Application](#) with the Department on or before the due date (including extensions) of the franchise and excise tax return covering the period for which the CNW election is to take effect. In addition, there is a checkbox on the first page of the franchise and excise tax return (Form FAE170/174) for each affiliated group member to check to indicate that it has made the CNW election.

The CNW election is binding for a minimum of five years, and it applies to each member of the affiliated group. All affiliated group members included in the CNW election **must** complete Schedule F2 of their separate returns; under this election, the taxpayer **does not** have the option of computing its net worth on both a consolidated *and* non-consolidated basis for a given tax year and using the lesser amount as its net worth franchise tax base.

The CNW election remains in effect until the affiliated group revokes it; the affiliated group may revoke its CNW election after the minimum required five-year period by filing another Consolidated Net Worth Election Registration Application with the Department on or before the due date (including extensions) of the tax return for the period during which such election is to be revoked and checking the “revoke election” box on the first page of the application. The Commissioner is authorized to accept a late election, a late revocation of an election, or to permit an early revocation of an election to compute net worth on a consolidated basis, if the

Commissioner determines that there is a good and reasonable cause for such action;<sup>214</sup> the taxpayer must submit such petitions to the Commissioner in writing.

**⚠ The CNW election is an alternative method used to compute the net worth franchise tax base. It is NOT an election to file a consolidated franchise and excise tax return. Each affiliated group member subject to franchise and excise tax will continue to file separate returns, but the consolidated net worth amount reported on Schedule F2, Line 1 will be the same for all affiliated group members.**

An affiliated group will **not** be allowed to compute its net worth on a consolidated basis **unless** all members of the affiliated group close their taxable year on the same date. If an affiliated group member exits the group during a tax year due to a change in ownership, merger, or liquidation, the member exiting the group will be excluded from the affiliated group, and it must compute its net worth on a non-consolidated basis on Schedule F1 of the return. In addition, if an affiliated group member is in final return status,<sup>215</sup> it will **not** be permitted to compute its net worth on a consolidated basis **unless** the entire affiliated group is in final return status during the same tax period.<sup>216, 217</sup>

Consolidated net worth is defined as the difference between the total assets less the total liabilities of the affiliated group at the close of business on the last day of the tax year, as shown by a pro forma consolidated balance sheet including all members of the group. The pro forma consolidated balance sheet is to be prepared in accordance with generally accepted accounting principles wherein transactions and holdings between members of the group and holdings in non-domestic persons<sup>218</sup> have been eliminated.<sup>219</sup>

## 2. Affiliated Group Members

### *Entity Type and Nexus*

In general, with respect to a taxpayer that is subject to the Tennessee franchise tax on a standalone basis, affiliated group members can be any type of domestic person<sup>220</sup> (entity):

- in which the taxpayer, directly or indirectly, has more than 50% ownership interest;
- that, directly or indirectly, has more than 50% ownership interest in the taxpayer; and
- in which a person described in the bullet point above, directly or indirectly, has more than 50% ownership interest, **regardless of whether such persons do business in Tennessee.**<sup>221</sup>

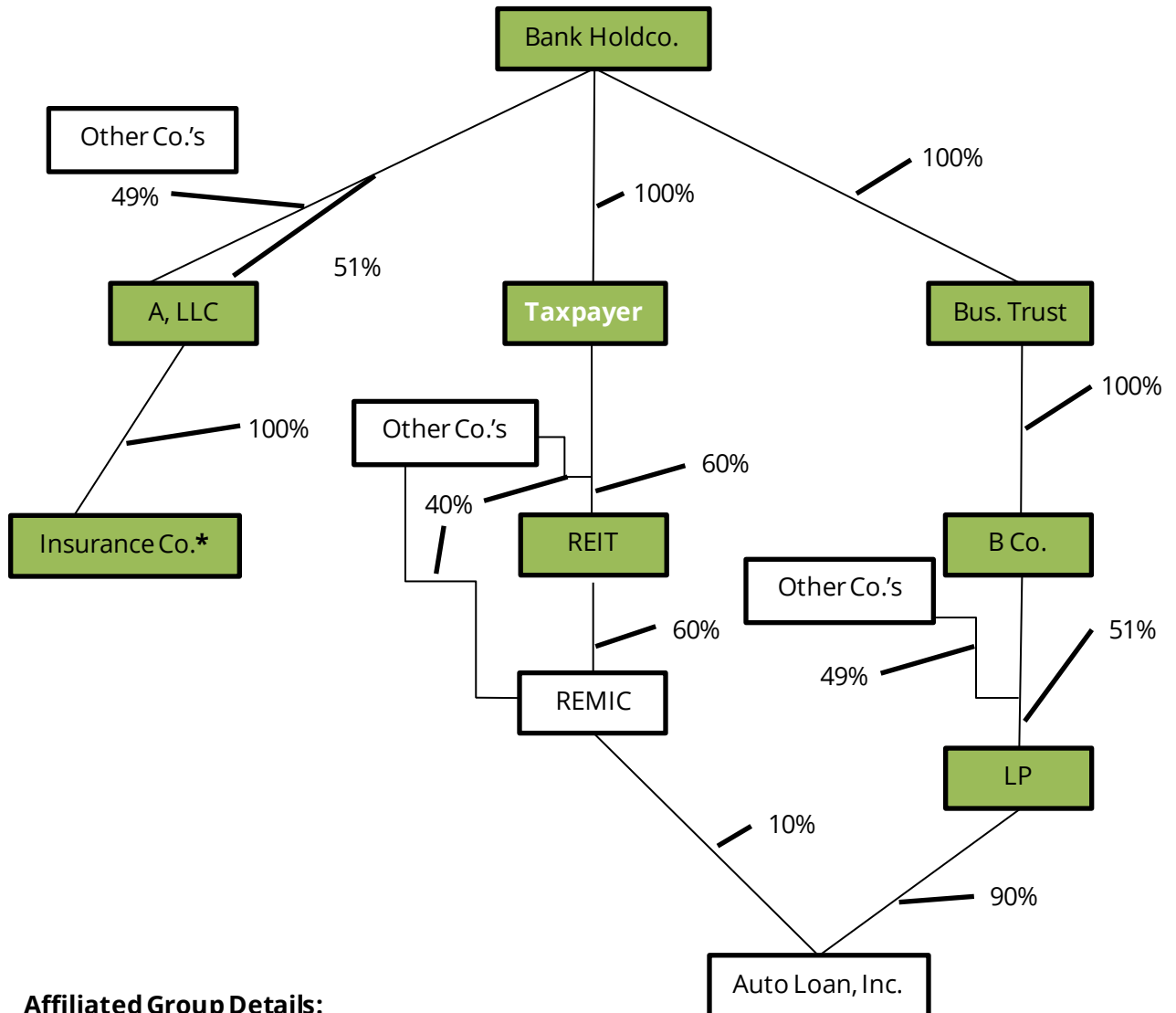
Affiliated group members can be a combination of corporations, subchapter S corporations, LLCs, PLLCs, RLLPs, PRLLPs, LPs, cooperatives, joint-stock associations, business trusts, regulated investment companies, REITs, state-chartered or national banks, or state-chartered or federally chartered savings and loan associations. Basically, affiliated group members may include any entity that meets the definition of a “person” or “taxpayer,”<sup>222</sup> **regardless of whether the entity does business in Tennessee.** The Consolidated Net Worth Election Registration Application lists affiliated group members that include both financial institutions and non-financial institutions. In addition, it lists affiliated group members that have nexus with the state as well as those that do not. The affiliated group members subject to franchise and excise tax are listed under Part 1 of the application, and those not subject to the tax are listed under Part 2. Note that the inclusion of affiliated group members not having nexus with the state on this application does **not** subject them to franchise and excise tax, although the net worth of such entities *is* included in the affiliated group’s consolidated net worth computation.

All affiliated group members are required to be listed on the Consolidated Net Worth Election Registration Application, regardless of their entity type or whether they have nexus with the state. If an entity meets the definition of an affiliated group member, it must be listed on the application. Only non-domestic persons are omitted from the application because, by definition, they are not affiliated group members.

#### *Greater-than-50% Ownership Interest*

Essentially, if there is a greater-than-50% ownership interest between entities (one of which is subject to the Tennessee franchise tax on a standalone basis), then both entities are affiliated group members. The greater-than-50% ownership interest requirement ensures that an entity can only be included in one affiliated group. Greater-than-50% owned subsidiaries of a parent company would be affiliates of one another, even if their only connection was their common parent.<sup>223</sup> On the following page is an example organization chart of an affiliated group reflecting includable affiliated group members.

### Example Affiliated Group Organization Chart



**Affiliated Group Details:**

- Affiliated group members are highlighted in green.
- All affiliates are domestic persons.
- All affiliates have the same year end.
- All affiliates have a greater-than-50% ownership interest among one another.

\* Although this entity is exempt from franchise and excise tax, it is *still* included in the affiliated group; however, it would not be included in the consolidated net worth computation. See the Other Issues section in this chapter for more information.

### Domestic Person

Affiliated group members must be *domestic persons*. Domestic person means any person with more than 20% of its property, payroll, and sales factors in the United States, as compared to those attributes worldwide. The apportionment provisions at Tenn. Code Ann. § 67-4-2111 are to be used for this computation. In the following example, the entity is a domestic person because more than 20% of its property, payroll, and sales are in the United States.

	United States	Worldwide	U.S./WW %
Property	100	5,000	2.00%
Payroll	0	2,500	0.00%
Sales <sup>224</sup>	321,000	600,000	53.50%
Sales	321,000	600,000	53.50%
Sales	321,000	600,000	53.50%
Total			162.50%
Factors			5
Average			32.50%

It is important to understand the difference between the federal meaning of *foreign* and *domestic* and the state's meaning of these terms. For federal tax purposes, *foreign corporation* means a corporation chartered in a foreign nation, whereas *domestic corporation* means a corporation chartered in the United States. For franchise and excise tax purposes, *foreign corporation* means a corporation chartered outside of Tennessee, whereas a *domestic corporation* means a corporation chartered in Tennessee.

The United States generally taxes domestic corporations on their worldwide income, without regard to whether the income arose from a transaction outside of the United States. Foreign corporations are also taxed, but only on income that is either 1) *effectively connected*<sup>225</sup> with a trade or business conducted in the United States or 2) *fixed, determinable, annual, or periodical*<sup>226</sup> from U.S. sources. A domestic corporation's worldwide income is reported on Form 1120 and a foreign corporation's income subject to U.S. income tax is reported on Form 1120-F. A foreign corporation filing on Form 1120-F may be an affiliated group member if it meets both the greater-than-50% ownership test and is a domestic person.

### 3. Consolidated Net Worth Computation

*Consolidated net worth* for the affiliated group is computed as the *affiliated group's total assets less its total liabilities* as of the last day of the tax year, as shown by a pro forma consolidated balance sheet including all members of the group, prepared in accordance with GAAP, wherein



transactions and holdings between members of the group and holdings in non-domestic persons have been eliminated.<sup>227</sup> The consolidated net worth amount reported on Schedule F2, Line 1 will be the same for all affiliated group members that are required to file a franchise and excise tax return.

The consolidated net worth amount is based on 100% of all the affiliated group members' total assets less total liabilities, even when the ownership between affiliated group members is less than 100%. For example, a parent affiliate that has a 75% share in a subsidiary affiliate will include in this affiliated group's consolidated net worth computation 100% of the subsidiary affiliate's assets and liabilities, rather than the parent affiliate's 75% share of the subsidiary affiliate's assets and liabilities.

Once an affiliate meets the definition of an affiliated group member, its assets and liabilities are included in the consolidated net worth computation in their entirety. There is never a reduction in includable assets and liabilities due to a less-than-100% ownership interest between a parent and subsidiary affiliate. It is important to note that, due to the elimination of transactions and holdings between affiliated group members in the consolidation process, the consolidated net worth of an affiliated group will not be overstated, regardless of the percentage of holdings between affiliated group members. See the Verifying Affiliated Group Members section in this chapter for additional information regarding the consolidation process.

An example of a consolidated balance sheet, including intercompany eliminations, is shown on the following page. This consolidated balance sheet provides a level of detail that is similar to what taxpayers usually provide in the attachments to their consolidated federal income tax returns, reflecting the balance sheet attributes of each entity included in the consolidated federal return, a single intercompany eliminations column, and a column for the consolidated totals that are ultimately reflected on the consolidated federal return.

Consolidated Balance Sheet Example						
Balance Sheet	Parent	ABC Inc.	DEF Inc.	XYZ Inc.	Eliminations	Consolidated Totals
<b>ASSETS:</b>						
Cash	\$ 70,000	\$ 75,000	\$ 50,000	\$ 85,000		\$ 280,000
Accounts receivable, net	-	25,000	150,000	42,500		217,500
Intercompany note receivable	160,000	-	-	-	(160,000)	-
Investment in ABC Inc.	260,000	-	-	-	(260,000)	-
Investment in DEF Inc.	100,000	-	-	-	(100,000)	-
Investment in XYZ Inc.	50,000	-	-	-	(50,000)	-
Inventory	-	100,000	175,000	127,500		402,500
Fixed assets, net	-	200,000	225,000	85,000		510,000
<b>TOTAL ASSETS</b>	<b>\$ 640,000</b>	<b>\$ 400,000</b>	<b>\$ 600,000</b>	<b>\$ 340,000</b>	<b>(570,000)</b>	<b>\$ 1,410,000</b>
<b>LIABILITIES:</b>						
Accounts payable	\$ -	\$ 90,000	\$ 150,000	\$ 40,000		\$ 280,000
Intercompany note payable	-	40,000	60,000	60,000	(160,000)	-
Note payable - bank	100,000	-	240,000	140,000		480,000
Other liabilities	50,000	10,000	50,000	50,000		160,000
<b>TOTAL LIABILITIES</b>	<b>\$ 150,000</b>	<b>\$ 140,000</b>	<b>\$ 500,000</b>	<b>\$ 290,000</b>	<b>(160,000)</b>	<b>\$ 920,000</b>
<b>EQUITY:</b>						
Capital stock	\$ 10,000	\$ 1,000	\$ 1,000	\$ 1,000	(3,000)	\$ 10,000
Additional paid-in capital	40,000	9,000	9,000	9,000	(27,000)	40,000
Retained earnings	440,000	250,000	90,000	40,000	(380,000)	440,000
<b>TOTAL EQUITY</b>	<b>\$ 490,000</b>	<b>\$ 260,000</b>	<b>\$ 100,000</b>	<b>\$ 50,000</b>	<b>(410,000)</b>	<b>\$ 490,000</b>
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>\$ 640,000</b>	<b>\$ 400,000</b>	<b>\$ 600,000</b>	<b>\$ 340,000</b>	<b>(570,000)</b>	<b>\$ 1,410,000</b>

Taxpayers generally begin the franchise tax consolidated net worth computation with either the consolidated federal return Schedule L balance sheet or with the consolidated balance sheet included with the taxpayer's audited financial statements. Both methods may require adjustments to ensure that all affiliated group members are included in (and non-affiliated group members are excluded from) the franchise tax consolidated net worth computation. See the Verifying Affiliated Group Members section in this chapter for examples of adjustments that would need to be made, using these two methods, to arrive at the correct franchise tax CNW affiliated group composition.

### *Holdings in Entities that Are Not Affiliated Group Members*

A taxpayer that is subject to the Tennessee franchise tax might have several investments in other legal entities that it reports as assets on its separate entity balance sheet – ranging from wholly-owned or majority-owned (more than 50%) subsidiaries, whose financials are required to be consolidated with the taxpayer's for GAAP external financial reporting purposes, to smaller investments that the taxpayer might account for under the GAAP equity method of accounting (*usually for entities in which the taxpayer has a 20%-50% ownership interest*) or by carrying the fair value of the investment on its balance sheet (*usually for entities in which the taxpayer has an ownership interest of less than 20%; if the fair value of such investment is not readily ascertainable, the taxpayer might simply carry the investment on its balance sheet at historical cost*).

**In determining the franchise tax CNW amount, the taxpayer will eliminate only transactions and holdings between *members of the affiliated group* and holdings in *non-domestic persons*.**<sup>228</sup> Therefore, unless the investee is a non-domestic person,<sup>229</sup> the taxpayer will not eliminate holdings in investees in which the taxpayer (or another CNW affiliated group member) has an ownership interest of 50% or less. Although 50%-or-less owned investees do not meet the criteria to be CNW affiliated group members,<sup>230</sup> investment accounts for such investees that are reported as assets on the separate entity balance sheets of CNW affiliated group members are nevertheless included in determining the affiliated group's CNW amount. For example:

- Parent Co. and Large Co. are separate legal entities, and both are subject to the Tennessee franchise tax. Parent Co. owns 90% of Large Co.'s outstanding common stock. Both entities meet the definition of a CNW affiliated group member, and both meet the requirements to make the CNW election.
- In addition to its investment in Large Co., Parent Co. also owns 40% of the outstanding common stock of Medium Co. Also, Large Co. owns 15% of the outstanding common stock of Small Co. The remaining outstanding shares of Medium Co. and Small Co. are owned by other legal entities that are not affiliated with Parent Co. or Large Co. Neither Medium Co. nor Small Co. meet the definition of a CNW affiliated group member because Parent Co.'s and Large Co.'s respective ownership interests in each investee does not exceed 50%. Medium Co. and Small Co. are both domestic persons.
- In preparing the pro forma consolidated balance sheet from which the CNW amount will be derived for the Parent Co. CNW Affiliated Group, Parent Co.'s "Investment in Large Co." account will be eliminated; this consolidating elimination is necessary because Large Co. is a CNW affiliated group member, and thus, all of its actual assets and liabilities will be brought over in consolidation and combined with those of Parent Co. – in lieu of the Large Co. investment account. On the other hand, because Medium Co. and Small Co.

are *not* CNW affiliated group members, but Parent Co. and Large Co. carry their investments in these entities, respectively, as assets on their separate entity balance sheets, the “Investment in Medium Co.” and “Investment in Small Co.” accounts are not eliminated in the consolidation process; these investees’ separate entity balance sheets are not being consolidated with Parent Co.’s.

- As illustrated below, the ultimate result is that 100% of Parent Co.’s and Large Co.’s assets and liabilities are included in the pro forma consolidated balance sheet, which assets include Parent Co.’s 40% investment in Medium Co. and Large Co.’s 15% investment in Small Co. While the inclusion of the Medium Co. and Small Co. investment accounts might seem contradictory, as these entities are not themselves CNW affiliated group members, this result is consistent with the Tennessee franchise tax CNW provisions, which require that the total assets of all CNW affiliated group members be included in the group’s CNW amount computation and only transactions and holdings between *members of the group* (and holdings in *non-domestic persons*) are eliminated.

<b>Parent Co. CNW Consolidation Worksheet</b>			<b>I/C Eliminations</b>		<b>Consolidated</b>
	<b>Parent Co.</b>	<b>Large Co.</b>	<b>Debit</b>	<b>Credit</b>	
<b>Assets</b>					
Cash & receivables	\$ 200,000	\$ 50,000			\$ 250,000
Inventory	250,000	100,000			350,000
Property, plant, & equipment (net)	1,378,000	500,000			1,878,000
Parent Co. - Investment in Large Co. (90%)	270,000	-		270,000	-
Parent Co. - Investment in Medium Co. (40%)	360,000	-			360,000
Large Co. - Investment in Small Co. (15%)	-	25,000			25,000
<i>Total assets</i>	<b>\$ 2,458,000</b>	<b>\$ 675,000</b>			<b>\$ 2,863,000</b>
<b>Liabilities</b>					
Accounts payable	\$ 150,000	\$ 50,000			\$ 200,000
Notes payable	430,000	325,000			755,000
<b>Stockholders' Equity</b>					
Common stock	\$ 500,000	\$ 100,000	100,000		\$ 500,000
Additional paid-in capital	100,000	20,000	20,000		100,000
Retained earnings	1,278,000	180,000	180,000		1,278,000
Noncontrolling interest	-	-		30,000	30,000
<i>Total liabilities &amp; stockholders' equity</i>	<b>\$ 2,458,000</b>	<b>\$ 675,000</b>	<b>300,000</b>	<b>300,000</b>	<b>\$ 2,863,000</b>

#### 4. Apportionment of Consolidated Net Worth

Affiliated group members that are subject to the franchise tax will multiply the consolidated net worth amount (Schedule F2, Line 1) by an apportionment ratio (Schedule F2, Line 2) to arrive at their share of the affiliated group's consolidated net worth subject to franchise tax. Each member computes its share by multiplying the consolidated net worth amount by a fraction, the numerator of which is the individual affiliated group member's Tennessee attributes (property, payroll, and sales) and the denominator of which is the affiliated group's total attributes everywhere. The attribute amounts included in the denominators of the affiliated group's apportionment factors should be the same for all affiliated group members subject to franchise tax.

Similar to the consolidated net worth computation, the consolidated net worth apportionment factors are calculated based on pro forma consolidated financial statements prepared in accordance with generally accepted accounting principles wherein transactions and holdings between members of the affiliated group and holdings in non-domestic persons have been eliminated.<sup>231</sup> Pursuant to GAAP, the consolidated balance sheet and income statement includes 100% of the assets, liabilities, revenues, expenses, etc. of less-than-100% owned affiliates. Therefore, even in the case of a less-than-100% owned subsidiary, 100% of the subsidiary's apportionment attributes will be included in the apportionment factors (after the elimination of intercompany transactions and holdings, and holdings in non-domestic persons).

- For example, an affiliated group consists of a parent entity and a 60% owned subsidiary. The subsidiary owns \$300,000 of real and tangible property, none of which is located in the state. The subsidiary has \$600,000 in payroll, of which 20% is sourced to the state. The subsidiary has \$750,000 in sales, \$400,000 of which are sales of inventory made to the subsidiary's parent and \$350,000 of which are sales made to non-affiliated customers—of which 80% are sourced to the state. The 60% owned subsidiary's apportionment factors (to be combined with the parent entity's) are as follows:
  - **Property factor:** \$0 in Tennessee / \$300,000 total everywhere
  - **Payroll factor:** \$120,000 in Tennessee / \$600,000 total everywhere
  - **Sales factor:** \$280,000\* in Tennessee / \$350,000\*\* total everywhere
    - \*  $(\$750,000 - \$400,000) \times 80\%$ ; intercompany sales are excluded
    - \*\*  $\$750,000 - \$400,000$ ; intercompany sales are excluded

### Application of CNW Apportionment

The computation of the consolidated net worth apportionment ratio (Schedules 170NC, 170SF, 174SC, 174NC) may seem similar to that of the excise tax apportionment ratio (Schedule N); however, the following are notable differences between the two apportionment ratios:

- The excise tax apportionment ratio is based on tax basis books and records, whereas the consolidated net worth apportionment ratio is based on GAAP books and records in which transactions and holdings between affiliated group members and holdings in non-domestic persons are eliminated.
    - Property owned by the taxpayer should be reported on both Schedules N and 170NC at its original cost.<sup>232</sup> However, intercompany transfers of property between affiliated group members should be excluded from Schedule 170NC; this applies to intercompany transfers of inventory, land, and depreciable assets.
    - For example, an affiliated group consists of a parent entity and a 100% owned subsidiary. Both the parent and the subsidiary operate solely within the state. At the end of the tax year, the parent reports on its separate entity balance sheet (prior to consolidation) \$500,000 in inventory and the subsidiary reports \$250,000 in inventory. During the tax year, the subsidiary sold 200 units of inventory (at a total cost of \$100,000 to the subsidiary) to its parent for \$125,000. The parent has not sold any of this inventory to non-affiliated customers as of the end of the tax year. Because the parent records the inventory received via the intercompany transfer on its separate entity (pre-consolidation) balance sheet at the transfer price of \$125,000, in consolidation, the intercompany inventory amount must be reduced by \$25,000 to properly state the inventory at its original cost (i.e., cost to the subsidiary) of \$100,000. The parent and subsidiary inventory balances will appear on Schedules N and 170NC as follows:
      - **Parent (Sch. N)** – Prop. factor: \$500,000 in TN / \$500,000 everywhere
      - **Parent (Sch. 170NC)** – Prop. factor: \$475,000\* single / \$725,000\*\* cons.
      - **Sub. (Sch. N)** – Prop. factor: \$250,000 in TN / \$250,000 everywhere
      - **Sub. (Sch. 170NC)** – Prop. factor: \$250,000 single / \$725,000\*\* cons.
- \* \$500,000 parent inventory balance - \$25,000 I/C elimination
- \*\* \$500,000 parent inventory balance + \$250,000 subsidiary inventory balance - \$25,000 I/C elimination

- Assume the same facts as in the immediately preceding example, except that prior to the end of the tax year, the parent sells 75% of the inventory that it purchased from its wholly-owned subsidiary to non-affiliated customers. From a consolidated perspective, the markup on the 25% of intercompany inventory remaining on the parent's separate entity balance sheet must be eliminated, in consolidation, to properly state the remaining inventory at its original cost. First, the subsidiary's **gross profit percentage** must be determined as follows:  $(\$125,000 \text{ inventory transfer price} - \$100,000 \text{ cost of inventory to the subsidiary}) / \$125,000 \text{ inventory transfer price} = 20\%$ . The gross profit percentage (GPP) is then applied to the remaining intercompany (I/C) inventory balance as follows:  $\$125,000 \text{ inventory transfer price} \times 25\% \text{ (percentage of I/C inventory remaining)} \times 20\% \text{ GPP} = \mathbf{\$6,250 \text{ markup}}$  that must be eliminated in consolidation. The parent and subsidiary inventory balances will appear on Schedules N and 170NC as follows:
  - o **Parent (Sch. N)** – Prop. factor: \$406,250\* in TN / \$406,250\* everywhere
  - o **Parent (Sch. 170NC)** – Prop. factor: \$400,000\*\* single / \$650,000\*\*\* cons.
  - o **Sub. (Sch. N)** – Prop. factor: \$250,000 in TN / \$250,000 everywhere
  - o **Sub. (Sch. 170NC)** – Prop. factor: \$250,000 single / \$650,000\*\*\* cons.
    - \* \$500,000 parent inventory balance from preceding example less \$93,750 inventory balance sold to non-affiliated customers ( $\$125,000 \text{ transfer price} \times 75\% \text{ inventory sold} = \$93,750$ )
    - \*\* \$406,250 parent inventory balance - \$6,250 I/C elimination
    - \*\*\* \$406,250 parent inventory balance + \$250,000 subsidiary inventory balance - \$6,250 I/C elimination
- All intercompany transactions and holdings between affiliated group members and holdings in non-domestic persons are excluded from the consolidated net worth apportionment ratio but are included in the excise tax apportionment ratio.
  - The intercompany eliminations required to arrive at the consolidated net worth apportionment ratio are the same as the intercompany eliminations that are required to arrive at the consolidated net worth amount; this applies to all items of revenue, expense, gain, and loss incurred between affiliated group members, as well as intercompany transfers of property and intercompany holdings.

- For example, a parent entity owns a building located in the state that the parent purchased several years ago for \$500,000. During the current tax year, the parent sells this building to its wholly-owned subsidiary for \$260,000; at the time of the sale, the building's book value (cost less accumulated depreciation) to the parent was \$200,000. From a consolidated perspective, this intercompany transaction is not recognized. To determine the affiliated group's consolidated net worth amount, the building will be included in the affiliated group's consolidated GAAP balance sheet at the parent's book value of \$200,000 and it will be included in the group's property factor denominator (on Schedule 170NC) at the original cost to the parent of \$500,000—this amount will also be included in the *subsidiary's* property factor numerator (on Schedule 170NC). In addition, the parent's \$60,000 gain on the sale of the building will be eliminated from the group's retained earnings on the consolidated GAAP balance sheet and the \$260,000 gross proceeds from the sale of the building will be excluded from the group's sales factor numerator and denominator (on Schedule 170NC).
- Intercompany rental expense included in the property factor and the corresponding intercompany rental income that is included in the sales factor must be eliminated from the consolidated net worth apportionment ratio.

### *Single Sales Factor Election*

Manufacturers<sup>233</sup> may elect to apportion their net worth subject to franchise tax using a single sales factor apportionment ratio computed on Form FAE170, Schedule S. In addition, the electing manufacturer may also be part of an affiliated group that has made the consolidated net worth election. In this case, the manufacturer will apportion its share of the affiliated group's consolidated net worth by multiplying the amount by a fraction, the numerator of which is the individual manufacturer's Tennessee sales and the denominator of which is the affiliated group's total sales everywhere, computed on Form FAE170, Schedule 170SC.

**⚠ The single sales factor election applies only to the manufacturer making the election. It does not apply to the entire affiliated group.**

Affiliated group members that are not electing manufacturers will continue to use the apportionment ratio that they have traditionally used to apportion consolidated net worth. The property, payroll, and sales of all affiliated group members will continue to be included in the denominator of the affiliated group's consolidated net worth apportionment ratio. In other



words, the computation of an affiliated group's consolidated net worth apportionment ratio remains unchanged, even when a member of the affiliated group has individually elected to use a single sales factor apportionment ratio, in which case the electing affiliate will use the single sales factor apportionment ratio (rather than the group's "standard" consolidated net worth apportionment ratio) to apportion its share of the affiliated group's consolidated net worth.

### *Financial Institutions and Mixed Affiliated Groups*

Generally, a financial institution's franchise and excise tax apportionment ratio is based on a single receipts factor, where Tennessee receipts are divided by everywhere receipts.<sup>234</sup> All other taxpayers, except for common carriers,<sup>235</sup> compute their apportionment ratio by using a standard UDITPA<sup>236</sup> three-factor formula based on property, payroll, and triple-weighted sales. However, a mixed affiliated group problem arises when an affiliated group includes both financial institutions and non-financial institutions.

Under these circumstances, and absent any guidance to the contrary, the affiliated group members would not be using the same apportionment methods, and the apportionment ratio computation would be dissimilar (i.e., some affiliated group members would be using the single receipts factor (FIs) while others would be using the standard UDITPA formula (non-FIs)). To remedy this problem, the mixed affiliated group must determine whether the group is predominately a financial institution affiliated group or a non-financial institution affiliated group; this determination controls which apportionment method *all* affiliated group members (FIs and non-FIs, alike) must use to apportion consolidated net worth.<sup>237</sup>

If it is determined that a mixed affiliated group is a **financial institution affiliated group**, the **single receipts factor** should be used by all affiliated group members to apportion consolidated net worth. A financial institution affiliated group<sup>238</sup> is any affiliated group in which more than 50% of the group's aggregate gross income, excluding dividends and receipts resulting from transactions between members, is derived from conducting the business of a financial institution.<sup>239</sup> For the purpose of this determination, the computation of gross income of an affiliated group member does not include income from nonrecurring, extraordinary transactions.

If it is determined that a mixed affiliated group is a **non-financial institution affiliated group**, the **standard UDITPA three-factor formula** based on property, payroll, and triple-weighted sales should be used by all affiliated group members to apportion consolidated net worth.

### *Financial Institution Affiliated Groups and CNW Election Application*

Designation as a financial institution affiliated group does not change the manner in which the CNW election application is completed by the affiliated group. All affiliated group members are listed on the application, including both financial and non-financial institution affiliated group members. Financial institution affiliated groups may erroneously think that *only* affiliates that are themselves financial institutions should be listed on the CNW election application. For example, a bank that owns a brokerage company (which is not an FI) should include the brokerage company on the CNW election application. Because the CNW election application has a checkbox that states “check if application is for a financial institution affiliated group,” banks sometimes erroneously think that they should only list entities that, individually, are financial institutions. Rather, by checking this box, the bank is implicitly stating that they have performed an analysis of gross receipts from all affiliated group members and determined that a majority of the gross receipts (after eliminations) from all affiliated group members were derived from conducting the business of a financial institution; as such, regardless of whether, individually, an affiliated group member is a financial institution, all financial institution affiliated group members are listed on the bank’s CNW election application.

### *Form Selection for Consolidated Net Worth Apportionment*

The designation of an affiliated group as either a *financial institution affiliated group* or a *standard (non-FI) affiliated group* is important in selecting the correct consolidated net worth apportionment schedule. There are five consolidated net worth apportionment schedules (Schedules [170NC](#), [170SF](#), [170SC](#) & [174SC](#), [174NC](#)), but only one will be correct for any single taxpayer. A taxpayer cannot select the correct apportionment schedule until it determines if its affiliated group is either a financial institution affiliated group or a standard affiliated group. The following is a chart that will help you identify which of the five schedules should be used by the taxpayer.

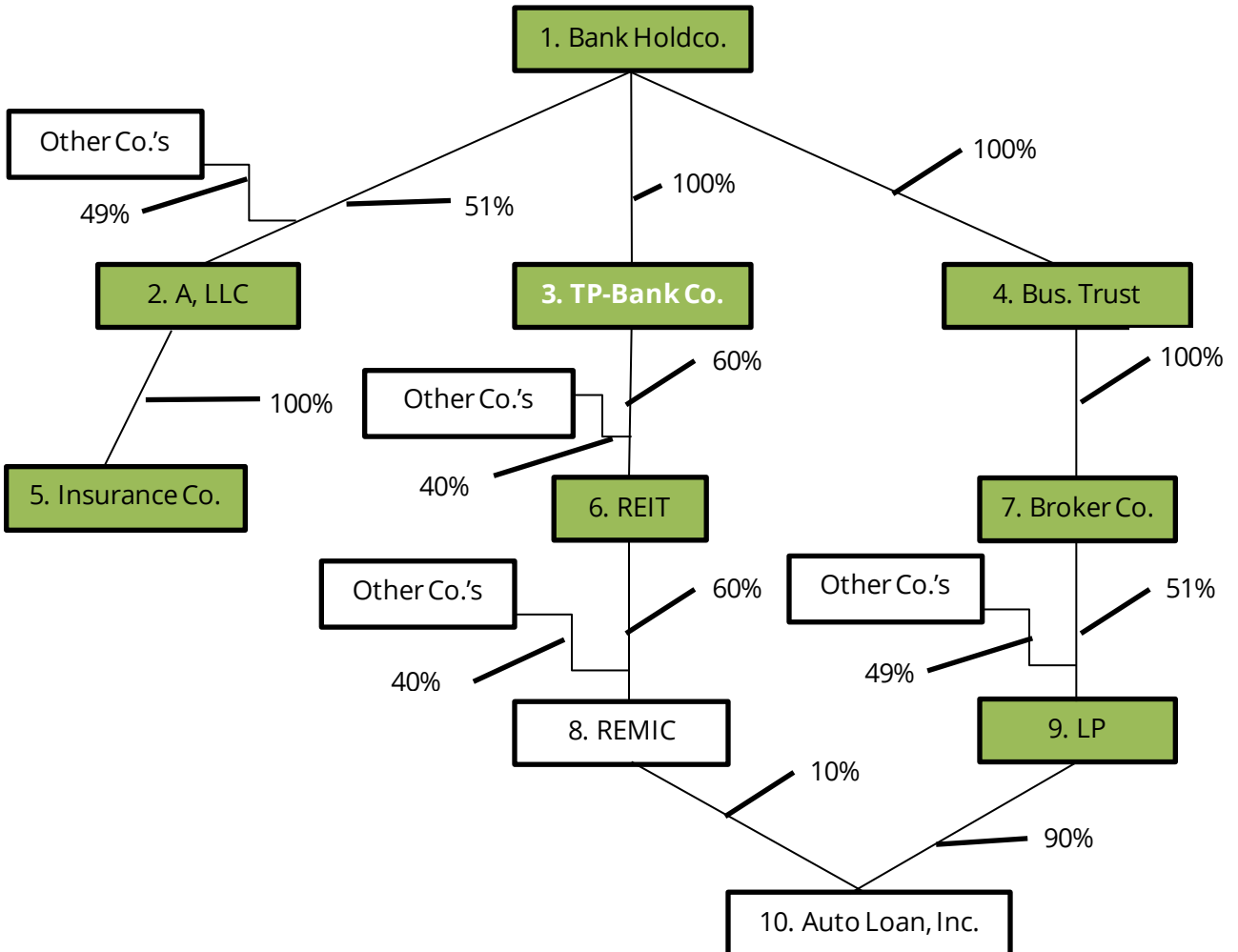
CNW APPORTIONMENT SCHEDULE SELECTION		
Individual taxpayer is:	Taxpayer is a member of a:	Use CNW apportionment schedule:
FI – files Form FAE174	Standard affiliated group	174NC
FI – files Form FAE174	FI affiliated group	174SC
Not an FI – files Form FAE170	Standard affiliated group	170NC
Not an FI – files Form FAE170	FI affiliated group	170SF
Manufacturer electing single sales factor apportionment – files Form FAE170	Standard affiliated group	170SC

*Example – Standard or Financial Institution Affiliated Group Determination*

On the following page is an example evaluation of an affiliated group for the purpose of determining whether the affiliated group is a financial institution affiliated group or standard affiliated group, and to determine the proper consolidated net worth apportionment schedule that should be used by each affiliated group member.

Note that entities number 1, 2, 3, 4, 6, and 10, individually, are financial institutions. Of these entities, 1, 3, and 10 qualify as financial institutions for franchise and excise tax purposes based on their business operations, while 2, 4, and 6 qualify as financial institutions because they are each a first-tier subsidiary of a financial institution.<sup>240</sup> However, the affiliated group as a whole is a *standard affiliated group* because less than 50% of the group’s gross receipts (excluding dividends and receipts resulting from transactions between members, and receipts from nonrecurring, extraordinary transactions) were derived from conducting the business of a financial institution.

In addition, note that entity number 5 is an insurance company. The insurance company is an affiliated group member; however, because insurance companies are exempt from franchise and excise tax, the insurance company does not file a return and its gross receipts are not included in the greater-than-50% test for determining whether the affiliated group is a financial institution affiliated group.



Entity	Taxpayer is Financial Institution?	Affiliated Group Member	Entity Gross Receipts	Entity Gross Receipts from FI*	FI Affiliated Group Member	CNW Apportionment Schedule
1.	Yes	Yes	\$ 1,000	\$ 900	No	174 NC
2.	Yes	Yes	2,000	1,500	No	174 NC
3.	Yes	Yes	3,000	2,100	No	174 NC
4.	Yes	Yes	4,000	3,000	No	174 NC
5.	No	Yes	N/A	N/A	N/A	N/A
6.	Yes	Yes	6,000	4,000	No	174 NC
7.	No	Yes	7,000	0	No	170 NC
8.	No	No	N/A	N/A	N/A	N/A
9.	No	Yes	9,000	3,000	No	170 NC
10.	Yes	No	N/A	N/A	N/A	N/A
<b>Total</b>			<b>\$ 32,000</b>	<b>\$ 14,500</b>	<b>45.31% receipts from FI activity</b>	

\* Receipts from conducting the business of a financial institution, after elimination of dividends and receipts from transactions between affiliated group members and nonrecurring, extraordinary transactions

## 5. Verifying Affiliated Group Members

Verification of affiliated group members is, perhaps, the most important step in determining consolidated net worth for franchise tax purposes, and it is often the step where most errors tend to occur. Because taxpayers sometimes apply the federal or GAAP definitions of an affiliate when determining the consolidated net worth affiliated group, it is helpful to understand the similarities and differences between the federal, GAAP, and state definitions<sup>241</sup> of an affiliate. From a state tax perspective, it is also important to understand the differences in the federal and GAAP definitions, because documents from these outside sources are often used to verify the affiliated group and consolidated net worth computation.

The following documents provide some degree of relevant information with respect to verifying affiliated group members:

- Organization chart, including ownership percentages
- Audited, consolidated financial statements and accompanying footnotes
- Federal Form 851 – Affiliations Schedule

However, none of the above documents, when examined alone, are sufficient in verifying affiliated group members.

### *Organization/Ownership Chart*

An organization chart visually displays entities owned directly and indirectly by a parent company. Organization charts are an easy way to see the big picture of the ownership structure and can be very helpful in quickly identifying potential affiliated group members. Several levels of organization charts may be needed if the organization has gone through any type of restructuring.

However, these charts generally do not show if an entity is a *domestic person*,<sup>242</sup> as defined by the state. Also, unless the chart is embedded in another document (such as an annual report), it is not as authoritative as the federal Form 851 (included in federal return that is signed by the taxpayer and filed with the IRS) or audited financial statements (audited by an independent accountant).

### *Audited Financial Statements with Footnotes*

Audited, consolidated financial statements, accompanying footnotes, and supporting consolidation workpapers can be used to verify the accuracy and completeness of the affiliates listed on the CNW election application and the net worth computation. In order to better understand the information from these sources, it is helpful to obtain a general understanding of the GAAP guidance on consolidation, equity method investments, and equity securities.

In general, a full consolidation occurs when the parent's ownership in a subsidiary is greater than 50% of the subsidiary's voting stock. The equity method is used to account for an investment in which the ownership interest is between 20% and 50%, and an investment in which the ownership interest is less than 20% would simply be shown as an investment on the balance sheet at fair value.

### *Consolidation (>50% Ownership) – GAAP*

Under GAAP, consolidated financial statements are required to be prepared for external financial accounting purposes by a parent and its majority-owned subsidiaries (>50% voting stock owned). The parent and each of its majority-owned subsidiaries still maintain a separate legal existence and keep their own separate books and records for internal financial accounting purposes. In consolidated financial statements, the attributes of all majority-owned subsidiaries are combined with those of the parent (with all intercompany transactions and holdings eliminated) to present the financial statements from the perspective of a single economic entity. However, there are exceptions to this general rule.

Some subsidiaries may meet the greater-than-50% ownership test but are excluded from the consolidation, while other entities may not meet this threshold but are included in the consolidation. This is because GAAP also permits consolidation when the parent has a less-than-50% ownership interest in the subsidiary but *controls* the subsidiary through contractual or other means; however, the state definition of affiliate considers only the greater-than-50% test. Also, a majority-owned subsidiary is generally included in consolidated financial statements even if it has a different fiscal year end, but it is not consolidated if it is in legal reorganization or bankruptcy. In contrast, for franchise tax consolidated net worth purposes, all affiliates are required to close their taxable year on the same date,<sup>243</sup> but an affiliate *could* be in bankruptcy and continue to be in the affiliated group.

As previously mentioned, under GAAP, *control* is the primary criterion for determining whether to consolidate a subsidiary. Generally, control exists when the parent owns (directly or indirectly)

over 50% of the voting stock of an affiliate. However, control could also exist if a company has a major economic impact on an affiliate and its business decisions, even if the parent owns only a minor voting interest in the subsidiary. If there is significant doubt concerning the parent's ability to exercise control over the subsidiary, the subsidiary will not be included in the consolidation. Usually, one of the first footnotes to an entity's audited financial statements will describe the principles of consolidation and the entity's reporting for investments in unconsolidated affiliates. The following is an example of such footnote:

The company's consolidated financial statements include the accounts of Parent Co. and its subsidiaries as of and for the fiscal years ended December 31, 20X3, 20X2, and 20X1. Intercompany accounts and transactions have been eliminated in consolidation. Investments for which Parent Co. exercises significant influence, but does not have control, are accounted for under the equity method.

When reading consolidated financial statements, another concept that is important to understand is the concept of a *noncontrolling interest*. GAAP requires that controlled subsidiaries be consolidated, since the parent and its majority-owned subsidiaries are viewed as a single economic entity. Furthermore, GAAP requires that 100% of the controlled subsidiary be consolidated, regardless of the parent's ownership percentage (i.e., even if the parent owns less than 100% of the subsidiary). Thus, a *noncontrolling interest* represents the ownership interests in the subsidiary that are held by owners other than the parent.<sup>244</sup>

For example, if a parent company owns (directly or indirectly) 80% of a subsidiary, the 20% owned by others is the noncontrolling interest. In this case, the consolidated income statement will include 100% of the results of operations of both the parent and the subsidiary, even though the parent's ownership of the subsidiary is only 80%. The net income line will reflect 100% of the parent's and subsidiary's net income (excluding intercompany transactions). In addition, the consolidated income statement will break out the amount of consolidated net income attributable to the noncontrolling interest and to the parent. The net income attributable to the noncontrolling interest is presented as a subtraction from total consolidated net income to arrive at the consolidated net income attributable to the parent. The following is an example of a consolidated income statement with a noncontrolling interest presented:

<b>Parent Co.</b>	
<b>Consolidated Income Statement</b>	
<b>Year Ended December 31, 20X3</b>	
Revenues	\$ 395,000
Expenses	(330,000)
Income from continuing operations, before tax	65,000
Income tax expense	(26,000)
Income from continuing operations, net of tax	39,000
Discontinued operations, net of tax	-
Net income	39,000
Less: Net income attributable to the noncontrolling interest	(7,800)
Net income attributable to Parent Co. shareholders	<u>\$ 31,200</u>

On the consolidated balance sheet, GAAP requires that noncontrolling interests be reported as part of the equity of the consolidated group.<sup>245</sup> The equity section of the balance sheet will report the total equity of the consolidated group (including that of both the parent and the noncontrolling interest). Note, unlike the consolidated income statement, where the consolidated net income attributable to the noncontrolling interest is presented as a subtraction in arriving at consolidated net income attributable to the parent, on the consolidated balance sheet, the noncontrolling interest remains part of total consolidated equity (net worth). It is important to note that, for franchise tax purposes, the consolidated net worth computation will include any noncontrolling interests attributable to consolidated affiliated group members in which the parent owns less than 100% of the affiliate. On the following page is an example of a consolidated balance sheet with a noncontrolling interest presented:



<b>Parent Co.</b>	
<b>Consolidated Balance Sheet</b>	
<b>As of December 31, 20X3</b>	
<b>Assets:</b>	
Cash	\$ 570,000
Accounts receivable	125,000
Available-for-sale securities	125,000
Plant and equipment	220,000
Total assets	<u>\$ 1,040,000</u>
<b>Liabilities:</b>	
Total liabilities	<u>\$ 555,000</u>
<b>Equity:</b>	
Parent Co. shareholders' equity:	
Common stock, \$1 par	200,000
Paid-in capital	42,000
Retained earnings	123,500
Accumulated other comprehensive income	22,500
Total Parent Co. shareholders' equity	<u>388,000</u>
Noncontrolling interest	<u>97,000</u>
Total equity	485,000
Total liabilities and equity	<u>\$ 1,040,000</u>

The chart below highlights some of the differences between the rules for GAAP consolidation and franchise tax net worth consolidation. Taxpayers will almost always have to make some adjustments to their GAAP consolidated financial statements to arrive at the correct franchise tax affiliated group and consolidated net worth amount due to the differences between the GAAP and franchise tax rules for consolidation. Thus, it is very important to be aware of these differences and to recognize that there is an increased likelihood for error in this area.

Consolidation Criteria	GAAP	Franchise Tax CNW
Consolidate entities in which parent/affiliate has >50% direct/indirect stock ownership	Yes	Yes
Only <i>domestic entities</i> <sup>246</sup> are included in the consolidation	No	Yes
Majority-owned <i>foreign subsidiary</i> is consolidated	Yes, unless parent does not have control	Depends if foreign subsidiary is a domestic entity <sup>247</sup> (if so, Yes)
Consolidated affiliates can have different year ends	Yes	No
Consolidated entities can be in legal reorganization or bankruptcy	No	Yes
Consolidate entities in which parent/affiliate has <50% direct/indirect stock ownership, if control exists	Yes	No
Exclude from consolidation entities in which parent/affiliate has >50% direct/indirect stock ownership, if control does <b>not</b> exist	Yes	No

#### Equity Method (20-50% Ownership) – GAAP

Under GAAP, the *equity method* of accounting is used by an entity (the investor) to account for its direct or indirect investment in the common stock of another entity (the investee). The general rule is that stock ownership between 20% and 50% in the investee requires use of the equity method; however, the underlying criteria for use of the equity method is whether the investor has the ability to exercise *significant influence* over the operating and financial policies of the investee.<sup>248</sup> Under the equity method of accounting, the investor records its initial equity method investment in the investee by debiting a balance sheet account called *Investment in [Investee]* for the purchase price (fair value) of its share of the investee’s common stock, and by crediting its cash account for the amount paid. For example, on January 5, 20X3, Parent Co. purchases a 25% share of Investee Co.’s common stock. On that date, the fair value of Investee Co.’s total common stock was \$500,000. Parent Co. will record its investment by making the following journal entry in its books:

Investment in Investee Co.	125,000	
Cash		125,000

Over time, the investment account is adjusted to reflect the investor's share of any increase or decrease in the value of its investment in the investee as of each balance sheet reporting date. The investor increases the investment account to reflect its share of the investee's net income when it is earned by the investee (or decreases the investment account for its share of the investee's losses), and the investor decreases the investment account for its share of dividends declared by the investee. For example, during the year, Investee Co. reports net income of \$750,000 for the reporting period and declares total dividends to all stockholders of record of \$20,000. To account for its share of these items and to appropriately adjust the investment account, Parent Co. will record the following journal entries in its books:

Investment in Investee Co.	187,500	
Equity earnings in Investee Co.		187,500
Dividends receivable	5,000	
Investment in Investee Co.		5,000

Continuing the above example, at the balance sheet reporting date, Parent Co. will report a balance in its Investment in Investee Co. account of \$307,500. In addition, Parent Co.'s share of the equity earnings (net income) from Investee Co. will ultimately flow into Parent Co.'s retained earnings account and be included in Parent Co.'s shareholders' equity.

If Parent Co. owned a majority share (>50%) of Investee Co.'s common stock and obtained control of Investee Co., Parent Co. would be required to consolidate Investee Co. in its consolidated financial statements for external financial reporting purposes. For internal financial reporting purposes, however, Parent Co. would continue to use the equity method of accounting to account for this investment (the investment account and all intercompany transactions between the two entities would be eliminated in consolidation). If Parent Co. does not take control of Investee Co. and maintains its 25% ownership interest in this entity, then the investment account will not be eliminated in consolidation and will be reported as an asset on Parent Co.'s consolidated balance sheet.

#### *Fair Value and Cost Methods (<20% Ownership) – GAAP*

Under GAAP, when an entity acquires a relatively small ownership interest (<20%) in another entity, it usually accounts for this investment on its balance sheet at fair value. Under the fair value method, the investor recognizes its share of income from the investment when dividends

are declared by the investee, and the investor also recognizes its share of net income from the change in the fair value of the investment during the reporting period. The investor adjusts the investment account to fair value at each balance sheet reporting date.

Alternatively, if the investor cannot readily determine the fair value of its investment, it may simply maintain the investment on its balance sheet at historical cost. In this case, the investor recognizes income from its investment only from its share of dividends declared by the investee. The investor generally would *not* adjust the investment to fair value at the balance sheet reporting date.<sup>249</sup>

### *Federal Form 851 – Affiliations Schedule*

[Form 851](#) identifies the common corporate parent and members of a federal affiliated group. As mentioned previously, the federal definition of affiliated group is different from the state definition. For federal income tax purposes, an affiliated group is one or more chains of includable corporations connected through stock ownership with a common parent corporation. An includable corporation is a corporation other than an IRC §501 exempt corporation, an insurance company, a foreign corporation, a regulated investment company (RIC), a REIT, or an S corporation. In addition to stock ownership, the percentage of voting power is also a consideration for federal purposes.<sup>250</sup> Part II of the form lists the common parent, subsidiaries, ownership relationships, and related percentages.

Federal Form 851 is helpful in that it identifies *some* affiliates that would meet the state's definition of an affiliated group member—those in which there is an 80%-or-more ownership interest. However, non-corporate affiliates and corporations in which the common parent corporation has an ownership interest of 50% or more, but less than 80%, are **not** identified on this form. On the following page is a reference chart that reconciles the differences between the federal affiliated group members that would be reflected on Form 851 and those that would be includable in a franchise tax consolidated net worth affiliated group.

Common Parent Ownership Percentage/Type	Include in Federal Affiliated Group (Form 851)	Include in CNW Affiliated Group
Stock ownership: 80% or more	Yes	Yes
Stock ownership: 1 - 50%	No	No
Stock ownership: 51 - 79%	No	Yes
Non-corporate entities	No	Yes
Foreign corporations, insurance companies, S corporations, or REITs	No	Yes <sup>251</sup>
Non-domestic person, per TN definition	Yes	No

## 6. Other Issues

### *Changes in Affiliated Group*

The affiliated group is required to notify the Department annually of any changes to the affiliated group. There are checkboxes at the top of the [Consolidated Net Worth Election Registration Application](#) ("CNW application") for *amending the election to add or remove group members* and for *revoking the election*. In addition, there are also checkboxes for each affiliate to indicate *new member* or *remove member* along with a blank in which to list an *effective date* for such action. It is important for taxpayers to notify the Department of these changes because the Department maintains this information to determine when affiliated group members were added to or removed from the affiliated group. Affiliates disposed of before year end will be excluded from the affiliated group.<sup>252</sup> However, affiliates acquired during the year and held at year end will be bound by the group's election and will be included in the affiliated group.<sup>253</sup> When an affiliated group files an amended CNW application with the Department to add or remove group members, it need only list the parent of the affiliated group and list **only** the information of the affiliated group members that need to be added or removed from the affiliated group, check the appropriate checkbox (*new member* or *remove member*), and provide the effective date of this action for each affiliate listed.

### *Indebtedness and Non-Domestic Entities*

Due to the elimination of all intercompany accounts between affiliated group members in consolidation, any indebtedness between the affiliated group members generally would not exist. However, there may be instances in which the affiliated group has indebtedness owed to

or guaranteed by non-domestic entities. Because non-domestic entities cannot be affiliated group members, indebtedness owed to or guaranteed by non-domestic entities is **not** eliminated in the consolidated net worth computation.

### *Exempt Entity Affiliates*

The consolidated net worth election is a group election that is binding on all affiliated group members. However, it is likely that some entities that meet the definition of an affiliate might also happen to be an entity that is exempt from franchise and excise tax. In this case, the exempt entity would still be listed as an affiliated group member on the CNW application, but its net worth and apportionment factors would be **excluded** from the affiliated group's consolidated net worth computation and apportionment ratio, respectively.<sup>254</sup>

For example, an insurance company meets the definition of an affiliate for consolidated net worth purposes, but it is also exempt from franchise and excise tax. As such, it should be listed on the CNW application, but because the insurance company is exempt from franchise and excise tax, its net worth and apportionment factors are excluded from the affiliated group's consolidated net worth computation and apportionment ratio, respectively.

## **7. Audit Procedures**

The following list, while not comprehensive, provides a general overview of the audit procedures that a consolidated net worth audit entails. Modifications may be made to these audit procedures due to the particular facts and circumstances of a given audit, at the auditor's discretion.

### *Review Taxpayer's CNW Application*

- Obtain a copy of the taxpayer's original or amended CNW application.
- Verify that the taxpayer's CNW application was timely filed.
- The auditor may not revoke a CNW election.

### *Identify Affiliated Group Members*

- Request the consolidation workpapers used by the taxpayer in computing the consolidated net worth amount. Generally, a worksheet listing account balances with a

column for each affiliate, an eliminations column, and a column reflecting the consolidated totals of the affiliated group will be sufficient.

- Request a list of the names and FEINs of the affiliated group members if this information is not readily or easily identifiable on the taxpayer's workpapers.
- Compare the affiliated group members included in the consolidation workpapers with those listed on the CNW application and inquire about any differences between the two with the taxpayer.
- Determine that all affiliated group members have the same year end. If they do not, then the affiliated group cannot make the CNW election.

#### *Search for Entities Included or Omitted in Error*

- To determine whether entities have been included in, or excluded from, the affiliated group in error, request the following documents from the taxpayer for the audit period(s) under review:
  - Organization chart, including ownership percentages
  - Audited, consolidated financial statements and accompanying footnotes
  - Federal Form 851 – Affiliations Schedule
- Review the organization chart, financial statements, and Form 851 to determine whether the affiliated group members meet the greater-than-50% ownership test.
  - Each of these source documents, when reviewed separately, is typically inadequate for the purpose of determining whether this requirement is met. These documents should be reviewed together to reconcile the includable affiliated group members.
- Request a schedule detailing each affiliated group member's property, payroll, and sales in the United States and worldwide, to determine if all affiliated group members that meet the greater-than-50% test also meet the 20% domestic person test.

- Based on the audit work done, per the previous steps, identify entities that are included in, or excluded from, the affiliated group in error. **If adjustments are made to the affiliated group members, please see the sub-step below.**
  - As a preliminary matter, **and before continuing with any further audit work**, inform the taxpayer of your findings regarding the adjusted composition of the affiliated group, and request any additional information that you may need to make appropriate adjustments to the consolidated net worth amount and apportionment ratio for the newly-included affiliates.

#### *Verify Consolidated Net Worth Amount*

- Verify the consolidated net worth amount reported on Schedule F2, Line 1 of the franchise and excise tax return to the consolidation worksheet.
- Review the eliminations column of the consolidation worksheet and request additional information, if necessary, to reach a conclusion as to whether all transactions and holdings between members of the affiliated group, and holdings in non-domestic persons, have been eliminated in arriving at the consolidated net worth amount.
- Using the records at your disposal, independently compute the consolidated net worth amount to ensure that there are no inadvertent mathematical/computational errors and that the consolidated net worth amount is computed in accordance with Tenn. Code Ann. § 67-4-2106(b).

#### *Consolidated Apportionment Schedule Selection*

- Request to see the taxpayer's workpapers that detail the taxpayer's analysis of whether the affiliated group, as a whole, is a financial institution affiliated group or a standard affiliated group
  - Compare the entire affiliated group's gross receipts from financial institution business activities<sup>255</sup> with its receipts from all business activities to determine whether more than 50% of the affiliated group's gross receipts result from conducting the business of a financial institution.
  - Confirm that the gross receipts for the purpose of this comparison exclude intercompany transactions and nonrecurring, extraordinary transactions.



- Confirm the affiliated group's status (financial institution or standard) with the taxpayer and verify that the taxpayer is using the correct consolidated net worth apportionment schedule based on this determination.
  - See the Form Selection for Consolidated Net Worth Apportionment section in this chapter for more information on determining the proper consolidated apportionment schedule to be used by the taxpayer.

### *Verify Consolidated Net Worth Apportionment Ratio*

- Verify the denominator amounts of the property, payroll, and sales factors in the consolidated net worth apportionment ratio to those reported in the taxpayer's consolidated net worth apportionment ratio workpapers.
- In general, it is appropriate to follow the same audit procedures that are used to verify apportionment ratio factors for excise tax purposes, as detailed in Chapter 14 of this manual. However, remember that there are additional audit procedures that are unique to consolidated net worth that must also be implemented, as detailed below.
- **Audit procedures unique to consolidated net worth (CNW) apportionment:**
  - Verify that the CNW property factor has been computed using GAAP books and records (with intercompany eliminations), as opposed to tax basis books and records. Note, however, that property owned by the taxpayer, regardless, is still valued at its original cost.
  - Verify that all CNW apportionment factors are computed by eliminating transactions and holdings between members of the affiliated group. Remember, non-domestic persons are not affiliated group members, so transactions with them are not eliminated.
  - Understand that the type of apportionment ratio used by the taxpayer for CNW apportionment may differ from the one the taxpayer uses for excise tax apportionment (UDITPA three-factor formula, single receipts factor formula, modified CNW apportionment for common carriers).

- If the taxpayer is a financial institution unitary group that files a combined franchise and excise tax return on Form FAE174, the total gross receipts of the taxpayer's CNW affiliated group could exceed those reported on Schedule SE of the combined return because the CNW affiliated group may include affiliates that are non-unitary with the taxpayer.

#### *Review Affiliates Not Currently Under Audit*

- Confirm in the Department's records that all affiliated group members that are subject to franchise and excise tax are filing tax returns and are abiding by the group's CNW election, properly completing Schedule F2 (rather than F1) of the return.
- Verify that the consolidated net worth amount reported on Schedule F2, Line 1 is the same for all affiliated group members.
- Verify that the denominator amounts of the CNW apportionment ratio property, payroll, and sales factors reported in the everywhere (consolidated) column of the apportionment schedule are the same for all affiliated group members, regardless of which apportionment schedule is used by the affiliated group.

## Chapter 10: Property Valuation

### Overview

The franchise tax is .25% of the greater of a taxpayer's net worth or the book value of real and tangible property owned or used within the state.<sup>256</sup> The franchise tax property base, reported on Schedule G of the franchise and excise tax return, is often referred to as the "minimum tax base" or "minimum measure" because taxpayers without taxable net worth, or whose net worth is less than the book value of real and tangible property owned or used within the state, are subject to franchise tax based on the book value of their owned or used property within the state.<sup>257</sup> The franchise tax base will never be less than the actual value of the real or tangible property owned or used in Tennessee, excluding exempt inventory and exempt required capital investments.<sup>258</sup>

The franchise tax base includes the book value of tangible property owned or used in Tennessee, as determined in accordance with generally accepted accounting principles ("GAAP"). If books and records are not maintained in accordance with GAAP, the value of the property may be computed in accordance with the accounting method used by the taxpayer for federal tax purposes as long as the method fairly reflects the property's value. To the extent that GAAP records are not maintained by the taxpayer, the book value of property computed for federal tax purposes may be used in completing Schedule G.<sup>259</sup>

Schedule G must be completed regardless of whether the amount on Schedule F1 or F2 is greater than the Schedule G amount, and regardless of whether the federal Schedule L balance sheet is completed by the taxpayer.

#### 1. Property Included

Tangible property owned or used in Tennessee is reported on Schedule G. All tangible property that is not exempt from franchise tax and that is owned by the taxpayer in this state should be included on Schedule G regardless of whether the property is held for sale, held for investment purposes, or in service during the tax year. Property reported on Schedule G, which is discussed in detail in later sections, includes:

- Land
- Buildings
- Leasehold improvements

- Rented and leased tangible personal property
- Machinery and equipment
- Furniture and fixtures
- Automobiles and trucks
- Inventories
- Prepaid supplies
- Other tangible personal property

**⚠ Reporting Tip: When reporting the book values of tangible property, taxpayers should separate land, buildings, equipment, and auto values. If taxpayers enter the total book value of all tangible property on one line, auditors may require the taxpayer's detailed books and records to verify the reported amount.**

## 2. Property Excluded

### *Computer Software*

**Computer software is not considered tangible personal property for franchise tax purposes, and it should not be included on Schedule G.** Although capitalized software may be reported as a long-lived asset and amortized, it is nonetheless considered an intangible for franchise tax purposes and should be omitted from Schedule G.

According to GAAP, costs incurred for duplicating computer software, documentation, and training materials from the product masters and costs associated with the physical packaging of the product for distribution are considered inventory costs and are properly includable in the minimum measure as inventory.

Software that is depreciated because it is part of a tangible asset should be treated as tangible property for franchise and excise tax purposes.

- When dealing with these assets, the book value of depreciable property should be reported on Schedule G, and no value should be assigned to the software.

- For example, a bundled computer system may include preloaded software that is not separately invoiced.
- The removal of software from Schedule G may result in a decrease in franchise tax if the tax was originally computed based on Schedule G, as opposed to Schedule F.

### *Intangibles*

Intangible property such as cash, stocks, bonds, and goodwill should not be included on Schedule G.

### **3. Property Exempted**

Property exempt from inclusion on Schedule G is discussed in detail in later sections and includes:

- Exempt inventory
- Exempt capital investment
- Construction in progress
- Exempt certified green energy production facility equipment
- Certified pollution control equipment

### **Property Owned**

For taxpayers whose tangible assets are owned and used entirely within the state, the amounts reported on Schedule G should agree with the related balance sheet prepared under GAAP accounting and to the related book basis depreciation schedule. Taxpayers that own or use assets both within and outside of the state will only report the assets owned or used in Tennessee on Schedule G.

If GAAP books and records exist, they must be used to compute the franchise tax base. However, if books and records are not maintained in accordance with GAAP, then federal tax basis records may be used.<sup>260</sup>

Railroad companies may choose to compute their franchise tax base by using either GAAP basis accounting or the accounting method used for federal tax purposes.<sup>261</sup> They may value their real and tangible personal property in accordance with the method used for federal tax purposes as long as the chosen method fairly reflects the property's value for franchise tax purposes.

## 1. Land and Buildings

The book basis cost of land is reported on the first line of Schedule G and the book value of real estate is reported on the second line. Auditors may reconcile these entries with information that is available to the public on the county property assessor's website.<sup>262</sup> This audit procedure may help the auditor identify possible real estate omissions from the franchise tax base.

- For example, if an auditor wished to confirm the ownership of a motel located in Mount Juliet, the auditor may:
  - Navigate to the county property assessor's website
  - Click on Wilson County on the map of Tennessee
  - Enter the property address
  - Then view the property's ownership information and sales records

### *Replacement Property from a Like-Kind Exchange*

The basis of replacement property received in a like-kind exchange that should be reported on Schedule G in the year of the exchange is the purchase price (fair value) of the replacement property plus any other expenses that are properly capitalized to the replacement property under GAAP.<sup>263</sup> The replacement property will subsequently be depreciated in accordance with GAAP and the net book value of the property reported on Schedule G. See Chapter 11 for additional information on like-kind exchanges, including the basis of replacement property includable on Schedule G when GAAP records are not maintained by the taxpayer.

## 2. Leasehold Improvements

Leasehold improvements located in Tennessee are also included on Schedule G, Line 2. Note that lease expenses are not reported on this line.

Leasehold improvements are long lived amortizable assets. Improvements to a leasehold may provide a lessee with many of the benefits of property ownership. A lessee may invest in improvements on leased assets to enhance the assets' usefulness. These investments are

referred to as leasehold improvements and are often made to property leased for relatively long periods of time.<sup>264</sup>

- Improvements may range from relatively inexpensive fixes to extensive remodeling to prepare the asset for the intended use of the lessee.
- Leasehold improvements (net of accumulated amortization) are reported on Schedule G, Line 2.
- Leasehold improvements are established in a separate account at cost and amortized over the shorter of the life of the improvement or the length of the lease.
- For franchise and excise tax purposes, leasehold improvement expenses are treated differently than the lease agreements themselves.
  - If a lease agreement expense is entered on Schedule G, Line 2 instead of on Lines 11-13, the franchise tax base will be understated because the expense will escape the franchise tax code’s rental multiples.<sup>265</sup>

### 3. Depreciable Property

Depreciable property is reported on Schedule G at book value (cost less accumulated depreciation).

Only the property located in the state is reported on Schedule G.

- Amounts reported on Schedule G, Lines 1-4 should be the book value of the property as of the last day of the tax period, unless the taxpayer is in final return status, in which case the taxpayer must use either pre-liquidation values or monthly averaging.<sup>266</sup>

<b>Schedule G - Determination of Real and Tangible Property</b>		
<b>Book Value of Property Owned - Cost less accumulated depreciation</b>		In Tennessee
1. Land .....	(1)	_____
2. Buildings, leaseholds, and improvements .....	(2)	_____
3. Machinery, equipment, furniture, and fixtures .....	(3)	_____
4. Automobiles and trucks .....	(4)	_____

For additional information on final returns, see Chapter 5 – Filing Requirements.

### *Mobile and Movable Property*

Construction companies, common carriers, and air carriers commonly have mobile/movable property. The value of mobile or movable property located both inside and outside the state, whether it is owned or leased, is based on the total percentage of time it is in the state during the tax period.

GPS tracking systems tied to industry specific software owned by many taxpayers may provide a means to accurately track assets by location and time. Common carriers and air carriers maintain mileage records by state because of state and federal reporting requirements. Mileage is considered a reasonable approximation of time and may be used for the Schedule G calculation.

However, the value of a vehicle assigned to a traveling employee is considered 100% in Tennessee if the employee's compensation is assigned to Tennessee for purposes of the taxpayer's apportionment formula payroll factor or if the vehicle is licensed in Tennessee.<sup>267</sup>

Mobile or movable property includes:

- Vehicles
- Construction equipment
- Trailers
- Containers
- Barges
- Airplanes
- Other Property

#### **AUDIT – MOBILE AND MOVABLE PROPERTY**

When conducting an audit, auditors first gain an understanding of the taxpayer's business and consider what mobile or movable property may have been located inside and outside of the state.



### Mileage Verification

For movable property apportioned on Schedule G, auditors may request and review the records that serve as the basis for the apportionment (time or miles) and test the calculation.

If mileage numbers came from the Schedule O, P, or R apportionment schedules, auditors may check to make certain that only the mileage portion of the ratio was used and that it was not reduced by the intrastate receipts or originating revenue. Because the Schedule O, P and R apportionment ratios are computed based on the miles of *all revenue-generating equipment* (even equipment that did not enter the state), the Schedule G amount should be computed as *all revenue-generating equipment* times the miles/mileage ratio.

If necessary, auditors may verify that the miles reported on Schedule O and the miles used in apportioning mobile equipment on Schedule G agree with the International Fuel Tax Agreement (IFTA) reports.

### Traveling Employees

Auditors may verify that vehicles assigned to traveling employees are fully included on Schedule G if the employee's compensation is assigned to Tennessee or if the vehicle is registered in Tennessee and not apportioned based on mileage.

Auditors may also verify that any apportionment based on time or miles is applied only to mobile or movable property and not to all the Schedule G assets.

### Property in Transit

Property in transit between a buyer and seller and shown on the books and records of the taxpayer in accordance with the taxpayer's regular accounting practices will be included in the minimum measure of the franchise tax if it is destined to a Tennessee location.<sup>268</sup> In some situations, property in transit between the U.S. and a foreign country is specifically exempted from all federal and state taxation under a U.S. treaty agreement.

## 4. Prepaid Supplies

Prepaid supplies are generally categorized as current assets or other assets on the balance sheet. Only prepaid supplies located in Tennessee are entered on Schedule G, not all prepaid expenses.

## 5. Inventory

Inventory reported on Schedule G, Line 7 includes all inventory included in the taxpayer's book/GAAP balance sheet and located in Tennessee, including raw materials inventory, work in progress inventory, and finished goods inventory. Any exempt finished goods inventory is deducted on Line 7b.<sup>269</sup>

### *Exempt Finished Goods Inventory*

Finished goods inventory in excess of \$30 million is exempt inventory. Exempt finished goods inventory that is eligible for deduction from Schedule G must meet the following requirements:

- Owned by the taxpayer;
- Stored in a facility used primarily for manufacturing, warehousing, or distribution of such inventory;
- Held for wholesale or retail sale by the taxpayer but not sold over-the-counter to consumers at the location where stored, (inventory not held at a retail location);
- Shown as inventory on the taxpayer's books and records kept in accordance with generally accepted accounting principles; and
- In need of no further fabrication or processing by or for the taxpayer; except in the case of configuring, testing, or packaging of computer products.<sup>270</sup>

### *Examples*

- A taxpayer in the business of processing bourbon whiskey considered barreled whiskey as finished goods inventory after it was stored for two years.
  - The whiskey, if it meets the other requirements of the finished goods definition, would properly be classified as finished goods inventory, because after two years it met the federal definition of bourbon whiskey and was sellable without need of further fabrication or processing.
- An auto parts company with a division that rebuilds automotive parts (e.g., starters, generators and engines) cannot deduct the parts on hand that have not yet been rebuilt as finished goods inventory because they need further processing.

- This inventory should be categorized as work in progress inventory in the taxpayer’s records and fully reported on Schedule G.
- A taxpayer has a distribution center warehouse in Tennessee as well as several supermarket type grocery stores throughout the state. The taxpayer’s inventory records revealed that it had in excess of \$30 million of inventory, but less than \$30 million at its warehouse facility. The taxpayer claimed a portion of this amount as exempt inventory, but it should have reported \$0 in exempt inventory. Below is a schedule detailing the computations to arrive at this conclusion.

	<b>2014</b>	<b>2015</b>	<b>2016</b>
<i><u>As Reported by Taxpayer</u></i>			
Finished Goods Inventory – Total	\$51,138,453	\$52,380,714	\$49,501,102
Finished Goods Inventory – Reported	<u>30,000,000</u>	<u>30,000,000</u>	<u>30,000,000</u>
Exempt Inventory	<u>\$21,138,453</u>	<u>\$22,380,714</u>	<u>\$19,501,102</u>
<i><u>As Reported by Auditor</u></i>			
Finished Goods Inventory – Warehouse	\$ 21,138,453	\$22,380,714	\$19,501,102
Other Inventories – Warehouse	1,036,047	1,406,747	2,694,595
Finished Goods Inventory* - Grocery Stores	<u>28,963,953</u>	<u>28,593,253</u>	<u>27,305,405</u>
Total Inventories	\$51,138,453	\$52,380,714	\$49,501,102
Exempt Inventory	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

\* This inventory does not meet the definition of finished goods inventory because it is held at a retail location.

## 6. Construction in Progress

### *Qualifying Property*

Property that is considered construction in process (“CIP”) is not included in the franchise tax base, as computed on Schedule G, nor is it shown as a deduction on Schedule G.<sup>271</sup> Property must meet four requirements to be considered CIP.

CIP property must be:

- Owned by the taxpayer;

- Clearly under construction;
- Not used by the taxpayer (either in whole or in part); and
- Shown on the books and records as property under construction, where no depreciation expense has been recorded.

### *Tangible Personal Property*

Tangible personal property (“TPP”) may also qualify as CIP if the property meets the criteria and supporting documentation is provided. When tangible personal property is placed in service, it can never revert to a CIP classification regardless of any repairs, periods of inactivity, obsolescence, maintenance, etc. Depreciation expense taken on an asset indicates that it has been placed in service and therefore no longer qualifies as CIP.

For TPP to qualify as CIP, the property must:

- Be owned by the taxpayer;
- Be recognized on the balance sheet in a construction in process, or similar type of, account (except for inventory), where the asset is not being depreciated or expensed for book and/or tax purposes or is part of an inventory classification;
- Never be utilized or benefited from at any time, either in whole or in part, (as well as not being considered an inventory item); and
- Need additional work or completion, such as installation, configuration, or improvement, etc., before any operation or utilization can begin.

### *Example*

- A diversified manufacturer has plants in several states, including one in Tennessee. During the period under audit, its plant in Tennessee was undergoing a production line expansion where specialized machinery and equipment as well as leasehold improvements were booked to a CIP account and reported as such in the year-end financial statements.
- Both the tangible property and leasehold improvements are allowed as excludable CIP from the minimum measure of the franchise tax base, as computed on Schedule G.

### *CIP on Balance Sheet*

Generally, the balance sheet will show a CIP account that accumulates the costs incurred as the construction project is being completed. When the project is complete, the CIP account balance is transferred to a fixed asset account and depreciation begins. When the asset is placed in service and depreciation begins or any part of the project is utilized, the asset is no longer exempt from inclusion in the minimum measure. For example:

- If a company is incurring costs to build a retail facility, and the facility is not yet complete at year end, then the costs associated with the project are considered CIP since the property is not yet in use.
  - For accounting purposes, this means the property is not yet capitalized as a depreciable asset, and the company cannot take depreciation expense on the asset. As such, costs incurred go into some type of CIP account in the asset portion of the balance sheet.
  - When the project is finished, the costs roll over from a CIP account and are set up as a depreciable asset like any other facility, building, warehouse, etc. At this point, the asset is in use, and depreciation expense is allowed on the capitalized value of the property.
  - These classifications are consistent with GAAP rules as to the recognition of the value of an asset that is either CIP or a depreciable asset.

### *Utilization of Property Evidenced by Depreciation*

The CIP exemption is intended to exclude only property that has not yet become a part of the capital employed in the business of the taxpayer. If property is in the process of being constructed and there is no actual utilization by the taxpayer, then it is not included in the franchise tax base, as computed on Schedule G. For example:

- If a manufacturer is building a new plant or is expanding an existing plant, then the amount will not be included in the franchise tax base until the construction is utilized in the business.

- If a big box retailer is expanding its space in a shopping mall, then the costs incurred for the new build-out would not be included in the minimum measure until the space is opened to consumers.
- If the taxpayer puts a fixed asset into use on the last day of its business year, then the entire amount would be included in the minimum measure.

For CIP to be excluded from Schedule G, the property under construction must have never been utilized or depreciated. CIP is reclassified as a depreciable asset when construction has been completed and the asset is being used. Once depreciation begins, an asset can never revert to CIP status.

### *Construction Businesses*

The determination of the utilization issue depends, in large part, upon the nature of the business of the taxpayer. The nature of the taxpayer's business may indicate that the property in question is not CIP.

When construction is the very essence of a taxpayer's business, the property under construction must be included on Schedule G. Contractors in the business of constructing buildings should treat their unfinished projects as work-in-progress inventory and *not* exempt CIP. For example:

- A taxpayer in the business of building commercial office space for lease is using the buildings it has under construction in conducting its business.
- The buildings under construction are part of the capital employed in doing the taxpayer's business and are includable in the franchise tax base.<sup>272</sup>

### **CONTRACTUAL BUILDING**

When construction companies perform construction on other persons' properties, pursuant to a contract, the property is not included as property on the construction company's Schedule G. Many builders use the "percentage of completion" accounting method, and their balance sheets will show a receivable for the amount of unreimbursed building costs or a liability if payment was received before the work was completed.

- The receivable/payable accounts may be referred to as "Costs in Excess of Billings," "Billings in Excess of Costs," or simply "Accounts Receivable."

- The use of these accounts would not trigger Schedule G recognition because the builder is not the owner of the property.
- In this case, the structure being built is not CIP for the builder, but the structure may be CIP for its owner. A review of the underlying construction contract will provide the name of the true owner.

If a taxpayer does not own the property, the CIP exclusion is not available to the taxpayer. The taxpayer would complete Schedule G like any non-construction taxpayer and the receivable accounts would be ignored. For example:

- A construction company agrees to build a structure for another entity. The construction company incurs material and labor costs as the structure is being built but will invoice the owner to recoup those costs plus a portion of the expected profit. The builder is paid periodically as the work progresses.
  - We can conclude that the builder is not the property owner because the construction costs are being reimbursed by the true owner that is named in the underlying construction contract.

### SPECULATIVE BUILDERS

If the taxpayer is a speculative builder, construction costs would be considered inventory and reported as inventory on Schedule G. Like manufacturers, speculative builders should report all types of inventory (raw materials, work in progress, and finished goods).

#### *Audit of CIP*

In evaluating a CIP exclusion, auditors will consider the given property's ownership, utilization, and depreciation.

- *Ownership of the property* – Because CIP is not included in the amounts reported on Schedule G, auditors may consider whether Schedule G omissions represent excludable CIP. A key component that auditors evaluate when auditing construction activity is whether the taxpayer owns the property at the completion of the project.
  - If the construction company *does* own the property at the completion of the project, and construction is the very essence of the company's business, the property would be considered work in progress inventory.

- The property would be included in the construction company's franchise tax base, and the company would be liable for franchise tax on the property.
- If the construction company *does not* own the property at the completion of the project, the property would not be considered inventory.
  - The property would not be included in the construction company's franchise tax base, and the construction company would not be liable for franchise tax on the property.
- *Utilization of property* – Auditors may inquire as to how a partially-built facility or piece of tangible personal property is being used. They may inquire about:
  - The accounting treatment of the property
  - The property's history of activity
  - The taxpayer's history with the property
- *Depreciation* – Generally, CIP claimed in an audit period will have likely been placed into service by the time audit work begins. As such, auditors may review depreciation schedules subsequent to the audit period to note when depreciation was first taken.

*Potential Audit Adjustments* – The following types of taxpayer errors could result in an audit adjustment that *increases* the franchise tax base:

- CIP was deducted from the Schedule G franchise tax base without first being included in the tax base. The net effect of the CIP entries was not zero.
- Depreciation was taken on the CIP before the end of the audit period. When depreciation begins, the property is no longer CIP and should be included in the franchise tax base like any other tangible property.
- The CIP exemption was claimed but the property should have been treated like inventory and included in the tax base.



The following taxpayer error could result in an audit adjustment that *decreases* the franchise tax base:

- An amount included in the Schedule G franchise tax base was under construction and had not been placed in service as of the end of the audit period. As such, it should have been excluded from Schedule G.

### **7. Exempt Certified Pollution Control Equipment**

Certified pollution control equipment is property used primarily for air or water pollution control or treatment of hazardous waste that has been certified by the appropriate government authority as necessary to meet the requirements of state, federal, or local law.

- The book value of this equipment should be reported with other equipment on Schedule G, Line 3, and then deducted on Schedule G, Line 8.
- The deduction amount should be the book value of the equipment and not its original cost.
- The book value of certified pollution control equipment may be deducted on Schedule G to the extent it was previously included on that same schedule and only if the Certificate of Exemption for Pollution Control is provided.<sup>273</sup>

### **8. Exempt Certified Green Energy Production Facility**

A certified green energy production facility is a facility certified by the Department of Environment and Conservation to produce electricity for use and consumption off the premises using clean energy technology.

Clean energy technology is technology used to generate energy from geothermal, hydrogen, solar, and wind sources.

The book value of equipment used to produce electricity at a certified green energy production facility may be deducted on Schedule G to the extent it was previously included on that same schedule and only if the Certificate of Exemption for Green Energy is attached to the return.<sup>274</sup>

See the [Supplement Application for Certified Green Energy Production Facility](#) and the related instructions for additional information.

## 9. Exempt Required Capital Investment

Taxpayers may take a deduction for two-thirds of the book value of capital investments that constitute the taxpayer's required capital investment made to qualify for the *additional annual job tax credit for higher level investments and job creation* ("HLIJC job tax credit").<sup>275</sup> Exempt required capital investments are deducted on Schedule G, Line 9.<sup>276</sup> If this exemption is claimed on Schedule G, Line 9, auditors may verify that the taxpayer claimed the HLIJC job tax credit on Schedules X and D of the tax return.

- The investments will qualify as "exempt required capital investments" only in those tax years in which the HLIJC job tax credit is allowed.
- The investment can include real or tangible property, purchased or leased.
- The Schedule G exemption may only be claimed for tax years in which the taxpayer claimed the HLIJC job tax credit.

### Calculation

- The calculation of required capital investments ("RCI") is made for each tax year of the investment period to determine the book value of the assets as of that tax year.
  - The value of assets in the first tax year is based on the RCI purchases in the first year of the investment period.
  - In subsequent years, any additional purchases within the investment period are included and any assets that were sold or removed from the state in that tax year are excluded.
- The value of assets in the minimum measure is always based on the net book value, so that each subsequent year a depreciable asset would have a decreased net book value.
  - Therefore, the exclusion of RCI is based on the same net book value as the assets when included in the minimum measure.
  - If the assets purchased as part of the RCI are financed through an Industrial Development Board, Tenn. Code Ann. § 67-4-2108(b) provides for treatment of those assets in the minimum measure.

## 10. Federal Repair Regulations

Federal repair regulations or tangible property regulations require that amounts paid to improve a unit of property are capitalized and that amounts paid for repairs and maintenance are expensed as a current deduction.<sup>277</sup>

In 2014, federal repair regulations changed depreciation rules and introduced a new system for maintaining accounts for tax depreciation, the multiple asset account method. This method permits taxpayers to group multiple assets into a single depreciation account.

**⚠ To the extent that the taxpayer's books are NOT maintained under generally accepted accounting principles, Schedule G of the franchise tax return conforms to these federal rules.**

### *Accounting Method Changes – Federal Form 3115*

Changes that taxpayers must make to conform to the repair regulations are considered changes in accounting method. Although these changes are mandatory, taxpayers must receive IRS consent to make the accounting change on federal Form 3115 – Application for Change in Accounting Method. Form 3115 requires that taxpayers make a calculation known as a 481(a) adjustment to prevent items of income or deduction from being omitted or duplicated. For example:

- If a taxpayer in 2012 capitalized and began to depreciate an improvement cost that is determined, under the repair regulations, to be an expense deductible as a repair, the taxpayer would have to stop claiming depreciation deductions beginning with the 2014 tax year.
  - To prevent the taxpayer from getting neither the benefit of a 2012 deduction of the cost, nor the benefit of depreciation deductions in 2014 and later years, the taxpayer makes a 481(a) adjustment that decreases the taxpayer's gross income for 2014 by the amount of the repair cost less the depreciation claimed before 2014.
- Alternatively, if a taxpayer deducted repair costs in 2012 that would be capitalized under the repair regulations, the taxpayer would have to begin taking depreciation deductions in 2014 (calculated as if the taxpayer had, in 2012, capitalized the cost and begun taking depreciation deductions for the cost).

- To prevent the taxpayer from getting both the benefit of the 2012 deduction of the cost and of the depreciation deductions to be taken in 2014 and later years, the taxpayer must make a 481(a) adjustment that is an increase, usually spread over a four-year period, of the taxpayer's gross income by the amount of the post-2013 depreciation deductions.

#### *481(a) Adjustment Implications for Schedule G*

Auditors often verify the values reported on Schedule G by agreeing the reported amounts with the taxpayer's GAAP financial statements and supporting depreciation schedules.

- When GAAP records are not maintained, tax basis records are allowed.
- Federal depreciation records may reflect changes because of the repair regulations and these changes will in turn be reflected on any Schedule G prepared using tax basis accounting.
  - In these cases, auditors may see newly capitalized amounts for items expensed in prior periods.
  - Auditors may also see previously capitalized amounts being removed from the current depreciation schedule even though the items acquired were not sold or moved out of state.

**⚠ Federal repair regulations may cause the franchise tax base to increase or decrease if a taxpayer's treatment to expense or capitalize a previously acquired repair or improvement item has changed under the repair regulations.**

- For example, a 2012 improvement might be reported on Schedule G for the first time in 2014 because of a 481(a) adjustment.
  - In this case, the auditor should not question why it was *not* reported on Schedule G in 2012 and 2013.
  - Similarly, a 481(a) adjustment might cause an asset reported in 2012 and 2013 to no longer be reported in 2014, even though the asset has not been disposed of or moved outside of the state.

- Again, if the change was the result of a repair regulation 481(a) adjustment, it should be accepted without further investigation.

## Property Rented or Leased

The franchise tax base is the value of real and tangible property owned or used within the state, including property rented by a taxpayer.<sup>278</sup> As with owned property, the source of rent expense amounts must come from GAAP records, if they are maintained by the taxpayer. To properly complete the rental section of Schedule G, the following topics, which are discussed in this section, should be considered:

- Property multiples
- Sub-rentals
- In lieu of rent
- Rent versus service
- License versus lease
- Operating versus finance leases
- Annualization requirements
- Property used, but not owed or rented

### 1. Property Multiples

The Schedule G value for rented property used in Tennessee is determined by multiplying the net annual rental by a statutory multiple.<sup>279</sup> The net annual rental amount is the gross annual rent paid less the gross rent received for sub-rental.<sup>280</sup> If the return is for a short period, the rents are annualized before applying the statutory multiple.

Most leased property clearly falls within one of the four “multiple” categories:

- Real property;
- Manufacturing equipment;
- Office furniture and equipment; and

- Mobile equipment.

Traditionally, the Department has treated construction equipment and items that do not seem to fit into other categories such as furniture, office machinery, and equipment. Planes, barges, and automobiles are categorized as delivery or mobile equipment.

### *Real Property*

The Schedule G value of rented real property used in Tennessee is determined by multiplying the net annual rental<sup>281</sup> by 8.

- This amount is reported on Schedule G, Line 11.

### *Manufacturing Equipment*

The Schedule G value of rented manufacturing equipment used in Tennessee is determined by multiplying the net annual rental by 3.

- This amount is reported on Schedule G, Line 12.

### *Furniture, Office Machinery, and Equipment*

The Schedule G value of rented furniture, office machinery, and equipment used in Tennessee is determined by multiplying the net annual rental by 2.

- This amount is reported on Schedule G, Line 13.

### *Delivery or Mobile Equipment*

The Schedule G value of rented delivery or mobile equipment used in Tennessee is determined by multiplying the net annual rental by 1.

- This amount is reported on Schedule G, Line 14.

## **2. Sub-Rents**

To qualify as a sub-rental:

- Rents received and rental expenses must be for the same property, and

- The sub-lessee must have the same rights as the original lessee with respect to the use of the property.<sup>282</sup>

Sub-rental income is only considered to the extent that it offsets the rental expense for that particular property. Rentals included in the minimum measure of franchise tax may be offset by sub-rentals only to the amount of rentals paid. If sub-rental income exceeds the corresponding rental expenses, the correct inclusion on Schedule G would be zero and not a negative value.<sup>283</sup>

Sub-rental income is not treated in the same manner on Schedule G and Schedule N. Sub-rents in relation to the property factor of the apportionment ratio are discussed later in Chapter 14 – Apportionment.

### *Examples*

- A real estate developer is the lessee of a motel, and it leases rooms to guests daily.
  - The amounts received from guests are not sub-rents, and there is no Schedule G offset.
  - The guests did not have the same rights as the lessee with respect to the use of the property.<sup>284</sup>
- A real estate developer is the lessee of a motel, and the developer leases the entire building to a motel operator.
  - The amount received from the motel operator is sub-rental income because the operator was treated as owner of the property and was given exclusive possession.
  - There was more than just a license or authority to do an act or series of acts on another's property.<sup>285</sup>
- A leased public warehouse contracts with customers to manage and store their inventory. The contracts detail the charges for facility rent, labor, and other expenses.
  - In this case, it was found that no portion of the receipts was considered offsetting sub-leases.
  - The contracts failed to show any transfer of property (an optional/alternative warehouse could be used), and they never indicated that the customers were granted any interest in the leased premises.

- Contrarily, the contracts gave the taxpayer/lessor exclusive possession and control of the warehouse facilities. The fact that the contract named an amount for rent is not sufficient to treat that amount as an offsetting sub-lease.
- The important question is whether the taxpayer/lessor granted the right to exclusive possession of the leased premises.
- A taxpayer rents a ten-story building and occupies two floors and subleases the remaining floors.
  - If the sub-lessee has the same rights as the taxpayer with respect to the use of the property, the rental receipt would be deductible as sub-rents on Schedule G.
  - In no case should the sub-rent deduction bring the related rent expense below zero.
    - For example, if the annual lease for the entire ten-story building was \$1,000,000 and two floors of the building are sub-leased for the same amount, then the Schedule G amount before the multiple should be zero [ $\$1,000,000 - \$1,000,000 = \$0$ ].

### *Audit - Sublease*

When auditors encounter subleases, they may request copies of all lease documents and verify that:

- The taxpayer's lease is a true lease and not a license or service;
- The sublease is for the same property;
- The lease and sublease agreements have the same terms with respect to the use of the property; and
- The deduction amount agrees with the taxpayer's books and records and is computed as discussed in the prior paragraph.



### 3. “In Lieu” of Rents

A lessee’s payments made to others on behalf of the lessor of real estate are considered rent for franchise and excise tax purposes.<sup>286</sup> Before “in lieu of rent” payments can be included as rents in the franchise tax base, it must be established that the payments tie to the property leased by the taxpayer.

#### *Interest, Taxes, Insurance, and Repairs*

The lessor of real estate is generally the owner of the property and, as such, is the party responsible for paying expenses related to the property. The following payments made by a lessee to a lessor, or to someone else on behalf of the lessor, are considered rent if there is an agreement that the lessee pay them:

- Interest
- Taxes
- Insurance
- Repairs
- Other expense items involving leased real property.

Interest, taxes, insurance, and repairs are *not* in lieu of rent payments if:

- It is shown that the taxpayer’s lease was only for land and that the expenses were related to a building owned by the taxpayer and not the leased land.
  - Long-term ground leases are common in areas where land is very valuable but is rarely for sale. Businesses wishing to operate in these areas will enter long-term ground leases and then build structures on the land. Therefore, the taxes, interest, insurance, and repairs on a taxpayer’s books may be in relation to a building they own and not the land they lease.
- The lease is for tangible personal property. The recharacterization of in lieu of rent expenses only applies to real property.
  - A copier with monthly rents of \$100 plus a maintenance agreement of \$20 per month to cover service, toner, etc. would be reported on Schedule G in the amount of \$1,200 under “furniture, office machinery, and equipment” (multiple

2). The reported amount is the \$100 base rent times 12 months. The maintenance charges are not part of the calculation.

#### 4. Rents that Include a Service

A taxpayer may pay for a service that includes equipment. When a taxpayer pays for a service that includes the use or rental of equipment, the entire payment should be categorized as being for a service if the taxpayer does not have the expertise to use the equipment on its own. For example:

- A taxpayer needs trees cleared from a lot and he hires an excavation company to do the work. In clearing the lot, the excavation company utilizes both equipment and an operator.
  - In this case, the primary element of the transaction is a service, and therefore, no rental amount would be included in the minimum measure.
  - The taxpayer did not have any control, use, or possession of the equipment.
  - However, if the taxpayer leased the bulldozer and used its own labor or contracted separately with an operator, then the bulldozer rents would be included in the minimum measure.

#### *Form and Substance of Agreements*

Lease/rental agreements may take on multiple forms, such as:

- One invoice that shows a single amount for the equipment and labor used;
- One invoice with breakdowns for rents and the operator's labor charges; or
- Two invoices from separate providers.

No matter the form, if the substance is that a service was provided to a business that had no capacity of using the equipment on its own, the entire amount is considered a service and not rents. For example:

- A builder enters into an agreement with a crane company to place a steel beam on top of a structure under construction.

- Even though the crane company’s invoice shows charges for both equipment rental and labor, the entire amount should be considered a service and thus excluded from Schedule G.
- Because the builder could not operate the crane on its own, it is evident that a service was purchased.
- If the equipment rental (crane) and operator are contracted for separately and the builder receives two invoices from different providers, the equipment rental will still be considered a service. The crux of the transaction is the same in that the equipment is of no value to the builder without the contracted operator.

### *Ability to Operate Equipment*

If a taxpayer has the skill and ability to operate certain equipment but chooses to contract with a third party to provide both labor and equipment, the amount paid still would be considered a service, because the taxpayer does not have specific rights to use the equipment and would most likely be in conflict with the owner if it tried to do so.

However, the outcome would be different if the taxpayer entered into separate agreements with the equipment lessor and the operator. In this case, the taxpayer would have the right to use the equipment on its own in addition to providing it to the operator for use, and the equipment rents would be includable on Schedule G.

### *Common Carriers and Trucking Companies*

Common carriers and trucking companies often contract with “owner operators” to pick up and deliver goods for them. The owner operators perform a service using their own equipment and labor. The owners may operate under the trucking company’s motor carrier (MC) authority, and their equipment may be included in the trucking company’s annual [Tennessee Ad Valorem Tax Report](#). Here, there is a service provided by the operator that entails both equipment and labor, which is not reportable on Schedule G of the trucking company. However, if the owner operator is a Tennessee taxpayer, its equipment used in the state would be reported on its Schedule G.

### *Third-Party Warehouse and Distribution Centers*

Often the “service or lease” question arises when a taxpayer contracts with a third-party warehouse and distribution center to store and distribute its inventory. In addition to

warehousing, these centers may offer a variety of services including inventory management, logistics, transportation, and packaging.

Even though the use of real property is integral to the services provided, no amount should be considered Schedule G rent unless the underlying agreement grants a specific, designated space for the taxpayer's exclusive use and full access and provides for a fee based on area (square footage) and time. Even though the agreement may indicate a monthly charge for rents based on square footage, no amount is includable on Schedule G unless the space is a specific/defined area with exclusive use and full access granted to the taxpayer.

Warehouse and distribution agreements often have elements of both real estate rents and services. When reviewing the actual agreement for possible Schedule G inclusions, auditors will consider the following:

- Does the taxpayer have use, full access, and rights to a designated space or area? Does the taxpayer have the type of rights to use the property that lessees normally have (such as lessees of office space)?
- Is the charge, whether labeled rent in the contract, based on an actual, specific space, or is it based on a service provided by the vendor in which the vendor uses the space?
- Who bears the risks and rights of the warehouse space, the vendor or the taxpayer?
- Who runs and operates the facility, the vendor's employees or the taxpayer's employees?

## **5. Distinguishing Between Leases and Licenses**

Licenses can have aspects that are very similar to leases, but licenses are not includable in the franchise tax base. The proper categorization of a transaction as a license or a lease is paramount in determining whether it should be included on Schedule G.

- The account name used in the taxpayer's books and records may not accurately describe the transaction. Sometimes bookkeepers use the words "rent" and "license" interchangeably, and transactions may have elements of both a license and a lease.
- Classification could turn on facts specific to a given contractual agreement.

- For example, a contractual agreement for use of a conference room may be more like that of a motel room as opposed to a business office, and as such, would be classified as a license instead of a lease.

Auditors may inquire and review the underlying contract before reaching their conclusion as to whether an agreement is a lease or a license.

### *Leases*

Generally, during the existence of a lease, the owner transfers the right to possess the leased property to the lessee, who is treated as the owner of the property and is entitled to exclusive possession. When the lessee is treated as the owner of the leased property, the lessee may control and use the property as if it were the true owner. However, the lessee is not required to pay the true owner's property tax and insurance on the leased property.

A lease must be for a defined area of real estate or specific, identifiable tangible property. The ability to assign the lease to others is not a requirement to be includable on Schedule G as a lease, but if this feature is present, it is likely that the agreement is a lease and not a license.

### *Examples of Leases*

- Storage Spaces
  - The tenant has exclusive control and use of a defined space, and the relationship is like that of a landlord/tenant.
- Car Rentals
  - Lessee has exclusive control and use of car, and the lessee is treated as the owner during the lease term.
- Business Offices
  - Landlord/tenant relationship where tenant has exclusive control and use of a designated space and is treated as the owner during the lease term.
- Conference Rooms

- Lessee has exclusive control and use of a designated space and the agreement is similar to an office lease that treats the lessee as the owner in relation to the specific property.
- This could easily be a license if the underlying facts were different.
- Forklift Rentals
  - Lessee has control and use of the equipment, even though the lessor may put some normal, reasonable restrictions on its use.
- Mall Kiosks
  - Lessee has exclusive possession of a defined area and control over the kiosk.
  - This could easily be a license if the underlying facts were different.

### *Licenses*

A license, with respect to real estate, is an authority to do a particular act or series of acts on another's property without possessing any estate therein. Leases are includable as rents on Schedule G, but licenses are not.

- Licenses provide a limited privilege. Generally, a license is not assignable and is revocable at the will of the licensor. Licenses may exist for real estate and other types of tangible and intangible property.

### *Examples of Licenses*

- Motel rooms
  - A guest only has a license or privilege to occupy; the owner retains legal possession of the property and maintains control of it.
- Reserved ticket seats
  - Patrons have a license to occupy the designated seats during an event (a limited act), but the owner retain control of the real estate and may revoke the license.

- Parking lot spaces
  - A landlord/tenant relationship does not exist; it is only a license to do a particular act (park) on the property.
- Storage in an undesignated warehouse space
  - This is not a landlord/tenant relationship; there is no set space and the products stored there could be moved by the real estate owner.
- Hunting privileges
  - A license to do a particular act on the land.
- Vending machine locations
  - A license, since the vending machine owner did not have exclusive possession or control of the area.
- Billboards
  - A license to do a particular act (advertise); the owner maintains control.
- Land “leases” for mineral extraction
  - Payments are actually for mineral extraction, even though the books and records classify them as “rents.”

## 6. Annualize Rent in Short Period

Taxpayers must annualize rents on all short-period returns.<sup>287</sup> As with proration, taxpayers must use the *number of days method* to annualize rent. To arrive at annualized rent, multiply the rent expense by 365.25 and then divide the product by the number of days in the short period.

- Annualized Rent = (Rent Expense x 365.25) ÷ # of Days in the Short Period
  - The rent expense comes from GAAP accounting records, unless GAAP accounting records are not maintained by the taxpayer.

### *Example*

The tax period is January 1<sup>st</sup> to June 30<sup>th</sup>. Real estate rents of \$60,000 were expensed for the tax period per GAAP basis financial records. These rents represent the taxpayer's only tangible property owned or used in Tennessee during the tax period. The franchise tax property base (Schedule G) is greater than the net worth base (Schedule F1) and is used in computing the franchise tax liability. In this example, the rents are annualized and the franchise tax is prorated, resulting in a tax liability of \$1,200.

- Annualized Rents are \$121,077.35
  - $(\$60,000 \times 365.25) \div 181 = \$121,077.35$
- Franchise tax property base reported on Schedule G is \$968,618.78
  - $\$121,077.35 \times 8 = \$968,618.78$
- Prorated franchise tax base is \$480,000
  - $(\$968,618.78 \times 181) \div 365.25 = \$480,000$
- The franchise tax is \$1,200
  - $\$480,000 \times .0025 = \$1,200$

## **7. Termination Fees, Renewals, and Software Fees**

### *Termination Fees*

Costs paid to terminate an existing lease are not Schedule G rents. Termination fees are not paid for the use of property but are a form of liquidated damages for breaking a lease.

### *Lease Renewals*

A lease may have an initial term for a set period with guaranteed renewals of an additional period. The annual rental during the initial period may differ significantly from the rental during the renewal period. Under GAAP, the annual lease expense is recorded based on a level lease stream over the life of the lease, including the renewal. This GAAP basis leveling is not followed for federal income tax purposes and is reported as a federal Schedule M-1 or M-3 adjustment. If GAAP basis records are maintained, the amount reported on Schedule G is the same as reported



under GAAP: the adjusted-levelled-lease amount. Contrarily, the Schedule N apportionment factor amount is always from tax basis records; so, the property factor amount is the rent expense reported on the federal return.

### *Software*

Software licenses, leases, subscriptions, and software research and development costs expensed in GAAP financial statements are not considered rents of tangible personal property for the franchise and excise tax base and should not be reported as rents on Schedule G.

### *Excess Rents*

Excess real estate rents, per Tenn. Code Ann. § 67-4-2006(b)(1)(N), should be excluded from Schedule G. See the discussion of excess rents in Chapter 11 – Excise Tax.

## **8. Common Lease Terms**

Auditors may request and review copies of lease agreements to determine the proper treatment of lease expenses for franchise tax purposes. The following are common lease terms that may be present in a lease agreement:

### *Gross Lease*

Tenant pays a flat rental amount, and the landlord pays for all property charges normal to property ownership. The flat rental amount paid is reported as Schedule G real property rents.

### *Fully Serviced Lease*

The fixed monthly rent charge includes the cost of certain types of services that may include janitorial services, trash collection, utilities, water and sewer charges, property taxes, etc. The entire amount paid is includable on Schedule G. The code and Rule 28 require the *addition* of “in lieu of” payments to rents reported on Schedule G, but there is no provision for a *deduction* from rents when the lessor makes payments like utilities that are normally paid by the lessee. For example:

- A lessee’s payments under a lease agreement are \$120,000 annually. The lease specifies that the lessor is responsible for payment of utilities, taxes, janitorial services, and maintenance, and interest charges.

- The lessee/taxpayer is only responsible for the annual rental payment of \$120,000, and this is the amount reported on Schedule G.
- No deduction from the \$120,000 rental amount is allowed for utilities, etc.<sup>288</sup>

### *Modified Gross Lease*

A modified gross lease is similar to a full-service gross lease, except that some of the base services are not included by the landlord (taxes, maintenance, insurance, janitorial, and utilities).

This type of lease is common in multi-tenant buildings, where different tenants have varying needs for electrical or janitorial services. The base rent is includable on Schedule G plus any additional amounts required to be paid by the terms of the lease that are in lieu of rent.

If a payment includes rent and other charges unsegregated, the amount of rent, “in lieu of rent,” and other charges shall be determined by considering the relative values of the rent and the other items. For example:

- A lessee paid rent of \$120,000 annually plus a monthly CAM charge that varied in amount. The total paid for CAM was \$9,743 for the year. The charge covered repairs, insurance, and janitorial services, but it was not itemized.
  - Because the CAM charges include both in lieu of rent items (repair and insurance) and items that were not in lieu of rent (janitorial), an estimate was made in arriving at the Schedule G rent amount.
  - In this case, the value of janitorial services was estimated at \$4,000 resulting in \$125,743 ( $\$120,000 + \$9,743 - \$4,000$ ) being reported as rents on Schedule G.
- Under the terms of the lease, the lessee pays \$120,000 for rent plus additional amounts for utilities (\$12,123), taxes (\$1,200), janitorial (\$4,000), and property repairs (\$3,200).
  - Because payments for taxes and property repairs would have been paid by the lessor had it not been for the lease agreement, they are considered payments in lieu of rent and are included in the rent amount on Schedule G.
  - The utilities and janitorial costs are true expenses of the lessee and are not considered payments in lieu of rent.

- The rent reportable on Schedule G is \$124,400 (\$120,000 + \$1,200 + \$3,200).

### *Common Area Maintenance (“CAM”)*

CAM charges are fixed or variable charges that can cover a wide range of expenses that are normally the responsibility of the landlord, including: repairs, insurance, property maintenance, and in some cases, the salaries of administrators who manage the facility.

CAM charges may be in lieu of rent payments to the extent that they are for taxes, insurance, and repairs. No portion of CAM charges for janitorial costs, administrative services, etc. should be considered rent.

### *Load Factor*

The load factor is a method of calculating total monthly rent costs that combines usable square feet and a percentage of square feet of common areas. The addition of a percent of the common area expenses to monthly rent is known as the load factor.

- For franchise tax purposes, both the base rental amount and the load factor amount are considered rent on Schedule G; the load factor is just a method for arriving at the rent charge.

### *Net Lease*

A net lease is a lease that requires the tenant to pay, in addition to rent, some or all the property expenses that are normally paid by the landlord/lessor.

- Expenses include:
  - real estate taxes,
  - insurance,
  - maintenance,
  - repairs,
  - utilities, and
  - other items.
- *Single net lease* – lessee pays property taxes as well as the base rent.

- *Double net lease* – lessee pays the taxes and insurance associated with use of the property in addition to monthly rent for use of the actual space.
- *Triple net lease* (net-net-net lease or NNN lease) – lessee pays all or part of the taxes, insurance, and maintenance associated with use of the property, in addition to the tenant’s regular monthly rent.
  - Payments for rent, taxes, and insurance would be includable on Schedule G.
  - Maintenance charges would also be included if they were primarily for repairs, as opposed to janitorial type services.

### *Base Year*

The base year is a unit of measurement used to calculate the rent charge. In general, a base year is calculated on a calendar year basis or the first 12 months of a tenant’s occupancy. The base operating expense account is the floor over which any increases in operating expenses will be passed on to tenants of a building.

## **9. Operating and Finance Leases**

Leases are classified as either “finance” or “operating” for financial accounting and federal tax purposes. GAAP and federal tax guidelines dictate how a lease transaction is reported on financial statements and tax returns.<sup>289</sup> **Therefore, it is not uncommon for a GAAP basis finance lease to be treated as an operating lease for tax purposes, and vice versa.**

### *Operating Leases*

Under an operating lease, a lessee’s rental payments are reported as rent expense on GAAP basis income statements. This rent expense is reported in the rental section of Schedule G, since this schedule is based on GAAP basis records.

**⚠ Rent expense found on Schedule G will not be found on the federal income tax return if the lease was capitalized for federal tax purposes.**

### *Finance Leases*

Finance lease transactions are sometimes referred to as sales-type leases or direct-financing leases and are treated as sales of leased property. Under a finance lease, the lessee is treated as

the owner. The lessee capitalizes the value of the leased asset and reports a depreciable asset along with a liability for the lease obligation. The capitalized value, net of accumulated amortization/depreciation, is reported in the first section of Schedule G for owned property.

Finance lease payments are not posted as rent expense. However, entries will be posted to the following accounts:

- Obligation under finance lease;
- Interest expense; and
- Amortization/Depreciation expense

**⚠ Rent expense found on a federal income tax return may not be found on Schedule G if the lease was capitalized under GAAP.**

### *Operating and Finance Leases on GAAP Financial Statements*

The presentation of leases on GAAP financial statements has recently changed.<sup>290</sup> Essentially, all leases, whether they are classified as operating or finance leases, are now reported on the face of the balance sheet, with some exceptions.<sup>291</sup> All leases, whether classified as an operating or finance lease, create a *right-of-use asset* and a *lease liability* that should appear on the lessee's balance sheet. On the following page is an example of a GAAP basis balance sheet and income statement that present both operating and finance leases:

<b>Balance Sheet</b>		
<b>Assets</b>		
<i>Property, plant, &amp; equipment:</i>		
<b>a</b>	Finance lease right-of-use asset	\$ 108,237
<b>b</b>	Less: Accumulated depreciation	(21,647)
<b>c</b>	Finance lease right-of-use asset, net	86,590
<b>d</b>	Operating lease right-of-use asset	18,595
	<b>Total assets</b>	<u>\$ 105,185</u>
<b>Liabilities</b>		
<i>Current liabilities:</i>		
<b>e</b>	Finance lease liability	\$ 20,568
<b>f</b>	Operating lease liability	9,070
<i>Long-term liabilities:</i>		
<b>g</b>	Finance lease liability	68,081
<b>h</b>	Operating lease liability	9,525
	<b>Total liabilities</b>	<u>107,244</u>
	<b>Equity</b>	<u>(2,059)</u>
	<b>Total liabilities and equity</b>	<u>\$ 105,185</u>
<b>Income Statement</b>		
<b>i</b>	Lease expense	\$ 10,000
<b>j</b>	Interest expense	5,412
<b>k</b>	Depreciation expense	21,647
	Net loss	<u>\$ 37,059</u>

Based on the above example, the “**c** Finance lease right-of-use asset, net” amount of \$86,590 will be reported in the owned property section of Schedule G. Lines **d**, **f**, and **h** refer to operating leases. These lines are not used in completing the franchise and excise tax return; however, they *do* alert the auditor to look to the income statement for rent expense to be reported on Schedules G, and Schedules 170NC and 174NC, if applicable.

The above income statement shows the expense accounts associated with the finance and operating leases in this example. The “**i** Lease Expense” amount of \$10,000 should be reported in the rental section of Schedules G and 170NC, if applicable.

Even though the financial presentation of leases under GAAP has changed,<sup>292</sup> the basic concepts on how leases are reported on Schedule G have not. For franchise tax purposes, finance leases are reported on Schedule G as an owned asset at net book value, and operating leases are reported at the net annual rental<sup>293</sup> amount times the applicable multiple (8, 3, 2, or 1).

### *Leases on Schedules G, N, 170NC, and 174NC*

In addition to Schedule G, lease information is reported on other schedules. For example, the standard franchise and excise tax apportionment schedule, Schedule N, is used to apportion net worth on Schedule F1 and net earnings subject to excise tax on Schedule J. Property values reported on Schedule N come from tax basis records. Owned assets, including those from finance leases, are valued at tax basis cost and all rents, including those from operating leases, use a multiple of 8.

Schedules 170NC and 174NC are used to apportion consolidated net worth on Schedule F2. Property values come from GAAP records. Owned assets, including those from finance leases, are valued at GAAP basis cost and all rents, including those from operating leases, use a multiple of 8. Please refer to Chapter 9 of this manual for a discussion on apportioning consolidated net worth between affiliated group members on Schedules 170NC, 170SF, 174NC, and 174SC.

The following chart highlights the reporting differences between schedules for leases:

SCHEDULE	GAAP RECORDS	TAX RECORDS	FINANCE LEASE	OPERATING LEASE	RENT EXPENSE	CAPITALIZED COST	CAPITALIZED BOOK VALUE
G – Owned (Lines 1-9)	X		X				X
G – Rental (Lines 11-14)	X			X	X <i>Multiple:</i> 1,2,3,8		
N – Owned (Lines 1-3)		X	X			X	
N – Rental (Line 12)		X		X	X <i>Multiple:</i> 8		
170NC and 174NC – Owned	X		X			X	
170NC and 174NC – Rental	X			X	X <i>Multiple:</i> 8		
N – Captive REIT – Owned		X	X			X	
N – Captive REIT – Rental		X		X	X <i>Multiple:</i> 8		

### *Leases on Federal Schedules M-1 and M-3*

Federal Schedules M-1 and M-3 reconcile financial statement “book” net income (loss) to “tax” net income (loss). Part III, Line 34 of Schedule M-3 (Form 1120)<sup>294</sup> is titled “Purchase versus lease (for purchasers and/or lessees)” and it shows the “book” to “tax” reconciliation for leases.

The instructions to Schedule M-3 state:



- Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a purchase or a lease may, under some circumstances, be characterized as the opposite for tax purposes.
- If a transaction is treated as a lease, the purchaser/lessee reports the periodic payments as gross rental expense. If the transaction is treated as a purchase, the purchaser/lessee reports the periodic lease payments as payments of principal and interest, and they also report depreciation expense/deductions with respect to the purchased asset.

Schedule M-3 has columns (a) through (d), with (a) being the “book basis” income statement amounts and (d) being the “tax basis” income statement amounts. Taxpayers are instructed to report in column (a) gross rent expense for a transaction treated as a lease for financial accounting purposes *but as a sale for U.S. income tax purposes*, and to report in column (d) gross rental deductions for a transaction treated as a lease for U.S. income tax purposes *but as a purchase for financial accounting purposes*.

In addition, taxpayers are instructed to report interest expense for such transactions on Part III, Line 8, column (a) or (d), as applicable, and to report depreciation expense or deductions for such transactions on Part III, Line 31, column (a) or (d), as applicable. Columns (b) and (c) of Part III, Lines 8, 31, and 34 are often used to report the differences between columns (a) and (d) for such recharacterized transactions. For example:

- Corporation X acquires property in a transaction, which it treats as a lease (rental) *for financial accounting purposes*.
- Because of the lease terms, the transaction is treated as a purchase *for U.S. income tax purposes*. X must treat the periodic payments it makes as partial payments of principal and partial payments of interest.
  - In its financial statements, X treats the difference between the financial accounting and U.S. income tax treatment of this transaction as a temporary difference.
- X reports in its financial statements \$1,000 of gross rental expense that, for U.S. income tax purposes, is recharacterized as a \$700 payment of principal and a \$300 payment of interest, accompanied by a depreciation deduction of \$1,200 (based on other facts).

- On its Schedule M-3, X must report the following on Part III, Line 34, column (a): \$1,000, its financial accounting gross rental expense; column (b): -\$1,000; and column (d): zero.
- On Part III, Line 8, X reports zero in column (a) and \$300 in columns (b) and (d) for the interest deduction.
- On Part III, Line 31, X reports zero in column (a) and \$1,200 in columns (b) and (d) for the depreciation deduction.

Auditors may review the federal Schedule M-3, and they may make additional inquiries if entries involving leases are noted. They will expect to see lease transactions reported differently between Schedule G and Schedule N of the franchise and excise tax return, since the franchise tax schedules are based on GAAP records and the excise tax schedules are based on federal tax basis records.

## 10. Industrial Development Corporation

Property leased from an industrial development corporation (formed under Tenn. Code Ann. § 7-53-1) may be treated as either a finance lease or as an operating lease. The taxpayer may elect whichever treatment it prefers, but it may only change its election once during the term of the lease. Generally, the taxpayer will elect to treat the lease as an operating lease until the capitalized lease under GAAP is depreciated down and becomes less than the lease payments.<sup>295</sup>

## Ownership in a General Partnership

A general partner is a partner who is personally liable for partnership debts. A general partnership is composed only of general partners.<sup>296</sup> General partnerships file federal Form 1065 with the “general partnership” box checked on Schedule B.

General partnerships are not directly subject to franchise and excise tax as a separate taxpaying entity. They are not required to file franchise and excise tax returns. However, their activity may be subject to the tax if they are directly or indirectly owned by an entity that offers limited liability protection, like a corporation, LP or LLC.<sup>297</sup>

Ownership of a general partnership may create a filing requirement for its partner. For example:

- A corporation’s only connection to Tennessee is its indirect ownership in a general partnership that is doing business and has substantial nexus in the state. This corporation, which did not otherwise have a filing requirement before acquiring an ownership interest in the general partnership, must now register with the Department

and file a franchise and excise tax return that includes both its own activities and its share of the general partnership's activities.

A general partnership that is owned directly or indirectly by an entity that provides limited liability protection will, in effect, be taxed at the first level of ownership that provides limited liability protection. Taxpayers reflect the general partnership's activity on their franchise and excise tax returns based on their pro rata ownership share. A partner's ownership percentage is found on its Schedule K-1 (Form 1065).

### 1. Owned Property Held by a General Partnership

Real and tangible property reported on Schedule G includes a taxpayer's share of any specific property held by a general partnership, where such taxpayer has a direct or indirect ownership interest in the general partnership. For reporting purposes, the general partnership's real and tangible property is reported at book value and treated as if it were owned by the respective partners. In the following example, \$7,000 is entered on Schedule G, Line 6 "Ownership share of real and tangible property of a partnership that does not file a return."

For example:

- A general partnership has two partners: Partner A, Inc. and Partner B, an individual. Partner A owns 70% of the general partnership, and Partner B owns the remaining 30%. The general partnership has equipment located in Tennessee with a book value of \$10,000. Partner A will include on Schedule G its share of the book value of this partnership property, computed as follows:

\$10,000	Equipment in Tennessee
<u>      70%</u>	Partner A's ownership percentage
<b>\$ 7,000</b>	<b>Report on Schedule G, Line 6</b>

- Audit Procedures:
  - First, find the partner's ownership percentage, reported on the taxpayer's federal Schedule K-1 issued by the general partnership.
  - Second, multiply that ownership percentage by the book value of the general partnership's owned property located in Tennessee.

A general partnership's owned real and tangible property may also include land, buildings, leasehold improvements, vehicles, prepaid supplies, inventories, and more. The pro rata share of all these items is reported on Schedule G, Line 6 of the taxpayer's return.

## 2. Property Leased by a General Partnership

The taxpayer's share of a general partnership's rents paid for property used in Tennessee is also reported on Schedule G of the taxpayer's return. The following example is similar to the one above, except that the general partnership paid \$20,000 in office equipment rents, measured by GAAP. Partner A's Schedule G will include its share of these rents, computed as follows:

\$20,000	Office equipment rents in Tennessee
<u>70%</u>	Partner A's ownership percentage
\$14,000	Report on Schedule G, Line 13, before multiple
<u>2</u>	Multiple from the form <sup>298</sup>
<b>\$28,000</b>	<b>Report on Schedule G, Line 13, after multiple</b>

### *Leases between Limited Liability Taxpayers and Related General Partnerships*

If the general partnership (lessee) is leasing property from the franchise and excise taxpayer/partner (lessor), the rental income received by the franchise and excise taxpayer from the general partnership would be considered sub-rental income to the taxpayer that must be subtracted from its ownership percentage share of the general partnership rental expense to arrive at the net annual rental to be reported on Schedule G (before the applicable multiple). The taxpayer, as the owner of the property being leased to the general partnership, must also include the property's net book value on Schedule G (as owned property).

- Example where *taxpayer* leases property **to** a *related general partnership*:

a. General Partnership Rental Expense Paid to Taxpayer:	\$10,000
b. Taxpayer Ownership Percentage (Sch. K-1):	70%
-----	
c. Taxpayer/Partner's Share of Rental Expense (a. x b.)	\$ 7,000
d. Sub-rental Income Received by F&E Taxpayer:	\$ 10,000
-----	
e. Rent Expense Reported by Taxpayer/Partner on Schedule G (c. less d., but not less than zero)	\$ 0

Note that the *taxpayer (lessor)* will include the book value of the property it is leasing as an owned asset on Schedule G, Lines 1, 2, or 3.

Contrarily, if a general partnership (lessor) is leasing property to a franchise and excise taxpayer/partner (lessee) who pays rent to the general partnership, the franchise and excise taxpayer's ownership percentage share of rental income received by the general partnership would be sub-rental income. This sub-rental income must be multiplied by the taxpayer's ownership percentage share, and the result must be subtracted from the taxpayer's rental expense paid to the general partnership to arrive at the net annual rental to be reported on Schedule G (before the applicable multiple). Under Tenn. Code Ann. § 67-4-2108(a)(6)(E), the taxpayer must also include its ownership percentage share of the general partnership's owned property that is being leased to the taxpayer on Schedule G because the taxpayer is occupying the property.

- Example where *taxpayer* leases property **from** a *related general partnership*:

a. Sub-rental Income Received by General Partnership	\$10,000
b. Taxpayer's Ownership Percentage (Sch. K-1):	70%
-----	
c. Taxpayer/Partner's Share of Rental Income (a. x b.)	\$ 7,000
d. Taxpayer's Rental Expense	\$ 10,000
-----	
e. Rental Expense Reported by Taxpayer/Partner on Sch. G (d. less c., but not less than zero)	\$ 3,000

Note that the *taxpayer (lessee)* will include its pro rata share of the general partnership's owned assets on Schedule G, Lines 1, 2, or 3.

### 3. Audit – Ownership of a General Partnership

During an audit in which the taxpayer has an ownership interest in a general partnership, the auditor may perform some or all of the following audit procedures:

- Request and review all federal Form 1065, Schedule K-1s received by the taxpayer and identify those that are from general partnerships.
- Inquire as to any connection that the general partnership has to Tennessee, including ownership or use of real and tangible property in the state.

- Identify the taxpayer/partner's ownership percentage of any general partnership that is doing business in the state (shown on Schedule K-1).
- Obtain a GAAP basis balance sheet and income statement, or similar financial information, for the general partnership. (Note that the owned and rented assets on these statements may include assets not owned or used in the state.)
- Request rent/lease documents in order to determine the appropriate rental multiple.
- Calculate the taxpayer's pro rata share of the property owned or used by the general partnership in the state that should be included on Schedule G.
- Inquire as to whether there are any leases between the taxpayer/partner and the general partnership and calculate the Schedule G inclusion amount after allowing for sub-rents.

## Ownership in a Pass-through Entity Not Subject to the Tax

The franchise tax property base (Schedule G, Line 15) includes a taxpayer's ownership share of the real or tangible property owned or used by any general or limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal tax purposes *that is not subject to the franchise tax* and in which the taxpayer has an ownership interest, either directly or indirectly through one or more such entities.<sup>299</sup>

In other words, the previous section concerning a taxpayer's ownership of a general partnership also applies when a taxpayer owns other types of pass-through entities that own or use property within the state, when such pass-through entities are not subject to the franchise tax. This scenario is rare; generally, most pass-through entities will be subject to the franchise tax on a separate-entity basis. For more information, see Chapter 3 – Nexus.

## Property Used and Neither Owned nor Rented

If property used by a taxpayer is neither owned nor rented or is rented for a nominal amount, a reasonable market rental rate may be used to determine the value of the property reported for franchise tax purposes.<sup>300</sup> For example:

- A restaurant paid management fees (instead of rents) to the owner of the property where the restaurant operates. There are no written agreements between the

restaurant and the property owner and no documentation of any services that the property owner performed for the restaurant.

- Here, a reasonable market rental rate may be used to determine the value of the rental for franchise tax purposes.

## Chapter 11: Excise Tax

### Overview

All persons, except those with nonprofit status or otherwise exempt,<sup>301</sup> are subject to a 6.5% corporate excise tax on the net earnings from business conducted in Tennessee for the fiscal year. Corporations, partnerships, LLCs, and business trusts, as entities that offer their owners limited liability protection, are subject to the excise tax. The excise tax return is filed on a separate entity basis for the same tax period covered by the corresponding federal return, but an entity may be exempt from this tax if the requirements of Public Law 86-272 are met.<sup>302</sup> See earlier chapters of this manual for a discussion of Taxable Entities, Exemptions, Public Law 86-272, and Return Filing.

The code defines *net earnings* differently for:

- A corporation or entity treated as a corporation for federal income tax purposes;
- A corporation electing S-corporation status;
- A financial institution that forms a unitary business;
- An entity treated as a partnership for federal tax purposes;
- An entity treated as a partnership for federal tax purposes that is directly or indirectly owned by a public REIT;
- An SMLLC whose single member is a general partnership;
- An SMLLC that is treated as an individual taxpayer for federal income tax purposes;
- A captive REIT affiliated group;
- A business trust; or
- Any other person doing business in the state not specifically listed above.<sup>303</sup>

The way net earnings are reported for federal income tax purposes depends on the taxpayer's entity type and its corresponding federal tax return form. For example, the federal taxable



income of a corporation is found on a single line (Line 28) near the bottom of the first page of federal Form 1120, but a partnership return filed on federal Form 1065 uses multiple lines on different pages of the return to report ordinary and other types of income and losses. These federal reporting differences are addressed on the excise tax return, Schedules J1 through J4. Each of these schedules begins with the taxpayer's net income or loss from the applicable federal income tax return and ends with a number that is carried to Schedule J, Line 1 (adjusted federal income or loss). Taxpayers should complete only one Sub-J Schedule (J1, J2, J3, or J4) based on the taxpayer's entity type before completing Schedule J of the excise tax return. Example of an *incorrect* filing:

- The business is a corporation, according to the Tennessee Secretary of State.
- The business registers with the Department as an LLC and claims the self-employment deduction on Schedule J1, Line 6.
- This is an improper filing because corporations must use Schedule J4, which has no line to deduct earnings subject to self-employment tax.

The starting point for computing net earnings for excise tax purposes begins with federal taxable income, as reported on federal Forms 1120, 1120-S, 1065, 1040, 990-T, or other variants of these forms. The first line of each Sub-J Schedule asks for the ordinary income (loss) from the applicable federal income tax return (based on entity type), and then subsequent lines make adjustments to federal taxable income that are specific to the type of federal form filed. Tennessee excise tax law requires certain *addition* and *subtraction* modifications to federal taxable income to arrive at net earnings subject to excise tax.

### *Virtual Currency Transactions*

Virtual currency transactions are reportable for franchise and excise tax purposes. Virtual currency is treated as property and is reported as an asset on book basis financial statements. This asset may be used in business transactions or held as an investment. Because the Tennessee excise tax computation begins with the net income reported on the taxpayer's federal income tax return, federal tax principles applicable to property transactions would apply. In addition, the franchise tax net worth base would include the book basis of any virtual currency asset. See IRS Notice 2014-21 – Virtual Currency – for more information on the application of federal tax principles.

## Recent Form Changes

There have been several changes to the line items on the excise tax return (Sub-J Schedules and Schedule J) in recent years due to federal tax reform and internal reformatting of the return. Throughout this chapter, unless otherwise indicated, all line item numbers are referenced from the 2022 Form FAE170.

## Schedule J1 – Partnerships

LPs and LLCs<sup>304</sup> that file a federal Form 1065 complete Schedule J1. These taxpayers are considered pass-through entities and are not subject to federal income tax because the profit or loss is “passed through” to the owners subject to federal income tax at the individual owner level. Each partner/owner/member receives a federal Schedule K-1 that they use to report their share of the pass-through entity’s activity on their respective individual return. Income and loss items are reported on Schedule K-1, Lines 1-13. The totals of all individual K-1s equal the amounts reported on Form 1065, Schedule K, which is the primary schedule used in preparing the excise tax return.

Entities treated as partnerships need more than one line to report their income (loss) so that the character of the items stays the same when reported at the partner/owner level. For example, contribution expense is reported on Schedule K, Line 13a, so that it maintains its character as a contribution when it is reported on the owner’s individual federal return where it is subject to limitations and reporting requirements of the individual owner.

### 1. Addition – Ordinary Income (Loss) from Form 1065

The amount entered on Schedule J1, Line 1 represents ordinary income (loss) and can be found on federal Form 1065, Page 1, Line 22 or federal Form 1065, Page 4, Schedule K, Line 1. The same amount is reported in both places on Form 1065.

### 2. Addition – Income Items Specifically Allocated to Partners, Including Guaranteed Payments

The amount reported on Schedule J1, Line 2 represents income items specifically allocated to partners, including guaranteed payments, and is the sum of the amounts reported on federal Form 1065, Schedule K, Lines 2-11.<sup>305</sup> These lines show the partners’ distributive shares of:

- Rental real estate;

- Other rents;
- Guaranteed payments;
- Interest income;
- Dividends;
- Royalties;
- Capital and ordinary gains (losses); and
- Other income (loss).

These amounts are in addition to the income and expense amounts shown on Form 1065, Page 1. For example, Page 1 does not have a line for interest or royalty income because these amounts are reported on Form 1065, Schedule K, Lines 5 and 7, respectively.

Form 1065, Schedule K, Lines 3a, 3b, 4a, 4b, 6b, 6c, 9b, and 9c may be ignored for franchise and excise tax purposes because their purpose is to provide additional information that is not needed for state tax. Only the far-right column of Schedule K is used in the excise tax calculation.

### *Guaranteed Payments*

*Guaranteed payments* are reported on both Form 1065 (Page 1), as a deduction, and Form 1065, Schedule K (Page 4), as income. *Guaranteed payments* are payments made to partners for services or for the use of capital (without regard to the partnership's profitability) and are deducted in arriving at ordinary income reported on Form 1065, Page 1. Additionally, these amounts are reported as separately stated income on Schedule K to be reported on the applicable partner's Schedule K-1.

For franchise and excise tax purposes, the ordinary income (loss) reported on Schedule J1, Line 1 includes the guaranteed payment expense, and the distributive share items reported on Schedule J1, Line 2 include the guaranteed payment income. Therefore, the net effect is zero. The taxpayer will ultimately get to deduct the guaranteed payment expense on Schedule J1, Line 6, as part of the amount subject to self-employment taxes, as discussed below. The following table indicates the lines of the federal and excise tax returns, respectively, on which the guaranteed payment amounts can be found and shows the netting effect of the deduction.

<b>Guaranteed Payment - Federal Return Line</b>	<b>Guarantee Payment Amount</b>	<b>Excise Tax Return - Schedule J1 Line</b>
Form 1065, Page 1, Line 10	\$ (280,000)	1
Form 1065, Page 4, Line 4	\$ 280,000	2
Form 1065, Page 4, Line 14a	\$ (260,000)	6

Even though the guaranteed payments are reported in three different places on the federal Form 1065, a properly completed excise tax return will allow this deduction only once. Note, the example illustrated in the above table assumes that the taxpayer reports other separately stated deductions totaling \$20,000 on Form FAE170, Schedule J1, Line 5. Therefore, the net deduction allowed on Line 6 of Schedule J1 is \$260,000. The ultimate self-employment deduction taken on Line 6 must be net of any other distributive items of expense or loss that have already been deducted elsewhere on Schedule J1. See the manual section *“Why do the instructions for Schedule J1, Line 6 contain the wording ‘net of any pass-through expense deducted elsewhere on this return?’”* for additional information regarding this adjustment.

### *Dispositions of Section 179 Property by Partnerships*

When a partnership sells, exchanges, or otherwise disposes of property for which a Section 179 expense deduction was previously claimed and passed through to its partners, the partnership does not report these transactions on its federal Form 1065 and related forms and schedules. Instead, the partnership provides its partners with the information they need to report these transactions (usually as an attachment to the partners’ Schedules K-1) on their individual federal income tax returns. In this case, the partnership’s Form 1065 will not include the gain or loss on the sale, exchange, or disposition of Section 179 property.

The excise tax is imposed at the entity level; therefore, a partnership that sells, exchanges, or disposes of Section 179 property in a taxable transaction should calculate the gain or loss that is to be included in the excise tax base on a pro forma basis at the partnership level, as if the partnership (and not its partners) had reported the transaction on its Form 1065 for the tax year in which the taxable transaction occurred, including all applicable forms and schedules. In calculating the gain or loss to be reported for Tennessee excise tax purposes, the partnership should disregard any Section 179 expense limits that would have been imposed for federal income tax purposes at the partner level.

### 3. Addition – Any Net Loss or Expense Distributed to a Publicly Traded REIT

Schedule J1, Lines 3 and 8 address situations where a publicly-traded REIT owns the taxpayer in full or in part (directly or indirectly). See Chapter 17 for more information on REITS.

During an audit, an auditor will likely perform the following activities when an entity treated as a partnership is owned directly or indirectly by a publicly traded REIT.<sup>306</sup>

- Identify the name and federal employer identification number (FEIN) of the public REIT. The current instructions to Schedule J1, Line 8 requests that taxpayers attach a schedule listing the name and FEIN of the REIT. Nevertheless, this information should be maintained by the taxpayer and be available to auditors.
- Determine that the REIT's stock/shares are traded on a national securities exchange. The REIT must be publicly traded, as defined in Tenn. Code Ann. § 67-4-2004(39).<sup>307</sup> Some REITs may appear to meet this definition but fail to do so because they are traded on an over-the-counter (OTC) exchange or a private exchange.<sup>308</sup> In addition, not all REITs that file with the Securities Exchange Commission are traded on a national exchange, in which case the taxpayer would not be allowed the reversal adjustments on Schedule J1, Lines 3 and 8.
- Obtain Schedule K-1s and/or an organization chart to verify that the pass-through entity is owned directly or indirectly by the public REIT.
- Determine that the amounts reported are correct. If the pass-through entity is indirectly owned by a REIT, the auditor will need to see all the K-1 schedules between the pass-through entity and the REIT in order to recalculate the adjustment amount for distributions made to a public REIT.

### 4. Deduction – Expense Items Specifically Allocated to Partners

The amount reported on Schedule J1, Line 5 represents expense items specifically allocated to partners and equals the sum of the amounts shown on federal Form 1065, Schedule K, Lines 12, 13a-13d, with three exceptions. Items not reported on Schedule J1, Line 5 are as follows:

- Payments for partner/member qualified pension or benefit plan expenses.

- The deductions for partner/member pension and benefit costs must be reported on Schedule J1, Line 7, instead of Line 5. This separate reporting is needed to identify amounts that must be reversed on Schedule K (of the franchise and excise tax return), ensuring that the costs do not create or increase a net operating loss.
- Amounts that were reported on federal Schedule K, Line 13 for Section 743(b) adjustments (code V).<sup>309</sup>
- Do not include excess business interest expense under 163(j) reported on federal Form 1065, Schedule K, 13d with a code K for tax years beginning after December 31, 2017, and before January 1, 2020. However, for tax years beginning after January 1, 2020, this amount may be reported as an excise tax deduction. See the manual section Tax Cuts and Jobs Act of 2017 for additional information.

The deductions commonly reported on Schedule J1, Line 5 are for the partners' distributive shares of Section 179 expense, contributions, investment interest expense, I.R.C. § 59(e)(2) expense, and other deductions. These amounts are in addition to the income and expense amounts shown on Form 1065, Page 1. Federal Schedule K and its attachments may include information that is needed by partners/members for them to accurately file their federal Forms 1040, but some of these amounts are not included in the total reported on Schedule K, Line 13d.

For excise tax purposes, caution should be taken to deduct only amounts included in the federal Schedule K, Line 13d number. There may be "white paper" attachments to the federal return that provide helpful information to the partners, but if their distributive amounts are not included in the federal Line 13d total, they should not be reported on Schedule J1, Line 5. To help discern "white paper" detail amounts that should not be deducted on the excise tax return from federal Schedule K, Line 13d amounts that are deductible on the excise tax return, a list of the federal Schedule K-1 reporting codes and accompanying descriptions can be found in the federal Form 1065 instructions online.

## **5. Deduction – Amount Subject to Self-employment Taxes Distributable or Paid to Each Partner or Member**

Net earnings subject to self-employment taxes are deducted on Schedule J1, Line 6 to the extent that they do not create or increase any net loss.<sup>310</sup> This amount is net of medical insurance payments previously deducted to determine ordinary income (loss) on Form 1065. If the amount is negative, the taxpayer must enter "0."<sup>311</sup> Any deduction on Line 6 is reversed out (added back)

on excise tax Schedule K - Determination of Loss Carryover Available.<sup>312</sup> Because this amount is backed out, an audit adjustment may not, in some cases, change the current year loss available for carryover. In the simplified example shown below, an audit adjustment disallowed the \$700 deduction for income subject to self-employment taxes, but this adjustment did not change the current year loss available for carryover of \$1,000 shown on the last line of Schedule K.

<i>Excise Tax Schedules ...selected lines</i>	<i>As filed by TP</i>	<i>Audited</i>
Schedule J1:		
1. Ordinary (loss)	(\$1,000)	(\$1,000)
Deductions:		
6. Subject to S-E	(700)	0
11. Schedule J1 Total	(\$1,700)	(\$1,000)
Schedule J:		
1. Federal income (loss)	(\$1,700)	(\$1,000)
27. Total business loss	(1,700)	(1,000)
Schedule K:		
1. Loss from line 31	(1,700)	(1,000)
3. Add: S-E from J1, 6	700	0
6. Current year loss c/o	(\$1,000)	(\$1,000)

In many cases, the self-employment deduction will impact the excise tax base. A discussion of the self-employment deduction follows.

### *What income is subject to self-employment tax?*

The federal tax definition of self-employment income can be complicated, but the concept is fairly simple. Generally, self-employment tax applies to wages, tips, and net earnings. The taxpayer calculates net earnings by subtracting ordinary and necessary trade or business expenses from gross income derived from their business. Self-employment income includes guaranteed payments made for services or use of capital and net income from a trade or business. Self-employment income does *not* include interest or dividend income earned from investments, rental income from real estate, or gains and losses from the sale of capital assets.<sup>313</sup>

### *Who is subject to self-employment tax?*

Corporations are not subject to the federal self-employment tax; only individuals are subject. Pass-through entities report profit (loss) subject to self-employment tax on Schedule K-1s issued to their partners who are individuals. Individuals report these numbers on their federal Form 1040 individual income tax returns and pay the applicable self-employment tax. A partner's "net earnings from self-employment" is generally their distributive share of the partnership's income arising out of the trade or business plus any guaranteed payments they receive from the partnership.<sup>314</sup>

Even though subchapter S-corporations issue Schedule K-1s to their owners, their income is not subject to self-employment tax. The only Sub-J Schedules with a deduction for amounts subject to self-employment tax are Schedules J1 and J2.

### *Where is income subject to self-employment tax reported on federal Form 1065?*

The net earnings (loss) amount from self-employment is found on federal Form 1065, Schedule K (Page 4), Line 14a.

### *How do taxpayers calculate the number reported on Form 1065, Schedule K, Line 14a? May the auditor question this amount?*

Generally, the Department accepts the numbers reported on the taxpayer's federal return as being correct. However, it is worth noting that the self-employment number reported on Form 1065, Schedule K, Line 14a does not impact the entity's net income (loss) subject to federal income tax,<sup>315</sup> and it may not receive a high level of review for accuracy by the taxpayer. For example:

- A partnership with ordinary income from operating a retail store would report that income as self-employment income on Schedule K, Line 14a. If the partners are individuals and general partners, this would be correct.
- However, if all the partners are corporations, no amount should be reported on Line 14a, since corporations are not subject to self-employment tax.



- If a partnership were to report self-employment income on Schedule K, Line 14a that includes an amount erroneously attributed to corporate partners, this error could potentially go undetected when the taxpayer reviews its partnership income tax return because, regardless of this error, the correct distributive share of partnership income (loss) subject to federal income tax will be reported to the corporate partners on the Schedules K-1 issued by the partnership. The self-employment income erroneously reported on the corporate partners' K-1s would not pose an issue to the corporate partners because corporations are not subject to federal self-employment tax; however, the partnership *should not be allowed* the Tennessee excise tax deduction for the self-employment income erroneously attributed to the corporate partners.

The [instructions](#) to federal Form 1065 (on page 40) include a Worksheet for Figuring Net Earnings (Loss) From Self Employment. Note that amounts allocated to corporations are deducted on Line 3b of this worksheet (they are excluded from the calculation of net earnings from self-employment). There are lines for other applicable adjustments on the worksheet as well.

Taxpayers should be able to provide auditors with this worksheet in support of the amount reported on Form FAE170, Schedule J1, Line 6. Auditors should briefly review this worksheet and generally be aware of its availability to support the “net earnings from self-employment” amount reported on federal Form 1065, Schedule K, Line 14a.

*Why do the instructions for Schedule J1, Line 6 contain the wording “net of any pass-through expense deducted elsewhere on this return”?*

Federal Form 1065, Schedule K, Line 14a reports net earnings from self-employment. This amount comes from the corresponding federal worksheet and is not reduced by I.R.C. § 179 or contribution expenses. Because the federal Schedule K self-employment amount is not reduced by these expenses, if the Department allowed the entire self-employment amount to be deducted on Schedule J1, Line 6, the taxpayer would be deducting the expenses twice, first on Schedule J1, Line 5 (expense items) and again on Line 6 (amount subject to self-employment taxes).

## 6. Deduction – Amount of Contribution, Not Previously Deducted, to Qualified Pension or Benefit Plans of any Partner or Member, Including all I.R.C. 401 Plans

Schedule J1, Line 7 represents the contribution to qualified pension or benefit plans, including all I.R.C. § 401 plans. This line item is not found on the other Sub-J Schedules. It is needed on Schedule J1 because expenses deducted for contributions to qualified pension (I.R.C. § 401 plans) or benefit plans *for partners or members* may not create or increase a net loss.<sup>316</sup> To ensure this requirement is met, pension expense is reported on Schedule J1, Line 7 and reversed on Schedule K, Line 3 of the loss carryover schedule found on page 4 of the franchise and excise tax return.<sup>317</sup>

The amount entered on Line 7 comes from federal Form 1065, Schedule K, Line 13d - code R. The 13d line may include other types of deductions, so it is important that only the one with code R (retirement) is reported on Line 7. A supporting schedule to the federal form lists the amounts reported on Line 13d and their respective codes.

Retirement plan and deferred compensation plan expenses paid to *non-partners* are deducted on page 1 of the federal Form 1065, Line 18 and are included in the partnership's ordinary business income (loss), which is reported Schedule J1, Line 1. However, pension plan expenses paid to *partners* are not included in the partnership's ordinary income (loss) but are separately reported on Form 1065, Schedule K, Line 13d – code R.<sup>318</sup>

All amounts reported on federal Form 1065, Schedule K, Lines 1-14a are reportable on Schedule J1 (Lines 2, 5, 6, and 7).

- Lines 2 and 5 separately report pass-through income and expenses.
- Lines 6 and 7 are needed to report expenses that, by statute, cannot create or increase a net operating loss.

If a taxpayer does not have a current year net operating loss or loss carryforward, the instruction to separately report pension and benefit costs on Schedule J1, Line 7 can go unheeded with no tax impact. However, the Department should ensure these deductions are allowed only once in arriving at the total deductions on Line 10. Also, care should be taken to not allow informational (white paper) amounts to be deducted in this total.

## 7. Deduction – Any Loss on the Sale of an Asset Sold within 12 Months after the Date of Distribution

Schedule J1, Line 9 represents amounts resulting from a pass-through entity that distributes an asset to one of its partners when the partner sells the asset for a loss within 12 months of the distribution. A loss on the sale of an asset by a partner is reflected on the franchise and excise tax return of the taxpayer that made the distribution, not the one that eventually sold the asset for a loss.<sup>319</sup> For example:

- Partnership distributed an asset to Partner on January 1, 2017. Partner sold the asset for a loss on October 1, 2017. Partnership will deduct the loss on its franchise and excise tax return due April 15, 2018 (assuming a calendar year taxpayer). This is the case even though Partnership distributed the asset to Partner and Partner sold it.

The result is substantially different when a distributed asset is sold for a loss rather than a gain.<sup>320</sup> Given the distribution and sale scenario mentioned above, the distributing taxpayer must deduct the loss if the following two requirements are met:

- The taxpayer is treated as a pass-through entity; and
- The distribution is to the taxpayer's owner (partner/member/shareholder).

Note that Tenn. Code Ann. § 67-4-2006(b)(2)(K) does not say the partner, member or shareholder is a nontaxable entity, so a loss reported on the seller's return would have to be reversed in addition to posting the deduction adjustment to the distributing taxpayer's return. For example:

- Taxpayer, LP distributes an asset to Partner, Inc. (also a Tennessee taxpayer), and Partner, Inc. sells the asset within 12 months at a loss. For excise tax purposes, the loss is recognized by Taxpayer, LP rather than by Partner, Inc.

**⚠ The wording on Form FAE170, Schedule J, Line 17 (and the related instructions) for tax years beginning prior to 7/1/2016 were in error and are not supported by excise tax law. These prior year forms and instructions erroneously included this deduction on Schedule J, which is applicable to all entity types subject to excise tax. This deduction may only be taken by partnerships on Schedule J1 and S corporations on Schedule J3.**

## Schedule J2 – Single-Member LLC Filing as Individual

SMLLCs filing as individuals must complete Schedule J2.<sup>321</sup> In cases where an SMLLC is owned by an individual, the business activities of the SMLLC will be included on the owner's individual federal tax return, Form 1040, e.g., Schedules C, D, E, and F and on Form 4797. The SMLLC should only include information from these schedules that represent its business activity. For example:

- An individual may file several Schedule C forms, but only the ones reporting the activity of the SMLLC would be used in computing the franchise and excise tax.

Auditors should request the tax basis trial balance of the SMLLC, and the net profit (loss) should be traced to the applicable federal schedules, and ultimately, to the excise tax return.

**⚠ Auditors will ask for the SMLLC's tax basis income statement in order to substantiate the total income/loss of the business, since its activity may be reported on multiple forms filed with the federal Form 1040.**

### 1. Addition – Net Profit or Loss

Although the IRS labels Form 1040, Schedule C "Profit or Loss from Business (Sole Proprietorship)," this form is also used to report the ordinary income activities of an SMLLC filing as an individual. The first section of Schedule C asks for the business name and other information that should readily identify the SMLLC. Net profit is listed on **Form 1040, Schedule C, Line 31**, which is reported on FAE170 Schedule J2, Line 1.

An SMLLC owned by an individual may make an election on Form 8832 to file as a corporation on federal Form 1120. In that case, the taxpayer would file federal Form 1120, as opposed to Form 1040 schedules. For excise tax purposes, an SMLLC electing to be taxed as a corporation would complete Schedule J4 instead of Schedule J2.

### 2. Addition – Capital Gains or Losses

Schedule J2, Line 2 is where SMLLCs should report capital gains and losses. These amounts are found on federal **Form 1040, Schedule D** along with the gains/losses from sources other than the SMLLC. Because capital gains/losses from various sources are reported on this schedule, the taxpayer should be ready to provide detailed schedules that tie the gains/losses to the SMLLC's books and records in the case of an audit. Capital gains and losses result from the sale or

exchange of capital assets. Capital assets are generally investments, as opposed to depreciable business property (the sale of which is reported on Form 4797).

For federal income tax purposes, capital losses are only deductible up to the amount of capital gains plus \$3,000 (\$1,500 if married filing separately); losses that exceed this limit may offset gains and income in future periods. This federal limit is not applicable for franchise and excise tax purposes, where capital losses are recognized in full in the year incurred. Only current year capital gain/loss activity should be included in the Tennessee taxable income/loss of the excise tax return. Any limitations or carryovers shown on Schedule D should be disregarded for excise tax purposes.

### 3. Addition – Rental Real Estate and Royalty Income or Loss

Schedule J2, Line 3 represents rental real estate and royalty income and loss amounts related to the SMLLC. The reportable amount comes from federal **Form 1040, Schedule E, Line 26** (or **41**, if there are any amounts reported on Schedule E, Parts II-IV or Line 40 of Part V, that relate to the SMLLC). Real estate rents reported on Schedule E are never subject to federal self-employment tax and, therefore, should **not** be included in the deduction on Schedule J2, Line 8.

Income or loss from ownership interests in pass-through entities is found on page 2 of Form 1040, Schedule E. This information is reported on Schedule J2 if the SMLLC has an ownership interest in the pass-through entity. Normally, partnership and S-corporation amounts reported on the back of Form 1040, Schedule E are from ownership by individuals, and not by the SMLLC, and as such would not be included on Schedule J2.

In an audit, the auditor will likely reconcile the amounts reported on Schedule J2 to the SMLLC's books and records to ensure that the excise tax return reflects only the transactions of the SMLLC and not of its individual owner.

### 4. Addition – Profit or Loss from Farming

Schedule J2, Line 4 represents an SMLLC's profit or loss from farming activities. This amount is found on federal **Form 1040, Schedule F, Line 34** and may include amounts from sources other than the SMLLC. The auditor should reconcile the amounts reported on the sub-schedule to the SMLLC's books and records in addition to Form 1040, Schedule F.

## 5. Addition – Ordinary Gain or Loss – Depreciable Property

Schedule J2, Line 5 represents the SMLLC's ordinary gain or loss from the sale or exchange of depreciable property used in the business. The sale of business property is reported on federal **Form 4797** as either a short or long-term gain or loss. Schedule J2 will generally include amounts from Form 4797, Line 18b, but only for amounts that can be sourced to the SMLLC's books and records.

## 6. Deduction – Amount Subject to Self-Employment Taxes Distributable or Paid to the Single Member

An SMLLC owned by an individual may deduct the income that is subject to federal self-employment tax, provided this amount shall not create or increase any net loss for Tennessee excise tax purposes. Schedule J2, Line 8 represents this amount. Generally, the SMLLC's net earnings reported on Form 1040, Schedule C are subject to self-employment tax and would be reported on federal Schedule SE. Income not subject to self-employment tax includes income from interest, dividends, investments, rental income from real estate, and gains or losses from the sale of capital assets. These types of income are generally reported on federal schedules other than Schedule C.

## Schedule J3 – Subchapter S-Corporations

A Subchapter S-corporation is a corporation that has made a federal election whereby it does not pay any federal income tax. Instead, the corporation's income and deductions are passed through to its shareholders. The shareholders must report the income and deductions on their own income tax returns. The S-corporation files federal Form 1120S and reports its ordinary income and other pass-through amounts on Schedule K, Lines 1-12. The ordinary income amount reported on 1120S, Schedule K, Line 1 originates from page 1, Line 21 and is reported on Schedule J3, Line 1. Note that Subchapter S-corporations do not receive a deduction for income subject to self-employment tax, as they are not subject to self-employment tax.

### 1. Addition/Deduction – Income and Expense Items as if no "S" Election

Schedule J3 Lines 2 and 4 require the S-corporation to recalculate income and expenses as if the entity were not an S-corporation. For excise tax purposes, "net earnings" means federal taxable income calculated as if the corporation had not elected S status.<sup>322</sup> Net earnings include ordinary business income plus any pass-through items of income or deduction. Schedule J3 begins with the ordinary business income (loss) amount from Form 1120S, Schedule K, Line 1, adds pass-through income items reported on Schedule K, Lines 2-10, and deducts pass-through

deduction items reported on Schedule K, Lines 11-12. The additions are reported on **Schedule J3, Line 2**, and the deductions are reported on **Schedule J3, Line 4**.

### *Dispositions of Section 179 Property by S Corporations*

When an S corporation sells, exchanges, or otherwise disposes of property for which a Section 179 expense deduction was previously claimed and passed through to its shareholders, the S corporation does not report these transactions on its federal Form 1120-S and related forms and schedules. Instead, the S corporation provides its shareholders with the information they need to report these transactions (usually as an attachment to the shareholders' Schedules K-1) on their individual federal income tax returns. In this case, the S corporation's Form 1120-S will not include the gain or loss on the sale, exchange, or disposition of Section 179 property.

The excise tax is imposed on S corporations at the entity level, as if the corporation had not elected S status for federal income tax purposes; therefore, an S corporation that sells, exchanges, or disposes of Section 179 property in a taxable transaction should calculate the gain or loss that is to be included in the excise tax base on a pro forma basis at the S corporation level, disregarding its elected S status, on a federal Form 1120 for the tax year in which the taxable transaction occurred, including all applicable forms and schedules. In calculating the gain or loss to be reported for Tennessee excise tax purposes, the S corporation should disregard any Section 179 expense limits that would have been imposed for federal income tax purposes at the shareholder level.

## **2. Deduction – Any Loss on the Sale of an Asset Sold within 12 Months after the Date of Distribution**

Schedule J3, Line 5 represents amounts resulting from an S-corporation that distributes an asset to its shareholder when the shareholder sells the asset for a loss within 12 months of the distribution. A loss on the sale of an asset by a shareholder is reflected on the franchise and excise tax return of the taxpayer that made the distribution, not the one that eventually sold the asset at a loss.<sup>323</sup> For more information, see the discussion at Partnerships – Schedule J1, Line 9.

## **Schedule J4 – Corporations and Other Entities**

Corporations file on federal Form 1120. Line 28, which reports “taxable income before net operating loss deduction and special deductions,” is the amount that should be reported on Schedule J4, Line 1. Taxpayers should not use Line 30 “taxable income,” because that line is net of the federal net operating loss deduction and special deductions. Tenn. Code Ann. § 67-4-

2006(a)(1) specifically states that “net earnings” or “net loss” is defined as federal taxable income or loss *before* the operating loss deduction and special deductions.

Any taxpayer filing federal Form 1120 or any variation of that form, except for a corporation electing S-corporation status, should complete Schedule J4. Entities using Schedule J4 include:

- Business trusts that are classified as corporations;
- Entities not chartered as a corporation (like an LLC) that have made a federal election to file as a corporation; and
- “Other” taxable entities not includable on Schedules J1, J2, or J3, such as organizations exempt from federal income tax that file federal Form 990-T to report taxable business income from nonexempt activities.
  - “Others” may include joint-stock associations, national banks, regulated investment companies, state-chartered banks, and federal or state chartered financial associations.<sup>324</sup>

## 1. REIT Taxable Income

REITs report their net income from federal Form 1120-REIT, Line 20 on Schedule J4, Line 2a and any dividends paid deduction from federal Form 1120-REIT, Line 21b on Schedule J4, Line 2b. REIT taxable income after any dividends paid deduction is then reported on Schedule J4, Line 2c.

## 2. Unrelated Business Taxable Income (Not-for-Profits)

A nonprofit reports its unrelated business taxable income (UBTI) that is subject to Tennessee excise tax on Schedule J4, Line 3 (2021 Form FAE170). Entities having a not-for-profit status generally are not subject to the Tennessee excise tax. However, to the extent a nonprofit has Tennessee net earnings that constitute UBTI, as defined under IRC §512, for federal income tax purposes, such net earnings *are subject* to the Tennessee excise tax.<sup>325</sup>

The amount reported on Schedule J4, Line 3 should be the UBTI reported on federal Form 990-T, Part I, Line 5 – total UBTI before net operating losses.<sup>326</sup> **Net losses should not** be reported on Form FAE170, Schedule J4, Line 3. For Tennessee excise tax purposes, if a nonprofit has a UBTI net operating loss for the tax year, the nonprofit should enter zero on Schedule J4, Line 3; the loss will be suspended in the same manner as it is for federal income tax purposes and applied in a future tax year for which the nonprofit has positive UBTI. The nonprofit is responsible for tracking and maintaining record of any suspended UBTI net operating losses for Tennessee



excise tax purposes. Also, a nonprofit with more than one unrelated trade or business may not offset a net loss of one unrelated trade or business against income or gain of another in determining reportable UBTI for Tennessee excise tax purposes.<sup>327</sup> In this case, the nonprofit should report on Schedule J4, Line 3 the sum of the positive amounts from all Schedules A (Form 990-T), Part II, Line 18, less any applicable charitable contributions deduction from Form 990-T, Part I, Line 4. For example:

- Nonprofit ABC has only one unrelated trade or business. For the 2018 tax year, Nonprofit ABC calculates a UBTI *net loss* of \$5,000 on federal Form 990-T, Schedule A. Nonprofit ABC should report zero on its 2018 Form FAE170, Schedule J4, Line 3 and maintain record of the UBTI net loss in its records. In 2019, Nonprofit ABC calculates UBTI *net earnings* of \$12,000 before applying any NOL carryovers. Nonprofit ABC should apply the 2018 UBTI NOL carryover of \$5,000 against its 2019 UBTI net earnings of \$12,000 and report \$7,000 on its 2019 Form FAE170, Schedule J4, Line 3. Nonprofit ABC should maintain detailed records of any UBTI NOLs generated and utilized for Tennessee excise tax purposes.
- Nonprofit DEF has two unrelated businesses, Activity X and Activity Y. For the 2019 tax year, Activity X results in UBTI *net earnings* of \$10,000 and Activity Y results in a UBTI *net loss* of \$3,000 (as calculated on each activity's respective federal Form 990-T, Schedule A). Nonprofit DEF will report the \$10,000 of UBTI net earnings from Activity X on its 2019 Form FAE170, Schedule J4, Line 3. The \$3,000 UBTI loss from Activity Y is suspended for Tennessee excise tax purposes. In 2020, Activity X results in UBTI *net earnings* of \$6,000 and Activity Y results in UBTI *net earnings* of \$5,000. Nonprofit DEF will apply the 2019 suspended UBTI loss of \$3,000 from Activity Y against the activity's 2020 UBTI net earnings of \$5,000, resulting in net earnings subject to excise tax of \$2,000. Nonprofit DEF will combine this amount with Activity X's net earnings of \$6,000 and will report \$8,000 on its 2020 Form FAE170, Schedule J4, Line 3. Nonprofit DEF should maintain detailed records for each of its unrelated businesses of any UBTI NOLs generated and utilized by such businesses for Tennessee excise tax purposes.

### 3. Addition/Deduction – Charitable Contributions

Schedule J4, Lines 5 and 8, address the timing difference that may exist as to when a taxpayer may deduct a charitable contribution for state excise tax versus federal income tax purposes. For excise tax purposes, charitable contributions may be deducted in full in the year in which the contribution was made, even though the full deduction may not be allowed for federal income tax purposes in that year. Corporations<sup>328</sup> report on Schedule J4, Line 8 current year charitable contributions that were not allowed as a deduction for federal income tax purposes due to the

federal limitation. If a corporation did not have current or previous year contribution limitations, both the state and federal contribution deduction would be the same. No entries would be made on Schedule J4, Lines 5 or 8.<sup>329</sup>

The IRC states that the charitable contribution deduction cannot exceed 10% of net taxable income.<sup>330</sup> However, any unused amount may be carried forward and used on subsequent federal tax returns for up to five years. This federal limitation and the associated carryover are not recognized for Tennessee excise tax purposes. The deduction is allowed in the year made for excise tax purposes.

Taxpayers should report on Schedule J4, Line 5 federal charitable contribution carryovers from prior periods that were deducted on federal Form 1120 in arriving at the corporation's current year federal taxable income but were deducted for excise tax purposes in a prior year (when incurred). The number reported on this line will be included in the federal Schedule M-1 or M-3 reconciliation.

The GAAP book-to-tax reconciliation for charitable contributions is found on federal Form 1120, Schedule M-1, Line 8b or Schedule M-3, Part III, Line 21.<sup>331</sup> Note that Line 21 does not allow entries under the per books "column a – income statement." Entries on this line only reflect federal timing differences. Initially, a taxpayer may not be allowed to deduct all of its contributions because of the 10% limitation and would enter the disallowed amount on Line 21, column b as a negative amount. In subsequent years, when the carryover amounts are used, those amounts would be entered as a positive number in column b. In years in which a carryover deduction is claimed on the federal return, auditors should disallow it by reporting it as an add-back on Schedule J4, Line 5.

Whenever a contribution is claimed on federal Form 1120, page 1, auditors should determine if the amount is a current year deduction, a carryover deduction, or a combination of both. Schedule M-3 will help in that regard. Also, several types of tax preparation software generate worksheets that provide this information.

#### **4. Addition – Capital Gains Offset by Capital Losses**

Schedule J4, Line 6 represents any capital loss carryovers that offset capital gains on the current federal income tax return. Tennessee allows the full capital loss deduction in the initial year (the year incurred) without limitation, whereas the I.R.C. places a limit on the capital loss deduction (see below). Because the entire loss is recognized in the initial year for Tennessee excise tax purposes, any capital loss carryovers that reduce federal taxable income in subsequent years are not permitted and are reported on this line as an add-back. See federal Form 1120

Schedules M-1, Line 8 or M-3, Part II, Line 24 and any detailed schedule attachments associated with federal Schedule D. The capital loss temporary difference is reported on Form FAE170 Schedule J4, Line 9 in the initial year.<sup>332</sup> See the discussion of federal Schedule D and capital gains/losses below for more information.

## 5. Deduction – Capital Losses Limited at Federal Level

Schedule J4, Line 9 represents any current year capital loss not deducted when calculating federal taxable income (loss). Taxpayers may fully deduct capital losses in the year they were incurred for Tennessee excise tax purposes, but certain limits apply federally and all or part of the capital loss may not be deducted for federal tax purposes. The amount reported on this line is from federal Form 1120 Schedule M-1, Line 3 or Schedule M-3, Part II, Line 24.<sup>333</sup> See the Schedule J4, Line 6 section above for additional discussion, including the excise tax treatment when a capital loss is offset by a capital gain in a subsequent period.

### *Federal Schedule D – Capital Gains and Losses*

Businesses report capital gains and losses on federal Form 1120, Schedule D. For a corporation, capital losses may be used to offset capital gains, but are never a deduction on their own. Any capital losses in excess of capital gains are *not* transferred to federal Form 1120 as a deduction. Unused capital losses may be carried back three years<sup>334</sup> and then forward five years for federal tax purposes.

The amount of “unused capital loss carryover” brought into a current year return is reported on federal Form 1120, Schedule D, Part 1, Line 6. This amount should be reported as a Schedule J4 add-back to the extent that it offsets current year capital gains. For example:

- Form 1120, Schedule D shows a \$100,000 capital loss incurred in another tax period but carried forward to the current year return where it offsets a current year capital gain of \$40,000.
- No capital gain or loss amounts are reported on page 1 of Form 1120. Instead, the capital gain is fully offset by the capital loss, and the unused loss of \$60,000 (\$100,000 - \$40,000) would go on federal Schedule D, Part 1, Line 6 of the subsequent year’s return.
- Schedule J4, Line 6 will report \$40,000. This is the current year capital gain that was offset by the capital loss carryover.

### *Pass-through Entity – Adjustment Not Needed*

This adjustment will never apply to pass-through entities, like partnerships, LLCs, and S-corporations because they pass through all capital gains and losses to their owners on federal Schedule K-1. Any federal limitation is applied at the partner/shareholder level. Note that the partnership federal Form 1065, Schedule D, does not have any limitation, but allows the entire gain or loss amount to pass through to its owners. As a result, no excise tax add-back or deduction is needed.

### *Audit Procedures – Capital Gain Offset by Capital Loss*

A common issue for taxpayers is applying the I.R.C. to Tennessee filings and erroneously filing amended excise tax returns to claim a loss carryback. Another issue is taxpayers erroneously filing an excise tax return by failing to add back a capital loss carryforward deducted on its federal return.

The add-back amount that should be reported on Schedule J4, Line 6 is found on federal Schedule M-1, Line 8<sup>335</sup> or Schedule M-3, Part II, Line 24. In the case of an audit, the auditor should review federal Schedule D (including detailed attachments). These documents should show any capital gains that were offset by capital loss carryovers.

Federal Schedule M-3, Part II, Line 24 is used to report both capital loss limitations and carryforwards used. Regarding loss carryforwards, the schedule's instructions state, "[i]f the corporation utilizes a capital loss carryforward on Schedule D in the current tax year, report the carryforward utilized as a *negative* amount on Part II, line 24, columns (b) or (c), as applicable, and column (d)." This line is also used to report the amount by which the current year capital losses exceed the current year capital gains. These amounts are not deductible for federal income tax purposes but would be reported as a Schedule J4 deduction. Federal Schedule M-3's instructions also state, "report as a *positive* amount on line 24, columns (b) or (c), as applicable, and (d) the excess of the net capital losses over the net capital gains reported on Schedule D."

The Line 24 positive and negative amounts need to be interpreted in conjunction with Line 23a. Note that Line 24 does not permit an entry in column (a) for a "per book" amount. Likewise, Line 23a does not permit an entry in column (d) for a "per tax" amount. To fully understand the book versus tax reconciliation, both Lines 23 and 24 need to be considered.

The example above would show that the current year gain of \$40,000 was the same for both book and tax purposes (Lines 23(a) and 24(d)). Even though both book income and tax income reflected a current year gain, for tax purposes that gain will be offset by the loss carryforward.

This would be reflected on Line 24. When “income per tax return – column (d)” Lines 23 and 24 are combined, they net to zero. In other words, the current year net gain of \$40,000 was fully offset by carryover losses. If this was the taxpayer’s only transaction, Line 30 would show net income per books of \$40,000 and net income per tax return of \$0.

The excise tax add-back and deduction lines serve the sole purpose of allowing the capital loss to be fully deducted in the year incurred and to reverse the impact of any federal return capital loss carryovers for excise tax purposes.

In the above example, there was a current year capital gain of \$40,000 that was offset by a loss carryover of \$100,000. Since the \$100,000 loss was fully deducted in the year it was incurred for excise tax purposes, the current year gain should be fully taxable for excise tax purposes. Therefore, \$40,000 would be reported on Schedule J4, Line 6.<sup>336</sup>

## **Schedule J – Computation of Net Earnings Subject to Excise Tax (All Entity Types)**

Tenn. Code Ann. § 67-4-2006(b) provides guidance on computing net earnings subject to excise tax. Section (b)(1) of that statute lists the additions to net earnings and losses, and section (b)(2) lists the deductions from net earnings and losses. These add-backs and deductions are reported on Schedule J, Lines 2-14 and Lines 16-29,<sup>337</sup> respectively, and are generally applicable to all types of entities, including those filing as partnerships, SMLLCs, and corporations. Statutory additions or deductions that apply only to a specific type of entity are found on Schedules J1, J2, J3, or J4 instead of Schedule J.

Due to numerous form revisions in recent years, the Schedule J line references below may be different from the ones on a tax return under audit for a previous year. Unless otherwise indicated, all line item numbers are referenced from the 2022 Form FAE170.

### **1. Schedule J, Line 1 – Federal Income (Loss)**

Every taxpayer should complete Schedule J1, J2, J3, or J4, depending on the federal form filed. The amount from the last line of the applicable sub-schedule is entered on Schedule J, Line 1. It is the adjusted federal income or loss before any state imposed add-backs or deductions that are applicable to all entity types.

## 2. Addition – Intangible Expense

Schedule J, Line 2 represents an intangible expense paid, accrued, or incurred to an affiliated taxpayer, which was deducted for federal income tax purposes. It is reported on this line as an add-back.

“Intangible property” includes patents, patent applications, trade names, trademarks, service marks, franchise rights, copyrights, licenses, research, formulas, designs, patterns, processes, formats, and similar types of intangible assets.<sup>338</sup>

“Intangible expense” is an expense related to, or in connection with, the acquisition, use, maintenance, management, ownership, sale, exchange, license, or any other disposition of intangible property, to the extent such amounts are allowed or allowable as deductions or costs in determining federal taxable income on a separate entity basis.<sup>339</sup>

“Affiliate” is any entity:

- In which the taxpayer, directly or indirectly, has more than fifty percent (50%) ownership interest;
- That, directly or indirectly, has more than fifty percent (50%) ownership interest in the taxpayer; or
- In which an entity described in the above bullet point, directly or indirectly, has more than fifty percent (50%) ownership interest.<sup>340</sup>

All taxpayers reporting a deduction on their federal returns for royalties, license fees, or other intangible expenses paid to an affiliate must add back the deduction on Schedule J, Line 2. The law concerning intangibles has changed several times since it was first enacted in 2004, but the add-back requirement has not changed.

In the case of an audit, the auditor will likely search for intangible expense deductions taken on the federal return and verify that the required intangible expense add-back has been made. The taxpayer must report the add-back or be subject to the minimum negligence penalty if the deduction is taken.<sup>341</sup>

*The penalty is calculated when it is determined that:*

- The taxpayer deducted an intangible expense (royalties/licenses) paid to an affiliate on its federal return and the taxpayer computed its excise tax based on the federal net income (loss) without adding back the intangible expense on Schedule J, Line 2; or
- The taxpayer added back the intangible expense on Schedule J, Line 2 and deducted the expense on Schedule J, Line 23 but did not attach the Intangible Expense Disclosure form.

*The excise tax and penalty calculation:*

- The excise tax is computed without the deduction; and
- A nondisclosure penalty is calculated:
  - Determine the difference between the excise tax calculated with the deduction and without the deduction. Multiply that difference by 50% to arrive at the penalty that may be assessed.
  - *For tax years beginning on or after 1/1/2009*, the minimum penalty is \$10,000 for each year there was a failure to disclose the intangible expense. For example:

<u>Intangible Expense Nondisclosure Penalty</u>	<u>2017</u>	<u>2018</u>	<u>Total</u>
Royalty Expense not reported as an add-back	\$9,273,706	11,829,595	
Apportionment ratio	0.002879	0.002781	
	26,699	32,898	
Excise Rate	0.065	0.065	
	1,735	2,138	
Penalty Rate	0.5	0.5	
Computed Penalty	\$868	\$1,069	
Minimum Penalty	\$10,000	\$10,000	\$20,000

Royalties, license fees, and similar intangible expenses are often included on the “Other deduction” line of the federal return. In the case of an audit, the auditor may review the detailed schedule for that line, including scanning the account titles of a detailed trial balance to identify intangible expense accounts. The auditor may also ask the taxpayer to provide a listing of payments made to various affiliates that own intangible property, including the date, amount,

and reason for the payment. The United States Patent and Trademark Office maintains a database of intangibles owners on its website. <http://www.uspto.gov/trademarks/index.jsp>.

**⚠ Taxpayers failing to add-back the intangible expense will be subject to a minimum negligence penalty that is the greater of \$10,000 or 50% of any adjustment to the initially filed return.**

See a discussion of the intangible expense deduction (Schedule J, Line 23) below and [Important Notice #17-27 – Intangible Expense Deduction](#).

### 3. Addition – Bonus Depreciation

Schedule J, Line 3 represents:

- depreciation expense deducted on the federal income tax return under the provisions of IRC Section 168 for “bonus depreciation”<sup>342</sup>

#### *IRC Section 168 Bonus Depreciation*

Tennessee permanently decoupled from federal bonus depreciation for assets acquired on or after July 15, 2002. This means the state does not allow the deduction for bonus depreciation in arriving at net earnings subject to excise tax. Except for bonus depreciation, the federal depreciation method and life used for depreciable assets are the same as what should be used for excise tax purposes.

What is commonly called “bonus depreciation” is also referred to as “special depreciation” on federal forms and instructions. The “bonus” or “special” depreciation deduction is reported on federal Form 4562, Part II, Line 14 and Part V, Line 25. Bonus depreciation is a form of accelerated depreciation that allows businesses to depreciate an additional percentage of the cost of new or used,<sup>343</sup> depreciable assets in the same year in which they were placed into service. When the first-year bonus depreciation is applied, the federal basis of the property is then reduced by this extra first-year bonus depreciation allowance, and the remaining adjusted basis is depreciated from year one through the life of the asset under the Modified Accelerated Cost Recovery System (“MACRS”) federal depreciation provisions.

When bonus depreciation was first enacted in 2002, the additional amount was 30% of the asset’s depreciable basis, but this percentage has changed several times over the years. Under



current federal law, bonus depreciation, as extended under the federal Tax Cuts and Jobs Act of 2017, may include used qualified property and is scheduled to phase out as follows:

<b>Asset Acquired Between:</b>	<b>Bonus Percentage:</b>
9/28/2017 – 12/31/2022	100%
1/1/2023 – 12/31/2023	80%
1/1/2024 – 12/31/2024	60%
1/1/2025 – 12/31/2025	40%
1/1/2026 – 12/31/2026	20%

Under Tennessee’s decoupling provisions, the excise tax is calculated using the asset depreciation model that existed prior to 2002. That depreciation model is MACRS.

### *Timing Difference*

Bonus depreciation creates a timing difference that exists every year between state and federal depreciation until the asset is fully depreciated. If the asset is disposed of before being fully depreciated, there will be a difference in the state and federal gain or loss amount. If the asset is held for its entire life, the same amount of depreciation will have been taken over the full term for both state and federal purposes. However, under bonus depreciation, more of the depreciation expense is taken in the initial year of the asset’s life, and less is taken in later years. For example:

- At the end of its useful life, an asset costing \$100 will report \$100 in accumulated depreciation, no matter which method of depreciation was used. But if bonus depreciation was used for federal income tax purposes, more of the expense will have been deducted earlier rather than later.

There are three Schedule J lines devoted to reporting the differences between state<sup>344</sup> and federal depreciation:

- The depreciation add-back (Line 3);
- Deduction (Line 16); and
- Adjustment for gain or loss (Line 17).<sup>345</sup>

The sum of the Schedule J adjustments taken during the life of an asset should net to zero at the end of the asset's life or at the time of sale or disposal. If bonus depreciation was *never* taken on an asset, the state and federal depreciation expense should be the same. This situation is somewhat uncommon because, for federal income tax purposes, taxpayers are required to take bonus depreciation unless they elect to opt out of taking it.

### *Reporting the Depreciation Adjustment on Schedule J*

The instructions to Schedule J, Lines 3 and 16 indicate that the amounts reported on these lines should only include amounts for assets actually subject to federal bonus depreciation.<sup>346</sup> However, in practice, taxpayers commonly report the state/federal depreciation adjustment in a variety of ways on Schedule J. Three common methods are listed below, but the most common method is listed first. All methods are acceptable, so long as the method chosen by the taxpayer results in the correct net increase or decrease being made to the excise tax base.

### *Common Depreciation Adjustment Reporting Methods:*

- *Full reversal method* – A Schedule J add-back is reported for the total depreciation expense deducted on the federal income tax return, and a Schedule J deduction is reported for the total state depreciation expense. In other words, entries on Schedule J, Line 3 reverse out the entire federal depreciation expense and entries on Schedule J, Line 16 claim the entire state depreciation expense.
- *Netting method (total depreciation)* – One amount is reported on a single Schedule J line (either Line 3 or 16, as applicable). This amount is the difference between the total federal depreciation expense and total state depreciation expense.
- *Netting method (bonus only)* – The federal bonus depreciation expense claimed in the current year is reported as an add-back, and a Schedule J deduction is reported for the difference between federal and state depreciation for those assets on which bonus depreciation was claimed in the current or a previous year. The entries on Schedule J, Lines 3 and 16 reflect the federal/state differences for just those assets for which bonus depreciation was currently or previously claimed.

### *Depreciation Schedules Generated by Computer Software*

Most taxpayers use computer software to prepare depreciation schedules. Schedules are normally maintained for GAAP books, federal tax books, federal alternative minimum tax books, and all the various state tax books. In the case of an audit, auditors should request that taxpayers provide paper or digital schedules based on specific audit criteria. For example:

- An auditor may request a detailed schedule that:
  - Can be tied to the federal income tax return;
  - Sorts assets by location, including state;
  - Shows bonus depreciation taken;
  - Lists asset description, cost, date of purchase, and date of sale (if applicable); and
  - Shows the depreciation method and estimated life used.

Auditors should verify that the depreciation expense deducted in arriving at Tennessee taxable income agrees with the Tennessee state depreciation schedule. This schedule should not show a deduction for bonus or special depreciation. Entries on Schedule J, Lines 3 and 16 are supposed to report the add-back of the current year's bonus depreciation and report the current year's additional state depreciation for assets that claimed bonus depreciation in previous years. Taxpayers report the state/federal depreciation adjustment on Schedule J in a variety of ways, as discussed in the prior section "Common Depreciation Adjustment Reporting Methods." Regardless of the method used, the depreciation deduction for excise tax purposes is based on depreciation schedules that have not deducted bonus depreciation.

Most detailed depreciation schedules follow a similar format, but the numbers may be presented in various ways. All depreciation schedules should list the same basic information, such as asset description and acquisition date, but will vary in the way they subtotal and organize information. For example, some schedules may require the user to sum the Bonus column, the Section 179 column, and an Annual Depreciation column to arrive at the year's total depreciation expense.

Generally, auditors should review, but not necessarily recalculate depreciation expense on individual asset items or foot the columns on the depreciation schedule. Auditors should familiarize themselves with the schedule to determine the current year's depreciation expense (federal and state) and recognize any significant errors.

Some obvious errors would include accumulated depreciation exceeding an asset's cost basis or the "beginning of the year values" not tying to the "end of year values" of the prior period. The depreciation method and life used in computing depreciation expense for Tennessee excise tax purposes should be the same as what was used for federal income tax purposes, except for bonus depreciation. The Section 179 deduction is permitted for both federal and TN purposes.

### *Audit Procedures - Depreciation*

In the case of an audit, the following is a general checklist the auditor may use in auditing depreciation.

- Request state and federal detailed depreciation schedules.
- Determine that the total depreciation expense from the federal detailed depreciation schedule ties to the pro forma federal income tax return.
  - With complex organizational charts, it is important to consider that the detailed listing given to the auditor may include or exclude lower-tier entities in error, so agreeing the total federal depreciation expense to the pro forma federal income tax return should be done.
- Determine that the difference in total state and federal tax depreciation expense per detailed schedules agree to the *net* adjustment made to the excise tax base, as shown on Schedule J. As long as the net adjustment is correct, it does not matter which Schedule J lines were used.
- Request state and federal gain/loss schedules of depreciable assets disposed of during the audit year, and determine that the amount shown on Schedule J, Line 17 effectively reverses out the federal gain/loss and replaces it with the state gain/loss. The same depreciation software that calculates depreciation expense normally also generates a gain/loss report.

### *Example: Asset Trade-in*

The depreciable cost basis of an asset will be the same for state and federal tax purposes if it is purchased for cash. However, the cost basis may be different if there was a trade-in. The following example shows how a new forklift purchased with cash and a trade-in can have a different depreciable cost basis for state and federal tax purposes:

- Forklift #1 is purchased for \$10,000.
- State tax depreciation taken on it totals \$2,000.
- Federal tax depreciation (which includes \$5,000 bonus depreciation) totals \$6,000.
- Later, Forklift #2 is purchased (no MACRS or bonus depreciation was claimed on Forklift #2). Payment is made by trading in Forklift #1 and paying \$6,000 cash.

Depreciable cost basis (state and federal) of Forklift #2:

- State cost basis is **\$14,000**  
*Reason:* \$6,000 cash plus \$8,000 book value of trade-in  
(book value is \$10,000 cost - \$2,000 accumulated depreciation)
- Federal cost basis is **\$10,000**  
*Reason:* \$6,000 cash plus \$4,000 book value of trade-in  
(book value is \$10,000 cost - \$6,000 accumulated depreciation)

*Example: Gain or Loss on Sale or Disposal*

Depreciable assets normally incur a gain or loss when sold or disposed. If bonus depreciation was never taken on the asset, the resulting gain or loss would be the same for both federal and state tax purposes.<sup>347</sup> However, if the taxpayer has taken bonus depreciation on the asset for federal income tax purposes and the asset is not fully depreciated at the time of disposal, the gain or loss will be different for federal and state tax purposes.

In the above example, if Forklift #2 was sold for \$13,000, there would be a federal tax gain of \$3,000 and a state tax loss of \$1,000. This \$4,000 difference is solely attributable to the bonus depreciation taken on the trade-in (Forklift #1). Because Forklift #1 was traded in and not sold outright, the gain/loss was deferred and recognized when Forklift #2 was sold.

	<u>Bonus</u> <u>Depreciation</u>	<u>MACRS</u> <u>Depreciation</u>	<u>Total</u>
Federal	\$5,000	\$1,000	\$6,000
State	<u>-0-</u>	<u>\$2,000</u>	<u>\$2,000</u>
Difference	\$5,000	(\$1,000)	<b>\$4,000</b>

Under the first reporting method discussed previously (the “full reversal method”):

- The taxpayer would report a Schedule J add-back of the total depreciation expense reported on the federal income tax return of \$6,000.
- The \$6,000 amount is given in the example narrative and is comprised of \$5,000 bonus depreciation and \$1,000 MACRS depreciation that is calculated on Forklift #1’s depreciable basis after bonus depreciation.
- Schedule J, Line 16 would reflect the total state depreciation expense for Forklift #1 (computed without bonus depreciation) of \$2,000.
- In addition, since Forklift #2 was sold for \$13,000, the federal return would have reported a gain of \$3,000. However, because it had a greater cost basis for state tax purposes, an entry should be made on Schedule J, Line 17 for the excess gain from the basis adjustment resulting from Tennessee permanently decoupling from federal bonus depreciation.
- The loss for state tax purposes is \$1,000 (\$13,000 received - \$14,000 state basis). The Schedule J, Line 17 *deduction* adjustment should reflect the reversal of the federal gain and replacement with the state loss. Schedule J, Line 17 would report \$4,000 (reversal of federal \$3,000 gain plus addition of \$1,000 state loss). The amounts reported on the Schedule J lines for this example are as follows:

<b>Schedule J Lines:</b>	<b>Amount:</b>
Add-back (Ln. 3)	\$6,000
Deduction (Ln. 16)	\$2,000
Excess G/L (Ln. 17)	\$4,000

#### **4. Addition – Gain on the Sale of a Distributed Asset**

Schedule J, Line 4 represents any gain on the sale of an asset sold within 12 months after the date of distribution to a nontaxable entity. Generally, the entity that distributed the asset is the entity that should report the gain. If an asset was distributed to a member, partner, shareholder, or certificate holder and no sale has taken place, or if the asset was sold 12 or more months after distribution, no entry is required. **Failure to report this gain may result in a 50% negligence penalty.**

### *Gain Reportable by Entities Not Normally Subject to Tax*

Prior to July 1, 2004, Tennessee law permitted taxpayers to distribute assets to a nontaxable entity (like an individual), which would in turn sell them at a gain within 12 months of the distribution. In such cases, no gain was reported by either entity. However, effective July 1, 2004, the gain on this type of transaction is subject to excise tax. The gain is taxed to either the distributing taxpayer<sup>348</sup> or the seller<sup>349</sup> (who is not normally subject to tax).

While the gain generally reverts to the taxpayer that makes the distribution, the seller may be subject to the tax if Tenn. Code Ann. § 67-4-2007(f) applies. Subsection (f) was enacted in 2004<sup>350</sup> and lists four criteria under which the gain is taxed to a seller that is not normally subject to tax:

- The distributor ceases to exist prior to a sale that occurred within 12 months of the distribution. For example:
  - Taxpayer XYZ is owned by Mr. Clark. All company assets are distributed to Mr. Clark in a liquidating distribution and the business is closed. As a result, Taxpayer XYZ is no longer subject to the franchise and excise tax. Mr. Clark sells a tractor that he received in the XYZ asset distribution at a \$1,000 gain within 12 months of the distribution. Generally, individuals are not subject to the excise tax; however, because Taxpayer XYZ no longer exists, Mr. Clark is subject to a 6.5% excise tax on the gain (\$65), and he must file Form FAE170 to pay the tax.<sup>351</sup>
- The nontaxable seller received the asset through a merger, liquidation, or similar event with the taxpayer within 12 months of the sale.
- The seller qualified for exemption as an obligated member entity within 12 months of the sale.
- The asset was distributed by an affiliate subject to tax during the 12 months prior to the sale by the nontaxable entity.

[Important Notice #08-06](#) explains the taxability of distributed assets and why, in some cases, an otherwise nontaxable entity or individual should file Form FAE170.<sup>352</sup> These four situations are discussed in more detail in the paragraphs that follow.

#### A) *Ceases to Exist*

If a taxpayer distributes an asset to an entity not subject to the excise tax, which then sells the asset within 12 months of the distribution at a gain, and the original distributing taxpayer does not exist at the time of the asset sale, the gain from the sale would be taxed to the selling entity that is normally not subject to excise tax.<sup>353</sup>

#### B) *Merger or Liquidation*

Usually a merger, liquidation, or similar event results in one entity surviving and one terminating. The surviving entity will be the one that makes the sale within the 12-month period. If the survivor is a taxable entity, the asset sale would be automatically included in the taxpayer's net income; no Schedule J adjustment would be needed. However, even if the survivor is normally a nontaxable entity, it would be subject to tax on the gain from the asset sale.<sup>354</sup> See [Revenue Ruling 11-53](#) for a more detailed example.

#### C) *Obligated Member Entity*

If a taxpayer distributes assets to an obligated member entity ("OME") that sells them for a gain, the gain would *not* be taxable to the OME if it had qualified for the exemption *more* than 12 months prior to the sale. Note that the 12-month period in this subsection refers to when exempt status was given and not the distribution date.<sup>355</sup> For example:

- An LLC qualifies for the OME exemption on December 31, 2016. A taxpayer distributes an asset to the OME on January 1, 2018, and the OME sells the asset that same day at a gain.
- The OME does not have to pay tax on the gain, because it did not qualify for the exemption within the 12-month period immediately prior to the sale.
- Nonetheless, the gain from the sale does not go untaxed. Tenn. Code Ann. § 67-4-2006(b)(1)(I) would require the distributing taxpayer to pay the tax, because the asset was sold within 12 months of the distribution to a nontaxable entity. Revenue Ruling 08-20 provides guidance on Tenn. Code Ann. § 67-4-2007(f)(1)(C) concerning the taxation of OMEs.

#### D) *Affiliate Distributes Asset*

This last section criterion<sup>356</sup> specifically identifies the distributing entity as an affiliate, but it does not specify that the distributing affiliate ceases to exist. Thus, both Tenn. Code Ann. §§ 67-4-



2006(b)(1)(I) and 67-4-2007(f)(1)(D) could potentially apply to the same fact scenario, but under § 2006(b)(1)(I), the gain would be taxed to the *distributing* entity and under § 2007(f)(1)(D), the gain would be taxed to the *selling* entity.

Therefore, if a taxpayer distributes an asset to an entity not subject to tax, and that entity sells the asset at a gain within 12 months of the distribution, the gain would be reported as an add-back on the distributing taxpayer's return.<sup>357</sup> However, if the tax is not collected from the distributing entity, regardless of the reason, Tenn. Code Ann. § 2007(f)(1)(D) permits the collection of the tax from the seller that is normally not subject to tax. In no event may the tax be imposed twice or imposed on an entity with a not-for-profit status.

### *Distributions Reported on Federal Income Tax Returns*

Taxpayers report distributions made during the tax period on their respective federal income tax return Forms 1065/1120/1120S, page 5, Schedule M-2. Schedule M-2 only informs the reader that a distribution was made for a certain amount. The auditor would need to evaluate additional information before concluding that the provisions of this section apply.

## **5. Addition – Tennessee Excise Tax Deducted on Federal Return**

Schedule J, Line 5 represents Tennessee excise tax deducted on the federal income tax return, which must be added back for excise tax purposes. Only the Tennessee excise tax (not the franchise tax) is added back. The amount reported is the amount that was actually deducted in determining federal net earnings.<sup>358</sup>

In the case of an audit, the add-back for excise tax does *not* come from the actual tax payments made during the audit period. The add-back is solely based on the excise tax deducted on the federal tax return for the tax period. For example:

- An accrual basis taxpayer may accrue excise tax expense on December 15, 2014, for the 2014 tax period, but make the actual tax payment in 2015.
- The add-back should be reported in the same year in which it was deducted on the federal return. Since the taxpayer maintains its book and tax records on an accrual basis, the deduction would have been reflected on its 2014 tax return.

An over-accrual of tax in a prior year can cause the current year's federal return to report a negative "deduction." In this event, the amount reported as an add-back on Schedule J, Line 5 can be negative. Tennessee excise tax refunds are excluded from net income to the extent they have been included in federal taxable income in the year of the refund.

Taxpayers often accrue both the franchise and excise tax liabilities in one journal entry that posts to a single "state tax expense" account. The portion representing the excise tax expense add-back can sometimes be found in the taxpayer's supporting work papers, but if it is not, the auditor may use their judgment based on the facts and circumstances to determine an appropriate add-back amount.

## 6. Addition – Gross Premiums Tax

Schedule J, Line 6 represents the gross premiums tax ("GPT") paid by the taxpayer. GPT is paid to the Department of Commerce and Insurance by self-insurers of workman's compensation. The amount at issue is always net of the .4% TOSHA surcharge. Not all taxpayers paying the GPT are required to make the Schedule J add-back, only those claiming the GPT credit on Form FAE170, Schedule D, Line 1. Taxpayers are given the *choice* of either taking the *deduction* (as shown on their federal income tax return) or taking the franchise and excise tax *credit*. Auditors that see an entry on Schedule D, Line 1 should make sure the same amount is shown as an add-back on Schedule J, Line 6.<sup>359</sup>

### *Actual Premiums Tax before Surcharge that Corresponds to the Franchise, Excise Tax Period*

The GPT credit and corresponding Schedule J adjustment should be based on the self-insurance premium tax invoice amount, regardless of when the actual cash outlay was made. Even though premiums are billed and paid in advance, taxpayers should base their credit on the invoice from the Department of Commerce and Insurance for the period that corresponds with the tax year of their franchise and excise tax return. Taxpayers will receive numerous invoices from the Department of Commerce and Insurance during a given year, so auditors should match the amount to the correct invoice. The invoices may report estimated numbers, actual numbers, and TOSHA surcharge amounts. Only the "actual" tax amount *before* the .4% TOSHA surcharge should be used for the credit.

## 7. Addition – Interest Income of States and Political Subdivisions

Schedule J, Line 7 represents interest income on obligations of states and their political subdivisions. Interest income on obligations of states and their political subdivisions, less allowable amortization, is exempt from federal income tax but not Tennessee excise tax.

Therefore, this type of interest (net of amortization) is entered on Schedule J, Line 7 as an add-back.<sup>360</sup>

### *Federal Forms and Schedules*

The add-back amount may be found in several places on federal forms and schedules:

- Federal Schedule M-1, Line 7 “tax-exempt interest” is recorded as a reconciling item between book and tax income.
- Federal Schedule M-3, Part II, Line 13.
- Federal Form 8916-A, Part II, Line 1. Form 8916-A is a supporting schedule to Schedule M-3, and it must be filed for each separate entity that is required to file a Schedule M-3. Tax-exempt interest income is reported on this line.
- Federal Form 1120, Schedule K, Line 9, “tax-exempt interest received or accrued.”
- Partnerships report tax-exempt interest income on federal Form 1065, Schedule K, Line 18a.
- S-corporations similarly report tax-exempt interest income on Form 1120S, Schedule K, Line 16a.

Federal Form 8916-A, Part III, Line 4 is where expenses related to tax-exempt interest may be reported along with other interest expenses. Auditors should not assume that all interest expense reported on Line 4 should be netted against the tax-exempt interest income add-back. Only “interest expense disallowed for federal purposes pursuant to 26 U.S.C. [I.R.C.] §§ 265 and 291” should be netted against the interest income.<sup>361</sup>

### *Amortization of Bond Premium*

If a bond yields tax-exempt interest, any *premium* must be amortized for federal income tax purposes. For example: a bond with a maturity value of \$1,000 bought for \$1,050 would have a \$50 premium. The premium is part of a bond’s basis. This generally means that each year, over the life of the bond, a part of the premium is used to reduce the interest income amount. If the bond yields tax-exempt interest income, this amortized amount is not deductible in determining

federal taxable income. However, each year, the basis of the bond and tax-exempt interest income are reduced by the bond premium amortization for the year.<sup>362</sup>

For federal income tax purposes, both the tax-exempt interest income and the related amortization are excluded from taxable income. This income and related expense are not excluded for Tennessee excise tax purposes. Therefore, the exempt federal interest income amount, *net of amortization expense*, is reported as an add-back on Schedule J.

### *Expenses Incurred in Connection with Assets Producing Tax-exempt Interest*

Generally, a non-bank taxpayer cannot deduct expenses or interest incurred in connection with acquiring or carrying assets that produce tax-exempt interest. This rule was designed to prevent taxpayers from excluding from taxable income the interest income earned on tax-exempt securities while at the same time deducting interest expense used to purchase these investments.

Banks were not initially subject to these rules, but they are now, with one exception. None of the interest expense incurred to carry or purchase tax-exempt obligations is deductible unless it is a “qualified tax-exempt obligation,” also known as a “bank qualified obligation.” Financial institutions can deduct 80% of the interest expense to carry or acquire “bank qualified obligations.”<sup>363</sup>

### *Net Adjustment – Excise Tax*

The excise tax add-back for tax-exempt interest income recognizes that taxpayers may have been denied deductions related to the tax-exempt interest on their federal returns, as discussed above. Therefore, the add-back for excise tax purposes should reflect the federal tax-exempt interest income *net of the related expenses that are disallowed for federal income tax purposes*.

## **8. Addition – Depletion**

Schedule J, Line 8 represents the difference between “percentage” and “cost” depletion and is reported as an add-back on this line. This number will be included in the amount reported on federal Schedule M-1, Line 8 or M-3, Part III, Line 30 as a difference between book and tax income.

Capital assets and natural resources are not fully expensed when purchased. The wear, tear, and exhaustion of capital assets are deducted over several years as depreciation expense.

Similarly, the diminishing of natural resources is deducted over several years as *depletion expense*. *Depletion* is a deduction that recognizes the exhaustion of natural resources, such as mines, wells, and timberlands. Tennessee permits a deduction for “cost” depletion, but not for “percentage” depletion, so any deduction for “percentage” depletion in excess of “cost” depletion must be added back on Schedule J, Line 8.<sup>364</sup>

### Annual Federal Election

For federal tax purposes, taxpayers annually choose between two depletion methods, cost or percentage depletion. Each year, the taxpayer’s cost basis of the property is reduced (but not below zero) by the amount of depletion deducted for that year. Depletion expense is an estimate, because the total number of units of the natural resource owned is itself an estimate. Calculations under the two methods are as follows:

- *Cost depletion* – Estimate the total units (tons, gallons, barrels) of the natural resource owned, and then divide the total cost by the estimated number of units to arrive at the cost per unit. The number of units extracted/used multiplied by the per-unit cost equals the annual depletion expense. *The expense ends once the cost less depletion reaches zero.*
- *Percentage depletion* – This depletion is based on gross income from the property, rather than its cost. To calculate percentage depletion expense, multiply the gross income from the property by the depletion percentage for a specific mineral. The percentage factor varies according to the type of mineral (e.g., 5% for gravel, 15% for gold, etc.). Because this method is based on gross income rather than cost, it is possible for percentage depletion to exceed the cost basis of the asset. The asset’s basis is reduced by the amount of depletion taken until the basis of the property reaches zero. *However, percentage depletion may continue, even after “zero basis” has been reached.*

### GAAP Depletion

GAAP requires that a method like the “cost depletion” method mentioned above be used for financial reporting purposes. The book versus tax difference in depletion expense is reported on federal Schedule M-3, Part III, Line 30. If the taxpayer has elected to use percentage depletion, the Schedule M-3 difference amount is also the difference between cost and percentage depletion, which is an add-back for Tennessee excise tax purposes. This will always be a positive amount because, for federal reporting purposes, the taxpayer is required to use the method resulting in a greater depletion expense.

### *Tennessee Law – Depletion*

Tennessee law does not specifically mention depletion, but requires a deduction taken under 26 U.S.C. §§ 611-617, when “added with similar deductions in prior years, [to] exceed the cost of the property.”<sup>365</sup>

For Tennessee audit purposes, annual cost depletion is allowed because it meets the above requirement, whereas this is not always true for percentage depletion. Auditors should report as a Schedule J add-back the excess of percentage depletion over cost depletion. This difference will be found on federal Schedule M-1, Line 8 or federal Schedule M-3, Part III, Line 30.

### **9. Addition – Excess Fair Market Value over Book Value of Property Donated**

Schedule J, Line 9 represents non-cash charitable contributions to the extent that the fair market value of the property exceeds its book value. For excise tax purposes, only the book value of property donated to charity is allowed as a deduction in determining net earnings subject to excise tax.<sup>366</sup> *Book value* in this case is the tax basis of the asset, which is generally the asset’s cost less accumulated depreciation.

The adjusted federal income or loss reported on Schedule J, Line 1 may include a federal deduction for a non-cash charitable contribution, which has been adjusted to fair market value. Both the federal income tax deduction and the GAAP expense<sup>367</sup> will generally include a fair market value adjustment where a donated asset’s fair market value exceeds its book value. However, for excise tax purposes, the deduction is limited to the asset’s book value. The excess of the fair market value over the book value of the donated property must be reported as an add-back on Schedule J. Inventory is a common example of donated property that has a book value different from its fair market value.

Both GAAP and tax guidance provide for a fair market value adjustment to the charitable contribution expense/deduction. The GAAP guidance is found at ASC 720-25 and the tax guidance is found at I.R.C. § 170, but none of the fair market value adjustments permitted by this guidance are permitted for excise tax purposes. The Schedule J add-back is not the difference between the book expense and the tax expense but is the difference between the tax basis fair market value and the tax basis book value of the donated asset.

### *Federal Form 8283*

Federal Form 8283 reports information about noncash charitable contributions. This form provides detailed information concerning donated property, including the donor's tax cost basis and fair market value. Taxpayers may not be consistent in how they complete Form 8283 or the numbers that they report in columns a and d of the Schedule M-3, Part III, Line 19, "Charitable contribution of cash and tangible property." However, when Form 8283 is filed, auditors should always consider whether the federal deduction amount includes an amount that represents a fair market value over book value of donated property—the excise tax add-back.

**⚠ Taxpayers filing Form 8283 may be asked to provide additional information concerning any noncash donations. This may include the book and tax journal entries recording the transaction(s), including any fair market value adjustments. Also, a schedule reconciling the donated property's book value to the tax deduction may be requested.**

### *IRC § 170*

The Tennessee charitable contribution deduction for excise tax purposes conforms to I.R.C. § 170, except for:

- percentage limitations (discussed at Schedule J 4, Lines 5, 8), and
- the valuation of non-cash donations.

I.R.C. § 170 has many provisions and Tennessee conforms to all of them, except as noted above. For example, political contributions expensed under GAAP are not deductible for federal income tax purposes or for excise tax purposes.

### **10. Addition – Excess Rent to/from an Affiliate**

Schedule J, Line 10 represents the amount of rent that is deducted on the corresponding federal income tax return in excess of "reasonable rent" for real property owned by an affiliate<sup>368</sup> and must be added back on this line. Additionally, a taxpayer receiving excess rent, to the extent that it is added back to net earnings by its affiliate, may enter a negative amount on this line.<sup>369</sup>

"Reasonable rent" is rent that does not exceed 2% per month of the appraised value of the property for property tax purposes. The rent must be for "industrial and commercial property," which includes "all property of every kind used, directly or indirectly, or held for use, for any

commercial, mining, industrial, manufacturing, trade, professional, club whether public or private, nonexempt lodge, business, or similar purpose, whether conducted for profit or not” and includes real property with two<sup>370</sup> or more rental units used for dwelling purposes.<sup>371</sup>

**⚠ If a taxpayer fails to make this adjustment, and the failure is determined to be due to negligence, a 50% negligence penalty may be assessed.**

*Example – Excess Rents*

A.C.M.E., Inc. rents commercial buildings and equipment to its affiliates (greater than 50% owned). Excess rents do not apply to personal property, so columns (e)-(g) of the chart below are marked “n/a” for Skip’s Pizza, Inc. The remainder of the chart shows that the rents that Van’s Floral and Sandy’s, Inc. paid to A.C.M.E were excessive. In other words, their monthly rent expense was greater than 2% of the property’s appraised value. Column (f) of the chart shows one month’s excessive rent and column (g) shows the Schedule J add-back for the entire year, assuming the property was rented all year. Van’s Floral would report \$1,200 on Schedule J, Line 10 and Sandy’s would report \$120,000. Since Van’s Floral and Sandy’s were partially denied their rent expense deduction, A.C.M.E. can adjust its corresponding rental income. A.C.M.E. would report a negative \$121,200 on Schedule J, Line 10.

Affiliate Name (a)	Property & Location (b)	Appraised Value (c)	Monthly Rent (d)	2% of Col. (c) (e)	Excess rent (d) less (c) (f)	Schedule J Add-back (g)
Skip’s Pizza, Inc.	Oven - Paris	20,000	350	n/a	n/a	n/a
Van’s Floral, LP	Shed - Norris	30,000	700	600	100	1,200
Pand Music, Inc.	Bldg. - Erin	2 million	25,000	40,000	n/a	n/a
Sandy’s, Inc.	Bldg. - Erin	1 million	30,000	20,000	10,000	120,000

**11. Addition – Net Loss or Expense Received from a Pass-through Entity Subject to the Excise Tax**

This line applies to situations where a taxpayer owns a pass-through entity that is also subject to the excise tax and is filing an excise tax return. Without this add-back line, the benefit of a net loss or expense attributed to a pass-through entity could potentially be recognized once by the pass-through entity and again at the owner level.



The federal income tax return of the owner will include the owner's share of the items of income or loss from the pass-through entity (as reported on federal Schedule K-1). Because the Tennessee excise tax computation begins with federal taxable income, Schedule J, Line 11 reverses out losses and expenses from pass-through entities that are themselves subject to excise tax and filing an excise tax return. In addition, this same concept would also apply to income or gains from pass-through entities. Schedule J, Line 25 reverses the portion of the pass-through entity's gains and net income received by the taxpayer and included on its federal return.

*Lower-tier pass-through entity is not subject to franchise and excise tax or is exempt from tax*

If a franchise and excise taxpayer receives pass-through income or loss from an entity that is not subject to the excise tax, then the pass-through income/loss is **not** reversed out in arriving at the taxpayer's Tennessee taxable income. For example, a general partnership issues a Schedule K-1 to a Tennessee taxpayer filing a franchise and excise tax return. No Schedule J reversals are made on the taxpayer's return because the general partnership is not subject to the tax.<sup>372</sup> In addition, if the lower-tier entity is not subject to excise tax because the entity has qualified for a franchise and excise tax exemption under Tenn. Code Ann. § 67-4-2008, the pass-through income or loss should **not** be reversed out on the taxpayer's return.

There is a limited exception to the default position that a taxpayer does not reverse out of its excise tax base pass-through income or loss received from a lower-tier pass-through entity that is not subject to, or is exempt from, the excise tax. This exception applies to a situation where the lower-tier pass-through entity is a partially-exempt obligated member entity.<sup>373</sup> For example:

- Obligated Member Entities ("OME") are LLCs, LPs, or LLPs that would otherwise be subject to the tax, but they qualify for the OME exemption if all of the members or partners of the entity are fully obligated for the entity's debts and obligations. As a result, the exempt OME does not have to file a franchise and excise tax return, but instead is required to file the Annual Exemption Renewal (Form FAE 183).
- To the extent that any obligated member, or any owner of an obligated member, is a type of entity that provides limited liability protection, the obligated member entity will owe franchise and excise tax on the portion of income and equity attributable to such obligated member.<sup>374</sup> In this situation, the OME is only partially-exempt from the tax (see Chapter 2 of this manual for an in-depth discussion on partially-exempt OMEs).

- A franchise and excise taxpayer that is an owner of a partially-exempt OME *should* reverse out any pass-through income or loss received from the OME, as evidenced by the Schedule K-1 received from the OME, on the owner's return. The owner is permitted to make the pass-through reversal adjustment in this limited instance because the OME will be required to file an excise tax return and report and pay excise tax on the portion of its income or loss that is attributed to the owner, which is also subject to excise tax.

#### *Audit procedures when a taxpayer owns an interest in a pass-through entity<sup>375</sup>*

- Obtain copies of all Schedule K-1s received by the taxpayer for the audit period. If this is overly burdensome on the taxpayer, obtain a listing of all pass-through entities owned by the taxpayer that includes their names and FEINs.
- Determine which pass-through entities are subject to and filing a Tennessee excise tax return by reviewing the Department's internal records (TR3) to confirm this information.
- General partnerships do *not* pay franchise and excise tax; their pass-through income (loss) is subject to tax at the first level of ownership by an entity that is subject to the tax.
- An entity claiming a tax exemption under Tenn. Code Ann. § 67-4-2008, such as a venture capital fund or family-owned noncorporate entity, is not subject to excise tax and does not file an excise tax return. If the exempt entity is an LLC or partnership, its partners/members would **not** reverse the pass-through items on their returns.
- Pass-through reversal adjustments are not applicable to entities that are subject to the franchise tax but not the excise tax. In other words, a pass-through entity that pays only the minimum \$100 franchise tax because it is registered with the Tennessee Secretary of State does not meet the requirement of a taxpayer that is subject to and filing a Tennessee excise tax return.
- Entities that file a franchise and excise tax return and claim exemption from the excise tax under P.L. 86-272 do not meet the "subject to and filing" criteria for excise tax purposes, and their pass-through activity should *not* be reversed out on Schedule J, Lines 11 and 25 of the owner's franchise and excise tax return.
- Pass-through entities with all "In Tennessee" apportionment factors of zero are presumed not to be doing business in Tennessee and, therefore, are not deemed to be

subject to the excise tax. In this case, no amount should be reported by the owner on Schedule J to reverse out pass-through amounts received from such entities.

- Verify the accuracy of the amounts reversed on Schedule J, Lines 11 and 25. Determine that any pass-through amount reversed was in fact included in the taxpayer's federal return taxable income. Because pass-through entities are subject to excise tax on a separate-entity basis, the state does not tax the pass-through income again at the owner level. Auditors should verify that the adjustment only reverses an amount already included in the taxpayer's net income/loss. Generally, the flow-through amounts will be reported as "other income or loss" on the owner's federal income tax return. This would be Lines 10 (income) and 26 (loss) on federal Form 1120 and Line 7 on Form 1065. Pass-through amounts from Schedules K-1 retain their character, so interest income, capital gains, etc. will be reported on the appropriate lines of the recipient's income tax return.

Taxpayers will sometimes erroneously include 100% of the pass-through entity's income/loss on the Schedule J reversal lines instead of their distributive share, as shown on Schedule K-1. Generally, the amounts reported on Schedule K-1 are computed by multiplying the pass-through entity's total amounts on Schedule K by the partner's ownership percentage, but this is not always the case (a method other than percentage ownership may be used).<sup>376</sup> For excise tax purposes, it is always best to obtain a copy of the Schedule K-1 issued to the taxpayer, trace the items of income/expense to the taxpayer's federal income tax return, and then allow the reversals on Schedule J if the pass-through entity was itself subject to the excise tax.

Sometimes, taxpayers will correctly report a gain or income from a pass-through entity and claim a deduction on Schedule J, Line 25 in a given year, but in another year, fail to report an add-back for a loss or expense from a pass-through entity. For this reason, it is important for auditors to not only verify the numbers reported on the excise tax return but to also look for the omission of add-back amounts.

## **12. Addition – Amount Equal to Five Percent of IRC Section 951A Global Intangible Low-Taxed Income (GILTI)**

Please see the Tax Cuts and Jobs Act of 2017 section below for a discussion of global intangible low-taxed income ("GILTI"). The amount entered on Schedule J, Line 12 is equal to five percent of the amount deducted on Line 27, without regard to any deduction taken under IRC §250.<sup>377</sup>

### 13. Addition – Business Interest Expense Addback

Tennessee followed the federal Tax Cuts and Jobs Act of 2017 amendment that limited deductible interest under IRC §163(j) for tax years beginning after December 31, 2017, and before January 1, 2020. **For tax years beginning on or after January 1, 2020, the state has decoupled from this federal limitation.** The addback line on Schedule J, Line 13 and the deduction line on Schedule J, Line 28a serve to fully reverse the federal business interest expense deducted in arriving at the net earnings reported on Schedule J, Line 1 and to report the deductible amount for excise tax purposes. The amount reported on Schedule J, Line 13 is the total business interest expense deducted in arriving at the federal taxable income or loss reported on Schedule J, Line 1.

**Schedule J, Line 13 is only completed by taxpayers that file federal Form 8990. For Tennessee excise tax purposes, the taxpayer might have to prepare a pro forma Form 8990 due to the following:**

- For federal income tax purposes, a single business interest expense limitation is applied to a consolidated group of corporations that files a consolidated federal income tax return.
  - For excise tax purposes, the federal consolidated group’s business interest expense deduction must be [allocated](#) to each group member that incurred business interest expense during the tax year.
- Partnerships do not maintain business interest expense deduction carryforwards at the partnership level for federal income tax purposes; instead, the partnership passes such carryforwards through to its partners.
  - For excise tax purposes, these carryforwards should be maintained at the partnership level, and a partner who is subject to excise tax generally will *not* include its share of a partnership’s business interest expense attributes in the partner’s excise tax base unless the partnership is *not* filing a Tennessee excise tax return.

Small business taxpayers having annual gross receipts of \$27 million<sup>378</sup> or less for the prior three tax years generally will not file federal Form 8990, and they would not enter anything on Schedule J, Lines 13 or 28. Please see the Tax Cuts and Jobs Act of 2017 section below for additional discussion of the federal business interest expense limitation.

#### **14. Addition – Research & Development Expenditures (IRC §174)**

Report on Schedule J, Line 14 all research and development (experimental) expenditures deducted under IRC §174 in arriving at the taxpayer's federal taxable income reported on Schedule J, Line 1.

For tax years beginning on or after January 1, 2022, Tennessee has decoupled from Internal Revenue Code Section 174, as amended by the federal Tax Cuts and Jobs Act of 2017. As a result, taxpayers may continue to immediately deduct research and development expenditures as paid or incurred during the tax year.<sup>379</sup> Taxpayers will deduct such expenditures on Schedule J, Line 29. For additional information, see the Tax Cuts and Jobs Act of 2017 section below.

#### **15. Total Additions**

The total additions amount reported on Schedule J, Line 15 includes the statutory add-backs that apply to all entity types. Adjustments that apply to specific entity types are reported on the applicable Schedules J1, J2, J3, or J4.

#### **16. Deduction – Permitted Depreciation**

Schedule J, Line 16 represents depreciation under the provisions of IRC § 168 permitted for excise tax purposes due to Tennessee permanently decoupling from federal bonus depreciation. See the previous *Schedule J, Line 3* section (on the corresponding add-back) for a complete discussion of the Schedule J depreciation-related adjustments.

“Bonus depreciation” accelerates the depreciation deduction by allowing a greater deduction in the initial year the asset was placed in service. Consequently, a lesser deduction is claimed in subsequent years. Since Tennessee does not allow the deduction for federal bonus depreciation, the state deduction will be less than the federal deduction in the initial year and greater in subsequent years. Schedule J, Line 3 is used to report the federal versus state depreciation adjustment in year one, and Line 16 is used to report this difference in later years. However, as discussed previously, taxpayers may report the depreciation adjustments in different ways.

#### **17. Deduction – Excess Gain/Loss on Asset with Bonus Depreciation**

Schedule J, Line 17 represents the excess gain (or loss) reported for federal income tax purposes that results from Tennessee permanently decoupling from federal bonus depreciation. This subtraction is the difference between an asset's higher Tennessee basis and its lower federal basis (resulting from bonus depreciation taken on the federal return but disallowed on the state

return). Note that the taxpayer may *not* make an adjustment on this line to deduct depreciation relating to any period during which the taxpayer was *not* subject to this state's excise tax but took depreciation deductions for federal income tax purposes.<sup>380</sup> For an in-depth example of this concept, see *Hilloak Realty Co. v. Chumley*, 233 S. W. 3d 816 (Tenn. Ct. App. 2007).

See also the depreciation discussion under the previous *Schedule J, Line 3* section for examples of assets on which bonus depreciation was taken and which were disposed of before being fully depreciated.

### 18. Deduction – Dividends Received from 80%-owned Corporations

Schedule J, Line 18 represents all dividends received from corporations that are at least 80% owned.<sup>381</sup> Dividend income is found on federal Forms 1120, page 1, Line 4 and 1065, page 4, Schedule K, Line 6. Additionally, the same amount is reported on Form 1120, page 2, Schedule C, Line 23. Partnership returns do not have a federal Schedule C, but instead report the additional dividend information on an attachment to federal Schedule K.

All taxpayers may deduct dividends received from corporations in which they own 80% or greater of their stock. While federal Form 1120, Schedule C provides information concerning the percentage of stock ownership, it may not provide sufficient information to determine if the 80% test has been met. The auditor should obtain federal Form 851 – Affiliations Schedule – for additional ownership information. As an alternative, auditors could obtain an organization chart that shows ownership percentages.

**⚠ The dividends received deduction does NOT apply to indirect dividends. See Revenue Ruling 19-02 for a comprehensive, fact-based example.**

The deduction is for taxpayers that have a direct ownership interest in the entity from which they are receiving a dividend, regardless of the fact that the dividend payout process may have started with a lower-tier entity.

A “gross up” dividend is fictitious income (never paid nor received by the taxpayer) that is reported on federal Form 1120, Schedule C, Line 18 and is included in dividend income on the federal return. If this amount comes from stock ownership meeting the 80% test, then it can be deducted as such. If the 80% test is not met, it can be shown as non-business income. Either way, it is deducted for excise tax purposes. The preferred treatment is to report a “gross up” dividend on excise tax Schedule M – Nonbusiness Earnings Allocation.

A “Subpart F” dividend is not fictitious but is deferred income based on foreign profits and is reported on federal Form Schedule C, Line 16. Subpart F deemed dividend income may be deducted from the excise tax base only if it meets the 80% test or, in rare situations, is found to be non-business earnings.

If dividend income is deducted or removed from the excise tax base for any reason, then it must be added-back on Form FAE170, Schedule K, Line 2 to calculate the loss carryover available from the current year to the next year.<sup>382</sup>

The federal Tax Cuts and Jobs Act of 2017 (“TCJA”) requires taxpayers to report repatriated earnings on their 2017 and 2018 federal income tax returns. Also, Global Intangible Low-Taxed Income is reported in 2018 and later. These amounts should not be reported on Schedule J, Line 18 as dividends received. However, there is an exception related to the 2017 tax year for repatriated earnings, which is explained in [Important Notice #18-05](#). See the *Tax Cuts and Jobs Act of 2017 (TCJA)* section below for additional information.

### **19. Deduction – Donations to Qualified Public School Support Groups and Nonprofit Organizations**

Schedule J, Line 19 represents donations to qualified public school support groups and nonprofit organizations. All taxpayers may deduct charitable contributions from their Tennessee taxable income in the year in which the contributions were made. In addition to the normal charitable contribution deduction, taxpayers may also deduct 75% of monetary contributions made to qualified public school support groups and other nonprofit organizations if certain requirements are met. Therefore, a taxpayer may potentially deduct 175% of certain monetary contributions in arriving at Tennessee taxable income.

The primary requirements for the additional 75% deduction are:

- The receiving entity is not an individual but is an entity whose sole purpose is to promote and enhance Tennessee *public schools or any nonprofit organization* exempt from federal taxation under 26 U.S.C. §§ 501(c)(3), 501(c)(4), 501(c)(5).<sup>383</sup>
- The taxpayer has a [certification form](#) signed by the recipient certifying that the donated funds were spent on goods or services subject to sales and use tax and that the tax was actually paid.<sup>384</sup>
- The taxpayer/donor did not specify a specific purpose for the donation.

Auditors should review the taxpayer's certification form(s) in support of the deduction. If the nonprofit organization or public school support group makes a false certification, it must pay sales or use tax and any applicable penalties and interest, as if the donation had actually been spent on items subject to the tax.<sup>385</sup> See Important Notices # [04-17](#) and [05-04](#) for additional information.

## 20. Deduction – Federal Expense Reduction Related to Federal Credit

Schedule J, Line 20 represents expenses not deducted in determining federal taxable income, other than income taxes, for which a credit against the federal income tax is allowable.<sup>386</sup> There are numerous federal tax credits, and many of them do not result in federal or state adjustments to taxable income. Only credits that require the related expense be reduced on the federal income tax return are at issue. An excise tax deduction is reported on Line 20 when an expense is reduced for federal income tax purposes because a related credit against the federal income tax was taken. The amount of the federal credit is not necessarily the amount that is deducted on Schedule J. The excise tax deduction is *the amount that the federal expense was reduced* because the credit was taken. In the case of an audit, the auditor must read the federal instructions for the credit to determine the amount that is deducted from the federal expense, if any, because of the credit taken. Doing a search/find within the federal return instructions for “reduce” is often helpful.

Businesses typically make a federal tax journal entry to arrive at taxable income, and the difference will likely show up as a book-to-tax difference on Schedule M-3. For example, federal Form 5884 – Work Opportunity Credit – Line 2 reports the amount by which the salaries and wages expense is reduced because of the credit taken. This amount would also be reported as a permanent difference on federal Schedule M-1 or M-3 and should be reported on Schedule J, Line 20.

**⚠ Some credits reduce both expenses and capital assets. The Tennessee code specifically states that this adjustment is for an “expense” that is not deducted in determining federal taxable income, so an adjustment to an “asset” account would not qualify for the Line 20 deduction.**

On the following page is a list of several common federal tax credits, along with links to the corresponding federal forms and applicable line items.



<b>Federal Form Title – Credits</b>	<b>Federal Form:</b>	<b>See Federal Instructions for Line:</b>	<b>Line 20 Deduction Allowed?</b>
<i>Federal Form 3800 – General Business Credit – page 3 provides a list of all credits (including the following) that require a reduction to the related expense:</i>			
Credit for Federal Tax Paid on Fuels	4136	17	Yes*
Work Opportunity Credit	5884	2	Yes*
Credit for Increasing Research Activities	6765	17	Yes*
Orphan Drug Credit	8820	2a	Yes*
Disabled Access Credit	8826	6	Yes*
Empowerment Zone Employment Credit	8844	2	Yes*
Indian Employment Credit	8845	4	Yes*
Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips	8846	4	Yes*
Credit for Small Employer Pension Plan Startup Costs	8881	2	Yes*
Credit for Employer-Provided Childcare Facilities and Services	8882	7	Yes*
Low Sulfur Diesel Fuel Production Credit	8896	8 or 10	Yes*
Alternative Motor Vehicle Credit	8910	6	Yes*
Alternative Fuel Vehicle Refueling Property Credit	8911	7	Yes*
Mine Rescue Team Training Credit <i>(expired after 2020)</i>	8923	2	Yes*
Credit for Employer Differential Wage Payments	8932	2	Yes*
Credit for Small Employer Health Insurance Premiums	8941	-	Yes*
Employer Credit for Paid Family and Medical Leave	8994	1	Yes*
Federal Credit Forms – <b>No impact for TN excise tax:</b> 3468, 6478, 8586, 8611, 8834, 8835, 8847, 8864, 8874, 8900, 8906, 8907, 8908			No
*Based on a federal tax journal entry that shows the expense account ( <i>not an asset account</i> ) was reduced by the credit			

## 21. Deduction – Safe Harbor Lease

A safe harbor lease is a sale/leaseback transaction enacted by federal legislation in 1981 and repealed in 1982. It is not commonly seen on franchise and excise tax returns. The state does not recognize safe harbor leases; therefore, any federal tax journal entries made in relation to safe harbor leases should be reversed for excise tax purposes on Schedule J, Line 21.

Any amount included in federal taxable income solely as a result of a safe harbor lease election or any depreciation or other expense that could have been deducted, had it not been for a safe harbor lease election, is deductible on Schedule J. GAAP also does not recognize safe harbor leases. Book-to-tax differences will be shown on federal Schedule M-1 or M-3 and may include adjustments to rental income, sale/lease interest expense, depreciation/amortization, and brokerage fees.<sup>387</sup>

Safe harbor leases were established as part of the federal Economic Recovery Tax Act (ERTA) in 1981. This type of lease transferred tax benefits of ownership (depreciation and debt tax shield) from the lessee, if the lessee could not use them, to a lessor that could use them. The number of leases written under ERTA jumped dramatically in 1982, creating a loss in tax revenue, so Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982 to restore the lost revenue. This new act *repealed* safe harbor leasing and replaced it with the “finance lease.” The Department estimates that approximately 25 taxpayers in the state still have safe harbor leases that originated in 1981-1982.

Only three tests had to be met to qualify for a safe harbor lease:

- Lessor is a corporation;
- Lessor’s minimum investment in the leased asset is never less than 10%; and
- The term of the lease did not exceed 90% of the useful life of the asset or 150% of the present class life of the asset.

If all these requirements were satisfied, the transaction would qualify as a lease for tax purposes, regardless of other factors previously disallowed (e.g., bargain purchase options, limited-use property).

A feature of safe harbor leasing was the tax benefit transfer (TBT) lease. This enabled lessors to structure a lease with direct matching of incoming rentals and debt payments to make a single

payment to the lessee for the tax benefits. This aspect of the law quickly led to major sales of tax shelters to “nominal lessors” who were not normally in the leasing business. Several major companies did not pay taxes that year due to their tremendous participation in the TBT marketplace.

The state does not recognize safe harbor leases, and they are not commonly seen on franchise and excise tax returns. Therefore, if an old safe harbor lease from 1981 is still on the taxpayer's books, any taxpayer entries made for the safe harbor lease should be reversed for excise tax purposes. Auditors should review the book/tax journal entries concerning these leases and determine that the correct reversals have been reported on Schedule J, Line 21. If the net adjustment is an increase in taxable income, enter a negative number on this line.

## 22. Deduction – Nonbusiness Earnings

Schedule J, Line 22 represents the amount reported on Form FAE170, Schedule M, Line 8. Nonbusiness earnings are allocated and not apportioned; as such, they are removed from apportionable business income by deducting them on Line 22.<sup>388</sup> See Chapter 8, *Business and Nonbusiness Earnings*, for definitions of business and nonbusiness earnings. Nonbusiness earnings directly allocated to Tennessee are reported on Schedule M, Line 9 and then transferred to Schedule J, Line 34. To clarify, *total* nonbusiness earnings (including those directly allocable to Tennessee) are deducted on Schedule J, Line 22, and the nonbusiness earnings that are *directly allocated* to Tennessee are then added back to the excise tax base (after apportionment of business earnings) on Schedule J, Line 34.

## 23. Deduction – Intangible Expense Paid to an Affiliate

The Schedule J, Line 23 deduction for intangible expenses paid to an affiliate is only permitted *after* the taxpayer adds back the intangible expenses on Schedule J, Line 2. See the earlier discussion for *Schedule J, Line 2* above. The statutes concerning this deduction have changed several times since the initial disclosure requirement was enacted in 2004. The last major change occurred with the Revenue Modernization Act (“RMA”) in 2015. The RMA repealed previous statutes that required taxpayers to use Form IE-A and IE-N. Those forms became obsolete for tax periods beginning on or after July 1, 2016. The current form used by taxpayers to report intangible expenses is [Form IE](#). This form must be completed and attached to the franchise and excise tax return before claiming a deduction for intangible expenses paid, accrued or incurred to an affiliate.

Tenn. Code Ann. § 67-4-2006(b)(2)(N) states the intangible expense paid to an affiliate may be deducted when the expense has been disclosed on a new disclosure form and either:

- The affiliate receiving the intangible income is filing and paying the franchise, excise tax; or
- The affiliate receiving the intangible income is located in a foreign nation that is a signatory to a comprehensive income tax treaty with the United States or the affiliate is otherwise not subject to the excise tax.

The auditor may verify that the affiliate receiving intangible income is filing a franchise and excise tax return or is located in a foreign nation that is a signatory to a comprehensive income tax treaty with the U.S. or is otherwise not subject to the tax. The RMA made audit procedures easier, because under economic nexus, affiliates receiving intangible income will generally be subject to franchise and excise tax. Auditors may verify that the expense amount reported by one affiliate agrees with the intangible income amount booked by another affiliate.

In addition to the earlier discussion regarding intangible expenses:

- [Important Notice #17-27](#) explains changes to intangible expense reporting resulting from the Revenue Modernization Act, effective July 1, 2016, and links to the current form used to report intangible expenses, Form IE.
- [Important Notice #12-16](#) discusses the intangible expense deduction approval process for tax periods ending on or after July 1, 2012, until June 30, 2016. This notice includes discussion of Forms IE-N and IE-A.

#### 24. Deduction – Intangible Income from Affiliate

If a taxpayer accrues or earns intangible income in connection with a transaction with another affiliate that is also subject to the excise tax, the taxpayer may deduct such intangible income on Schedule J, Line 24, **but only if the corresponding intangible expense has been added back on Schedule J, Line 2 of the other affiliate's excise tax return and the affiliate *does not* subsequently deduct the intangible expense on Schedule J, Line 23.** In other words, the taxpayer will be eligible to deduct intangible income, to the extent included in its net earnings on a separate entity basis, received from an affiliate that is subject to the excise tax if the affiliate's corresponding intangible expense deduction is disallowed as the result of an audit conducted by the Department. Otherwise, a paying affiliate *must* deduct a valid, properly-disclosed intangible expense on its excise tax return and the receiving affiliate *must* report the corresponding intangible income on its excise tax return and may not deduct such income from its excise tax base. In either case, the net tax effect between the two affiliates cancels one another out.<sup>389</sup>

## **25. Deduction – Net Gain or Income Received from a Pass-through Entity Subject to the Excise Tax**

This line applies to situations where a taxpayer owns a pass-through entity that is also subject to the excise tax and is filing an excise tax return. Without this deduction line, the net income or gain attributed to a pass-through entity could potentially be recognized once by the pass-through entity and again at the owner level. The federal income tax return of the owner will include the owner's distributive share of the items of income or loss from the pass-through entity (as reported on federal Schedule K-1).

Because taxpayers calculate the Tennessee excise tax base beginning with federal taxable income, Schedule J, Line 25 reverses out activity from pass-through entities that are themselves subject to excise tax and filing a Tennessee excise tax return.<sup>390</sup>

Please see the suggested audit procedures found under the previous discussion of *Schedule J, Line 11*. Taxpayers will sometimes erroneously reverse 100% of the pass-through entity's income/loss on Schedule J instead of only the taxpayer's distributive share, as shown on Schedule K-1. Generally, the amounts reported on Schedule K-1 are computed by multiplying the pass-through entity's total amounts on Schedule K by the partner's ownership percentage, but this is not always the case (a method other than percentage ownership may be used for items specifically allocated to partners, such as guaranteed payments and net earnings subject to self-employment). For excise tax purposes, it is always best to obtain a copy of the Schedule K-1 issued to the taxpayer, trace the items of income/expense to the taxpayer's federal income tax return, and then allow the pass-through reversals on Schedule J if the pass-through entity was itself subject to excise tax.

## **26. Deduction – Deductible Grants from Governmental Units**

The federal Tax Cuts and Jobs Act of 2017 began imposing federal income tax on state grants for tax years beginning on or after January 1, 2017. Property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or to enable the corporation to expand its operating facilities, is now subject to federal income tax.<sup>391</sup> Tennessee has decoupled from this provision; thus, taxpayers should use Schedule J, Line 26 to reverse out any state grants included in federal taxable income.<sup>392</sup>

## 27. Deduction – IRC Section 951A Global Intangible Low-Taxed Income

Any global intangible low-taxed income (“GILTI”) included in Schedule J, Line 1 (adjusted federal income) is deducted on Sch. J, Line 27. The amount entered on this line is before any related IRC Section 250 deduction.

[Public Chapter 306 \(2019\)](#) imposes Tennessee excise tax on an amount equal to 5% of GILTI, before any related federal deductions. The 5% amount is reported on Sch. J, Line 12. See the Tax Cuts and Jobs Act of 2017 section below for more information on global intangible low-taxed income and see also [Important Notice #19-13](#).

## 28. Deduction – Business Interest Expense Deduction

Tennessee followed the federal Tax Cuts and Jobs Act of 2017 amendment that limited deductible interest under IRC §163(j) for tax years beginning after December 31, 2017, and before January 1, 2020. However, the state has decoupled from this federal limitation for tax years beginning on or after January 1, 2020.

For tax years beginning on or after January 1, 2020, a taxpayer will report its business interest expense deduction on Schedule J, Line 28a, but only if the taxpayer files federal Form 8990 and completes Schedule J, Line 13 of the excise tax return (see the previous section regarding Schedule J, Line 13 for an explanation of why a taxpayer might have to prepare a pro forma Form 8990 for excise tax purposes). **Taxpayers that are not subject to the federal IRC §163(j) limitation do not enter amounts on Schedule J, Lines 13 or 28.**

For excise tax purposes, the business interest expense deduction for tax years beginning on or after January 1, 2020, is:

- The *current period expense* without regard to the federal IRC §163(j) limitation; and
- Any 2018 or 2019 tax year business interest expense deduction carryforwards, to the extent deducted on the taxpayer’s current year pro forma federal income tax return.

The *current period expense* is the sum of lines 1 and 4 of the separate entity, pro forma federal Form 8990. In addition, if the taxpayer has an ownership interest in a pass-through entity that files federal Form 1065 but does *not* file an excise tax return, the taxpayer will also include its share of such pass-through entity’s current year excess business interest expense from Form 8990, Schedule A, Line 43, Column (c) on Schedule J, Line 28a.

### *Business Interest Expense Carryforwards*

The business interest expense carryforwards to be included on Schedule J, Line 28a are the carryforwards from the 2018 and 2019 tax years, to the extent they are deducted on the taxpayer's current year pro forma federal income tax return. A pro forma federal Form 8990 may be required to determine this amount.<sup>393</sup> When the "allowable business interest expense" deducted in arriving at federal taxable income exceeds the current year business interest expense on Form 8990, this evidences that a carryforward amount was utilized for federal income tax purposes. The "allowable business interest expense" amount for excise tax purposes is based on a pro forma Form 8990, Line 30, prepared without considering any amounts reported on Line 3 of the Form 8990 that are: 1) attributed to partnerships filing an excise tax return, and 2) partnerships *not* filing an excise tax return and *not* having contributed to the initial business interest expense deduction carryforward balance. A worksheet titled [Excise Tax Table of Business Interest Expense Carryforward](#) is available to establish the 2018 and 2019 carryforwards available at January 1, 2020, and to track their utilization and remaining balances. Also, an example of a completed table is included in a [tax article](#) on the Department's website.<sup>394</sup>

The [worksheet](#) is not required to be completed or submitted with the franchise and excise tax return; however, [Important Notice 20-16](#) explains that for audit purposes, taxpayers should maintain in their records information sufficient to verify the 2018 and 2019 carryforward amount(s) taken on the excise tax return, including but not limited to: total interest expense before the 163(j) limitation, interest expense deducted under the 163(j) limitation, carryforward available at the beginning of the 2020 tax year, carryforward deducted for federal income tax purposes by tax year, and carryforward balance remaining by tax year.

Tennessee taxpayers that are members of a federal consolidated group should allocate the federal consolidated group's business interest expense deduction carryforwards for the 2018 and 2019 tax years in the same manner as the [allocation](#) of the group's business interest expense deductions for these tax years. Please see [Important Notice # 19-18](#) for additional information as to how this allocation is calculated.

Any 2018 or 2019 business interest expense carryforward balances remaining for excise tax purposes, after any current year deduction, are reported on Schedule J, Line 28b.

See the Tax Cuts and Jobs Act of 2017 section below for more information on the federal interest limitation under IRC §163(j).

### **29. Deduction – Research & Development Expenditures (IRC §174)**

For tax years beginning on or after January 1, 2022, report on Schedule J, Line 29 the amount of research and development expenditures allowed by Section 174 of the Internal Revenue Code immediately before enactment of the Tax Cuts and Jobs Act of 2017. Note: The amount deducted under IRC Section 174 in arriving at the amount reported on Sch. J, Line 1 must be added back on Sch. J, Line 14. For additional information, see the Tax Cuts and Jobs Act of 2017 section below.

### **30. Calculated Amounts**

After making all the required additions to and deductions from federal taxable income, the Total Business Income (Loss) is reported on Schedule J, Line 31. The total business income is then multiplied by the apportionment ratio found on Line 32 to arrive at the Apportioned Business Income (Loss) on Line 33. If applicable, there will then be an add-back for any nonbusiness earnings directly allocated to Tennessee on Line 34 (from Schedule M, Line 9). If the taxpayer has any loss carryovers from prior years (see Schedule U), these will be deducted from the apportioned business income on Line 35. Ultimately, the amount of net earnings subject to excise tax is reported on Line 36 and is carried forward to Schedule B, Line 4.

### **Ownership of a Pass-through Entity**

A taxpayer that owns a pass-through entity that is not subject to franchise and excise tax and not filing a return, should include on its Schedule J any required add-backs and deductions associated with amounts received from the pass-through entity. The add-back and deduction provisions of the excise tax code apply to pass-through entities not doing business in Tennessee; their activities are included in the excise tax base to the extent that they are owned by an entity that is subject to excise tax and filing an excise tax return. Therefore, the Schedule J additions and deductions apply. For example:

- A Tennessee corporation owns 10% of a partnership that is not filing on its own in the state.
- The corporation would include its share of the partnership's property, payroll, and sales on Schedule N and its share of Schedule J add-back or deduction items on Schedule J.
- The partnership's tax-exempt interest income would automatically be included in the corporation's return as tax-exempt interest income; so, no additional inclusion on Schedule J would be needed.<sup>395</sup> In other words, the Schedule K-1 issued by the



partnership to the corporation would disclose the partnership's amount of tax-exempt interest income distributable to the corporation, and the corporation would include that amount as tax-exempt interest income on its federal Form 1120 (as an information item on Form 1120, Schedule K, Line 9).

- The corporation would report the tax-exempt interest income shown on Form 1120 as an excise tax Schedule J, Line 7 add-back, including the corporation's share of the partnership's tax-exempt interest income.

Partnerships' Schedule K-1 items of income and expense flow to their owners without losing their character, such as ordinary income, capital gains, contributions, and exempt interest.

Not all Schedule J add-back and deduction items are separately disclosed on a pass-through entity's Schedule K-1. For example, bonus depreciation is not separately disclosed. While it is technically correct to make the Schedule J adjustments for pass-through entities, it is sometimes impossible to do this because the Tennessee taxpayer only receives a federal Schedule K-1 and does not always have the necessary information to make such adjustments. However, in other cases, the corporation and the pass-through entity may be closely affiliated, and the necessary information might be readily available to the corporate owner.

The auditor should use their judgment in auditing this issue. If the taxpayer has made these adjustments, the auditor should verify the accuracy of the adjustments made, since they are technically correct. If the taxpayer did not consider making these adjustments, they still might have been made automatically (like the exempt interest situation previously discussed). Bonus depreciation is an add-back adjustment that will not be automatically recognized, but it is also a timing difference. Over the life of an asset, the same amount of expense will be taken whether the Schedule J adjustments were made or not. In most cases, audit work in this area will not result in a material tax impact and can be very time consuming.

### **Tax Cuts and Jobs Act of 2017 (TCJA)<sup>396</sup>**

The federal Tax Cuts and Jobs Act of 2017 ("TCJA") (enacted in December 2017) has many provisions that impact all types of taxpayers. Since the Tennessee excise tax computation begins with federal taxable income or loss, these tax reforms are embedded in the state excise tax return. Tennessee did not decouple from most of these changes. However, there are several provisions from which the state *did* decouple.<sup>397</sup> In this section, we will discuss the business expense limitation for large taxpayers, the taxability of state grants, repatriated earnings, global intangible low-taxed income ("GILTI"), and other TCJA impacts.

## 1. Business Interest Expense Limitation

Tennessee has decoupled from the federal business interest expense limitation under IRC §163(j) for tax years beginning on or after January 1, 2020. Any 2018 and 2019 tax year federal limits on business interest expense should be reflected on the excise tax returns for those tax years, because Tennessee did not decouple from the federal limitation until 2020.

IRC §163(j), as amended by the TCJA, imposes a limitation on certain interest deductions incurred by large businesses.<sup>398</sup> For most large businesses, business interest expense is limited to any business interest income plus 30 percent of the business' adjusted taxable income.<sup>399</sup> A problem exists when the franchise and excise taxpayer is included in a consolidated federal income tax return for which the federal consolidated group's business interest expense is limited. In this case, the federal limitation is computed at the consolidated group level, not the separate entity level.

Members of a federal consolidated group should allocate the federal consolidated group's business interest expense deduction among the individual group members who had business interest expense during the tax year. This allocation is made on a pro rata basis according to the amount of interest expense each group member paid to entities outside the federal consolidated group.

An individual group member's business interest expense deduction for excise tax purposes is the sum of its intercompany interest expense paid or accrued to other members of the federal consolidated group plus its allocation of the group's business interest expense deducted on the consolidated federal return. The Department has an [Excise Tax Interest Expense Worksheet](#) on its website to assist with this calculation. See also [Important Notice #19-18](#) for additional information regarding the business interest expense computation.

**⚠ Carryforward: IRC §163(j) provides that taxpayers may carry forward disallowed business interest expense deductions. For the 2018 and 2019 tax years, members of a federal consolidated group should allocate the consolidated group's carryforwards to the individual group members using the formula outlined above. Any carryforwards from the 2018 and 2019 tax years existing as of January 1, 2020, may be deducted for excise tax purposes in tax years beginning on or after January 1, 2020, but this carryforward deduction is subject to limitation.**

For tax years beginning on or after January 1, 2020, taxpayers will be allowed to fully deduct their current year business interest expense in computing their excise tax base without regard

to the federal 163(j) limitation imposed by the TCJA. In addition, any business interest expense deduction carryforwards from the 2018 or 2019 tax years that have not been deducted as of January 1, 2020, may be deducted, but only to the extent such carryforwards are deducted for federal income tax purposes. In other words, the carryforward deduction is limited in the same manner as it is for federal income tax purposes. A [worksheet](#) is available on the Department's website to assist taxpayers in establishing record of these carryforwards and subsequent utilization of the carryforwards.

The 2018 or 2019 tax year carryforward balances deductible for federal income tax purposes will be included on Schedule J, Line 28a of the excise tax return along with the current year's business interest expense. See [Important Notice #20-16](#) for information on the business interest expense carryforward allowed for excise tax purposes and the records required to be maintained by the taxpayer in deducting such carryforwards.

## 2. State Grants

The state decoupled from the TCJA provision that concerns the taxability of state grants. For federal income tax purposes, state grants are now included in federal taxable income.<sup>400</sup> The state did not adopt this provision of the TCJA. State grants are not subject to the excise tax. See Schedule J, Line 26.

## 3. Repatriated Earnings (2017)

The TCJA amended I.R.C. § 965. This section requires certain United States shareholders to pay a transition tax on the *untaxed foreign earnings* of certain specified foreign corporations as if those earnings had been repatriated to the United States. For federal income tax purposes, these deemed "repatriated earnings" are subject to a transition tax for the 2017 and 2018 tax years.

For the 2017 tax year, Corporations and S-Corporations will not report these deemed earnings on their respective federal Forms 1120 and 1120S; therefore, they will not be included in the excise tax base.

Partnerships will report repatriated earnings and the related exclusion amount on federal Form 1065. These amounts should be included in the net earnings calculation on Schedule J1. A deduction for dividends received from an 80%-or-more owned corporation may be made on Schedule J in the amount of the repatriated earnings less any exclusion amount. The partnership's apportionment formula should include repatriated earnings less the related exclusion amount and dividends received deduction. **(Note that the guidance for 2018 is completely different.)**

Finally, REITs are required to report repatriated earnings, net of any exclusion amount, on federal Form 1120-REIT as “Other Income” but can deduct them on federal Schedule A as dividends paid. As such, the net earnings calculation on Schedule J4 will include repatriated earnings less dividends paid. The amount received from an 80%-or-more owned corporation, net of any exclusion amount, may be deducted to the extent they are included on Schedule J4. The apportionment formula should include repatriated earnings less the related exclusion amount and any dividends received deduction.

Guidance for reporting repatriated earnings on a 2017 franchise and excise return is found in [Important Notice #18-05](#). **Repatriated earnings on 2018 returns are reported differently because of an amendment<sup>401</sup> to Tenn. Code Ann. §§ 67-4-2006(b)(1), (2).**

#### **4. Repatriated Earnings and Global Intangible Low-Taxed Income (GILTI) – Tax Years Beginning on or after January 1, 2018**

##### *Overview*

Both repatriated earnings (I.R.C. § 965(a)) and global intangible low-taxed income (I.R.C. § 951A) are addressed in Public Chapter 306, effective for tax periods beginning on or after January 1, 2018. Simply put, 5% of repatriated income and GILTI, before any related deductions, will be included in the excise tax base.<sup>402</sup>

The IRC Section 965(a) and 951A income is included in federal taxable income (the starting point in determining Tennessee taxable income). Franchise and excise taxpayers will reverse out these amounts in full and then add back 5% of the amounts on the excise tax return; the net effect is that only 5% of such income (before the related federal deductions) is included in the Tennessee excise tax base. The 5% is computed on the gross amount before any IRC Section 965(c) or Section 250 deductions. The Section 965(c) deduction relates to repatriated earnings.

The IRC Section 250 deduction relates to GILTI and foreign-derived intangible income (“FDII”) and is reported on federal Form 1120, Schedule C, Line 22, column (c). For federal income tax purposes, this amount is considered a special deduction and is included on Form 1120, page 1, Line 29b. The 5% add-back for GILTI is computed on Section 951A income before any deductions under Section 250.

##### *Foreign-Derived Intangible Income (“FDII”) Deduction is Allowed*

Section 250 of the Internal Revenue Code allows domestic corporations a deduction that is equal to 37.5% of its FDII plus 50% of 1) the GILTI (if any) included in the corporation’s gross income,

pursuant to IRC §951A, and 2) IRC §78 gross up dividend income relating to GILTI, for the taxable year.<sup>403</sup> At the federal level, the GILTI and FDII provisions operate in tandem with the intended purpose of encouraging U.S. multinational corporations to conduct their global business operations from the United States, rather than overseas.

Tennessee has decoupled, in part, from the federal income tax provisions relating to GILTI, including the GILTI portion of the IRC §250 deduction. Instead, for excise tax purposes, Tennessee requires the taxpayer to deduct from its excise tax base 100% of the GILTI included in the taxpayer's federal taxable income,<sup>404</sup> and add back to its excise tax base 5% of GILTI before the IRC §250 deduction.<sup>405</sup>

Although Tennessee has decoupled from the GILTI portion of the IRC §250 deduction for purposes of calculating the 5% GILTI addback, the FDII portion of the IRC §250 deduction, under IRC §250(a)(1)(A), is allowed as a deduction for excise tax purposes. For taxpayers that are taxed as a corporation for federal income tax purposes, "net earnings" or "net loss" for excise tax purposes is defined as federal taxable income or loss before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241, 242 [repealed], and 243-247.<sup>406</sup> Notably, the Section 250 deduction is not included in the list of disallowed special deductions. Therefore, the FDII portion of the Section 250 deduction is permitted for excise tax purposes. This should be the amount that is reported on federal Form 8993, Part III, Line 28 (on 2021 and current tax year form) or Part IV, Line 8 (on 2018-2020 tax year forms).

### *F&E Reporting for Repatriated Earnings & GILTI*

The franchise and excise tax forms have lines on Schedule J to report:

- The subtraction of all GILTI and repatriated income (before the related federal deductions), to the extent included in the taxpayer's federal taxable income; and
- The add-back of 5% of the total amount subtracted.

The *full subtraction* of GILTI and repatriated income for Tennessee excise tax purposes means that the related federal deductions – under IRC §§ 250 and 965(c) – are **not** permitted for Tennessee excise tax purposes. For example:<sup>407</sup>

- A partnership's federal Form 1065 and an S corporation's federal Form 1120-S may include federal 965(c) deductions that are not allowed for franchise and excise tax purposes.

- The amounts found on these federal return Schedules K are normally reported on Schedules J1 (partnerships) and J3 (S corporations) on the Tennessee excise tax return; auditors will need to identify and disallow these federal deductions.
- **The federal repatriated income deductions under IRC § 965(c) will only be reported for the 2017 and 2018 tax years; thus, auditors may limit their search for such deductions, as identified by Codes X and K, to these years.**
- GILTI may exist in tax years after 2018, but the related federal Section 250 deductions are *not* reported on federal return lines that are normally picked up in preparing Form FAE170.

All entities filing Form FAE170 will subtract repatriated earnings on Schedule J, Line 18 (2018 form) and add back 5% of that amount on Line 4 (2018 form). Taxpayers filing Form FAE174 will subtract repatriated earnings on Schedule J, Line 22 (2018 form) and add back 5% of that amount on Line 7 (2018 form).

See the following charts for information on where the income and deduction items relating to repatriated income and GILTI are found on 2022 tax year federal returns.

<u>Location of income on federal return ^</u>	Repatriated Inc. IRC § 965(a)	GILTI IRC § 951A
Corporation, 1120	N/A	Schedule C, Line 17, Column (a)
S Corporation, 1120-S	N/A	Schedule K, Line 10, Code E
Partnership, 1065	N/A	Schedule K, Line 11, Code H * <b>-OR-</b> Schedule K-2, Part VI *
<b>^ reverse out &amp; then add back 5% of amount reversed for F&amp;E</b>	* Due to federal changes to partnership GILTI reporting in recent years, auditors may need to consult with the taxpayer regarding any GILTI inclusions.	

<u>Location of deduction on federal return *</u>	Repatriated Inc. IRC § 965(c)	GILTI IRC § 250
<b>Corporation, 1120</b>	<b>N/A</b>	Schedule C, Line 22, Column (c) **
<b>S Corporation, 1120-S</b>	<b>N/A</b>	N/A ⌘
<b>Partnership, 1065</b>	<b>N/A</b>	N/A ⌘
<b>* deductions not allowed for F&amp;E</b>	** Lines <b>not</b> picked up for F&E ⌘ Deduction only available to C corporations	

Additional guidance for reporting repatriated earnings on a 2018 franchise and excise tax return can be found in [Important Notice #19-14](#) and guidance on reporting global intangible low-taxed income (GILTI) can be found in [Important Notice #19-13](#).

## 5. Qualified Opportunity Zones & Funds

Qualified Opportunity Zones and Qualified Opportunity Funds are components of a new series of gain deferral provisions that were enacted as part of the TCJA.<sup>408</sup> A Qualified Opportunity Zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.<sup>409</sup> A Qualified Opportunity Fund is an investment vehicle that files either a partnership or corporate federal income tax return and is organized for the purpose of investing in Qualified Opportunity Zone property.<sup>410</sup> A taxpayer who realizes eligible gains (e.g., capital gains and qualified 1231 gains) and invests these gains in Qualified Opportunity Zone property through a Qualified Opportunity Fund can temporarily defer tax on the amount of eligible gains they invest, generally until the taxpayer has an inclusion event (an event that reduces or terminates the taxpayer’s qualifying investment in a Qualified Opportunity Fund) or until December 31, 2026, whichever occurs first.<sup>411</sup>

Tennessee has not decoupled from the TCJA provisions that govern the federal income tax treatment of eligible gains that are invested in Qualified Opportunity Zone property via a Qualified Opportunity Fund. Therefore, to the extent a taxpayer defers (and subsequently recognizes) eligible gains for federal income tax purposes, pursuant to the TCJA Qualified Opportunity Zone and Qualified Opportunity Fund provisions, Tennessee conforms to the federal income tax treatment of such gains for Tennessee excise tax purposes. However, special consideration must be given to partnerships in applying the federal income tax treatment for Tennessee excise tax purposes.

### *Partnerships and Qualified Opportunity Fund Investments*

For federal income tax purposes, when a partnership realizes eligible gain, *either* the partnership *or* its individual partners can make the election to defer the gain, pursuant to the TCJA Qualified Opportunity Fund (“QOF”) provisions. The Tennessee excise tax treatment depends on whether the partnership makes the election to defer the eligible gain.

- If the **partnership elects** to defer eligible gain under the QOF provisions, then the partnership will make the election to defer such gain on Form 8949 (it will also have to file Form 8997 with its return), and the gain will not be included in the partners’ distributive shares on Form 1065, Schedule K. The eligible gain will be **deferred** for Tennessee excise tax purposes and subject to the QOF subsequent gain recognition provisions.
- If the **partnership does not elect** to defer eligible gain under the QOF provisions, then the partnership will include such gain in the partners’ distributive shares on Form 1065, Schedule K. The individual partners will then be eligible to make the election to defer their portion of the eligible gain on their individual income tax returns. In this case, the eligible gain will be **recognized** and not deferred for Tennessee excise tax purposes because the Tennessee taxpayer is the partnership, not the individual partners.

## **6. Research & Development Expenditures (IRC §174)**

Effective for tax years beginning on or after January 1, 2022, Tennessee has decoupled from IRC §174, as amended by the TCJA.<sup>412</sup> As a result, for tax years beginning on or after January 1, 2022, taxpayers are to apply IRC §174 as it existed and was applied immediately before the enactment of the TCJA, in determining the taxpayer’s net earnings or loss subject to Tennessee excise tax.

IRC §174 is an Internal Revenue Code section that concerns the deductibility of research and development (or “experimental”) expenditures. Prior to the TCJA amendment to IRC §174, taxpayers were permitted to deduct R&D expenditures as paid or incurred during the tax year. Alternatively, taxpayers could elect to treat R&D expenditures as deferred expenses, deductible over a period of five years. Under IRC §174, as amended by the TCJA, taxpayers are required to capitalize all R&D expenditures and must amortize such expenditures over a five-year period for federal income tax purposes.<sup>413</sup> However, because Tennessee has decoupled from this TCJA amendment, for Tennessee excise tax purposes, taxpayers will continue to deduct R&D



expenditures as paid or incurred during the tax year, consistent with how they treated such expenditures prior to the TCJA amendment.

Taxpayers will make two adjustments on the Tennessee excise tax return due to Tennessee's decoupling from this federal provision. Taxpayers will add back on Schedule J the R&D expenditures deduction taken on the taxpayer's federal income tax return for the taxable year. Taxpayers will then deduct on Schedule J the total amount of R&D expenditures paid or incurred by the taxpayer during the taxable year.

## M-3 and M-1 Federal Schedules

Federal Form 1120, Schedule M-3 and Form 1065, Schedule M-3 reconcile financial statement (book) income (loss) to federal taxable income (loss). The reconciliation is not "state tax" to "federal tax," so most reconciling items are not relevant for franchise and excise tax purposes. Nonetheless, many of the excise tax adjustments are found on these schedules. These schedules provide a quick way to identify potential Schedule J adjustments. They also serve as a double check<sup>414</sup> to ensure that Schedule J-type adjustments reported elsewhere on the federal return were not overlooked. All audits should include a review of the M-1 or M-3 schedule to identify potential Schedule J adjustments.

Small businesses with assets under \$10 million dollars use Schedule M-1, and large businesses with assets of over \$10 million dollars use Schedule M-3.<sup>415</sup> Small taxpayers may voluntarily choose to complete Schedule M-3 instead of M-1. Both schedules serve the same purpose and provide the same information, even though they are formatted differently. Schedule M-3 provides much more detail.

Schedule M-1 is located on page 4 or 5 of the corresponding federal income tax return, immediately below the balance sheet (Schedule L). Schedule M-3 is 3 pages long and is attached to the basic 4- or 5-page federal income tax return. There are versions of Schedule M-3 for both corporate<sup>416</sup> and partnership tax filers.<sup>417</sup> Schedule M-1 works well for small taxpayers with uncomplicated returns, but large businesses with more complicated returns should use the multipage Schedule M-3 to reconcile book income more fully with tax income.

### 1. Schedule M-3

Schedule M-3 reports the amount of net income (loss) "per books" at the bottom of page 2 of the 3-page schedule (Schedule M-1 shows this information on its first line). The first page of this schedule is where general information is reported, including:

- Whether the financial statements were audited.
- Whether a Form 10-K was filed with the SEC.
- The consolidated net income (loss) amount.

Occasionally, the information concerning the availability of SEC and audited financial statements may be helpful, but pages 2 and 3 of the schedule are the most useful.

For consolidated corporations, Schedule M-3, page 1 is completed once by the consolidated corporate parent. Pages 2 and 3 are completed for each member of a consolidated group. There are check boxes at the top of these pages to indicate if a given Schedule M-3 page was prepared for the:

- Consolidated group
- Parent corporation
- Consolidated eliminations
- Subsidiary corporation

Multiple M-3 schedules may be filed with the appropriate boxes checked. The one marked “subsidiary corporation” should match the net income of a taxpayer filing on a separate entity basis. The partnership version of the M-3 schedule does not have the check boxes for consolidated group, parent, etc. because they are not applicable to a partnership return.

The second page of Schedule M-3 reconciles income and gain/loss items, and the third page reconciles expense and deduction items. The totals from Part III are carried to the bottom of page 2, and the last line of page 2 shows the total net income (loss) “per book” and “per tax.”

**⚠ An initial audit step is to tie Schedule M-3, page 2, Line 30, column (d) “Income (Loss) per Tax Return” to excise tax Schedule J4, Line 1.**

Schedule M-3 was created because of the increasing number of book/tax differences and because the amounts reported on Schedule M-1 were often combined or netted, rendering the

schedule nearly useless to the IRS. Schedule M-3 solved that problem because it is very detailed. The income and expense items that are most likely to have book/tax differences are listed on pages 2 and 3. For items not specifically listed, taxpayers must attach detailed statements with the totals carried to the applicable “other” lines at the bottom of pages 2 and 3. Since *every* item of income and expense is listed, the totals at the bottom of page 2 will equal the entity’s net income per book and per tax.

The differences between Schedule M-3, Parts II and III “book” column (a) income/expense amounts and “tax” column (d) amounts are reported individually as temporary differences in column (b) and permanent differences in column (c). For each income/expense line item, column (a) *plus* column (b) *plus* column (c) equals column (d). If a taxpayer reports a difference as temporary when it should have reported it as permanent, there is no federal tax impact. So, while the “permanent” and “temporary” designations *do* provide good information, the auditor should not be overly concerned as to which column the difference is located. Some Schedule J adjustments are permanent differences and others are temporary.

*Temporary differences* will reverse in future years. For example, different book/tax depreciation methods will cause the current year depreciation expense to differ for book and tax purposes, but at some point, both methods will result in the asset being fully depreciated. In this case, the question is not *whether* the depreciation expense is deductible, but rather *when* it will be deducted. On the other hand, *permanent differences* never reverse in future years; these differences result from adjustments made because of IRS rules, rather than generally accepted accounting principles (GAAP). For example:

- Qualified businesses, when calculating their federal taxable income, may take a deduction for Domestic Production Activities.
- However, no actual expense is ever recorded in the GAAP accounting records, because there was never a cash outlay or obligation.

If a corporation or partnership is unable to determine whether an adjustment is temporary or permanent, it should report the difference in column (c) as a permanent difference.

Corporations that own an investment interest in a partnership report their share of the partnership’s income (loss), including the book/tax difference regarding exempt interest from the investment partnership, only on Schedule M-3, Part II, Line 9. The federal instructions for this line state that column (d) should reflect all amounts of income, gains, losses, or deductions reflected on the Schedule K-1 received from the partnership, without regard to any limitations

computed at the partner level (e.g., limitations on utilization of charitable contributions, capital losses, and interest expense).

In other words, all information shown on a corporate-investment-partnership’s Schedule K-1 is reflected on a single Schedule M-3 line, and any book/tax differences are reflected as differences on other Schedule M-3 lines that specifically address a given limitation. For example, the charitable contribution percentage limitation is reflected on Part III, Line 21 and the capital loss limitation is reflected on Part II, Line 24.

## 2. Chart of Schedule J4, J Adjustments

Schedule J, J4 Line Item	Federal Schedule M-3 Line	Book/Tax Difference <sup>418</sup>	Notes
Bonus Depreciation Schedule J, Line 3	Part III, 31	Temporary	Book/tax differences usually include more than bonus depreciation, so Schedule M-3 <i>isn't useful for F&amp;E</i> . See federal Form 4562.
Interest income on obligations of states Schedule J, Line 7	Part II, 13	Permanent	Book/tax differences may include more than interest from state obligations (i.e., “sale versus lease” book/tax differences). Also, this line does not report the applicable interest from pass-through entities owned by the F&E taxpayer. If the only reconciling item was exempt interest, it would be reported as a negative amount in column (c) of Schedule M-3. You can find the Schedule J add-back amount on federal Forms 1120, Schedule K, Line 9; 1065; and 1120S, Schedule K, Lines 18a and 16a, respectively.

Depletion Schedule J, Line 8	Part III, 30	Permanent	Generally, the book/tax difference will be the excess of percentage depletion over cost depletion.
Contribution carryover from prior period Schedule J4, Line 5	Part III, 21	Temporary	Not applicable for pass-through entities. Corporations using a carryover on Form 1120 in the current year will report it on F&E Schedule J4, Line 5. The amount reported on federal Schedule M-3, Line 21, column (d) should reconcile with F&E Schedule J4, Line 5.
Capital gains offset by capital loss carryover or carryback Schedule J4, Line 6	Part II, 24	Temporary	A negative amount on Schedule M-3, Line 24 reflects a capital loss carryover being utilized to offset current year capital gains. This is the excise tax add-back amount. However, auditors should review Schedule D to increase their understanding of the federal adjustment.
Excess fair market value over book value of property donated Schedule J, Line 9	Part III, 19	Permanent	Entries on this line may include book/ tax differences other than the excess of fair market value of donated property. Nonetheless, these entries, along with federal Form 8283, are the best sources to identify a potential add-back.

## Like-Kind Exchanges

### 1. Overview

A like-kind exchange (also known as a “1031 exchange”) is a transaction that involves the exchange of *like-kind* property that is held for use in a trade or business or for investment.<sup>419</sup> Properties are of *like-kind* if they have the same nature or character, without regard to their grade or quality.<sup>420</sup> For example, an improved apartment building and an unimproved office

building are considered *like-kind* properties. Properties exchanged in a like-kind exchange must be used in a trade or business or held for investment in order to qualify for the exchange.<sup>421</sup> Real property that is held primarily for sale (i.e., as a taxpayer's inventory) does not qualify.<sup>422</sup>

**⚠ Under the federal Tax Cuts and Jobs Act of 2017, effective January 1, 2018, only exchanges of *real property* are eligible for like-kind exchanges. Exchanges involving *personal or intangible* property are no longer eligible.**

Taxpayers benefit from like-kind exchanges because a like-kind exchange permits the taxpayer to defer gain recognition on the exchange of like-kind property for federal income tax purposes. The taxpayer will eventually recognize the deferred gain when it ultimately sells the property received in the exchange ("replacement property") in a subsequent taxable transaction. Like-kind exchanges are often engaged in by taxpayers that invest in real estate. Properties that qualify for like-kind exchange treatment can be in different states. However, properties located outside the United States do not qualify.<sup>423</sup> When an out-of-state taxpayer enters a like-kind exchange and receives replacement property that is in Tennessee, the taxpayer generally will establish nexus for franchise and excise tax purposes.

In this section, an overview of the federal tax mechanics of like-kind exchanges is provided, and the potential Tennessee franchise and excise tax implications of like-kind exchanges are considered.

## 2. Federal Tax Mechanics

### *Form 8824 and Related Forms and Schedules*

Taxpayers report like-kind exchanges on federal [Form 8824](#). Part I of this form provides information regarding the like-kind property given up and received by the taxpayer and the date(s) on which the properties were transferred. Part III of this form provides important information as to the realized gain, recognized gain, and basis of the like-kind property received by the taxpayer in the exchange.

Throughout this section, various federal forms and schedules (e.g., federal Form 8824, Form 4797, and Schedule D) are referenced on which like-kind exchanges and related transactions are reported. An appendix is included at the end of this section that contains examples of these completed forms and schedules, which illustrate the reporting requirements associated with like-kind exchanges and subsequent taxable dispositions. The figures reported on those forms

and schedules are derived from the example that is used throughout this section to illustrate an example like-kind exchange (see the Realized Gain section below).

### Realized Gain

Although the term “like-kind exchange” seems to imply that *only* like-kind property (e.g., an apartment building for another apartment building) may be transferred in a qualifying like-kind exchange, this is not the case.<sup>424</sup> Of course, only real property that is held for use in a trade or business or for investment, and that is of *like-kind*, will qualify for deferral of gain (or loss) realized from the exchange for federal income tax purposes. However, if the like-kind properties that are being exchanged do not have an equal fair market value, then the party to the transaction who is transferring the like-kind property with a *lesser* fair market value will also have to transfer other property/consideration to equal the fair market value of the like-kind property received; in addition to the like-kind property given up, this party may transfer cash, transfer non-like-kind property (i.e., personal or intangible property), or assume liabilities of the other party<sup>425</sup> in order to effectuate the like-kind exchange. This is because the total value given up in a like-kind exchange must equal the total value received.

While the overall transaction previously described *still* qualifies as a like-kind exchange, the party that *receives* property/consideration that is *not* like-kind will recognize a partial gain from the exchange. Therefore, both parties to the exchange must calculate the gain realized from the exchange before determining what amount of the realized gain, if any, the parties must recognize on their respective federal income tax returns. The realized gain, whether deferred in part or in full as a result of the exchange, also factors into the calculation of the basis of the replacement property received in the exchange.

#### Consider the following example:

- An out-of-state taxpayer invests in real estate and leases its properties to tenants.
- The taxpayer enters into a like-kind exchange in which it plans to exchange an apartment building located in its home state (“relinquished property”) with an office building located in Tennessee (“replacement property”).
- The taxpayer’s **original cost basis** in the relinquished property was **\$950,000** and the taxpayer has taken **\$617,500** in **depreciation** on the relinquished property, leaving the property with an **adjusted basis** of **\$332,500** on the date of the exchange.
- The relinquished property has a **fair market value** of **\$1,150,000** on the date of the exchange.



- The taxpayer also has a **liability** of **\$142,500** that is **secured by the relinquished property**; the other party to the exchange has agreed to assume this liability.
- The replacement property has a **fair market value** of **\$975,000** on the date of the exchange.
- The other party to the exchange will also transfer **\$32,500 cash** to the taxpayer in exchange for the relinquished property.
- For the purpose of this example, it should be assumed that both parties to the exchange have met all other prerequisites for the exchange to qualify as a like-kind exchange.<sup>426</sup>

In this example, the taxpayer that received replacement property located in Tennessee will realize a gain of \$817,500 from the like-kind exchange, calculated as follows:

Cash received	\$32,500
Liability assumed by other party	142,500
FMV of like-kind property received	975,000
Total value received	\$1,150,000
Less: adjusted basis of like-kind property given up	\$332,500
<b>Realized gain</b>	<b>\$817,500</b>

The realized gain is calculated as the difference between the total value (including the fair market value of both like-kind and non-like-kind property) received in the exchange and the adjusted basis of the property given up in the exchange. The realized gain can be found on Form 8824, Line 19. Note that the total value received is equal to the fair market value of the relinquished property on the date of the exchange. The total amount of the gain in this example, however, will *not* be recognized on the taxpayer's federal income tax return; the majority of this realized gain will be deferred as a result of the like-kind exchange.

### Recognized Gain

In a qualifying like-kind exchange in which like-kind property is transferred *solely* for like-kind property with an equal fair market value, no gain (or loss) will be recognized by either party to the exchange in the tax year in which the exchange takes place for federal income tax purposes. Rather, any gains (or losses) realized by the parties, respectively, from the exchange will be deferred until either party sells or otherwise disposes of its replacement property received in the exchange in a subsequent taxable transaction, in which case the selling/dispersing party will recognize any deferred gain or loss from the exchange. A party to a like-kind exchange *could* continue to defer gain or loss recognition by exchanging its replacement property in another qualifying like-kind exchange; however, upon the ultimate sale or disposition of the replacement property, the party will recognize any remaining deferred gains or losses.

Oftentimes, properties transferred in a qualifying like-kind exchange do not have an equal fair market value. As previously discussed, this necessitates the transfer of cash or other non-like-kind property to carry out the exchange. Cash or other non-like-kind property that is transferred in a like-kind exchange is commonly referred to as “boot.” Whenever boot is transferred in a like-kind exchange, the party to the exchange that receives boot will recognize a gain in the year of the exchange. The **recognized gain** will be the *lesser* of the **realized gain** or the **boot received** in the exchange.<sup>427</sup> The recognized gain can be found on Form 8824, Line 23. Losses are not recognized in like-kind exchanges involving solely like-kind property, but rather will continue to be deferred until recognition at a later time.<sup>428</sup>

Continuing with the [previous example](#), the out-of-state taxpayer transferred relinquished property with a fair market value of \$1,150,000 in exchange for replacement property with a fair market value of \$975,000 on the date of the exchange. Because the replacement property had a lesser fair market value than the relinquished property, the other party to the exchange also had to transfer boot totaling \$175,000 that consisted of \$32,500 cash and the assumed liability of \$142,500. The taxpayer’s realized gain on the exchange is \$817,500; thus, the taxpayer will **recognize a gain of \$175,000** based on the *lesser* amount of *boot received* in the exchange. The taxpayer will **defer recognition of the remaining \$642,500 of realized gain** until it sells or otherwise disposes of the replacement property in a subsequent taxable transaction. Deferred gain associated with a like-kind exchange can be found on Form 8824, Line 24.

When a taxpayer recognizes gain as the result of boot received in a like-kind exchange, the taxpayer initially calculates the amount of gain to be recognized on Form 8824, as previously discussed. This gain will also be found on Form 4797 and/or Schedule D of the taxpayer’s tax return. Depending on the depreciation method used to depreciate the relinquished property

and when the property was placed in service, the total gain recognized by the taxpayer may be divided between ordinary gain and capital gain for federal income tax purposes;<sup>429</sup> Form 4797 distinguishes between the character of both types of gain (ordinary and capital), whereas Schedule D will show only the portion of the gain that is characterized as capital gain.

**The way the gain is characterized for federal income tax purposes (ordinary or capital) has no impact on the excise tax treatment of the gain; the total gain is included in the excise tax base.** For example, looking at Form 4797, the total of any amounts reported on Lines 5 and 16 should be included in the excise tax starting point reported on the appropriate sub-J Schedule. The gain amounts reported on Form 4797 (and Schedule D) can be traced to the income section on page 1 of the taxpayer's federal return; however, the capital portion of the gain will be added to any other capital gains of the taxpayer and offset against any capital losses, so the net capital gain included on page 1 of the return may not match the capital gain reported on Form 4797, Part I.<sup>430</sup>

### *Basis of Like-Kind Property Received*

Determining the basis<sup>431</sup> of like-kind property received in a like-kind exchange is one of the most important aspects of the exchange. This is because any gain or loss on the future taxable sale or disposition of the property received in the exchange will be calculated with reference to this basis. Because like-kind exchanges are generally a nontaxable event, special consideration must be given to the determination of the tax basis for property received in the exchange.

In a qualifying like-kind exchange in which like-kind property is transferred *solely* for like-kind property with an equal fair market value, the basis of the like-kind property received will be the adjusted basis<sup>432</sup> of the like-kind property given up in the exchange.<sup>433</sup> In other words, the adjusted basis in the like-kind property given up is *substituted* for that of the like-kind property received (a "substituted basis"). Essentially, this is how the gain/loss deferral aspect of a like-kind exchange is accomplished. The basis of like-kind property received can be found on Form 8824, Line 25. There are two basic formulas that can be used to calculate the basis of like-kind property received in a like-kind exchange:

- **Fair market value of like-kind property received – Deferred gain + Deferred loss**
- **Adjusted basis of like-kind property given up + Gain recognized – Boot received + Boot paid – Loss recognized (*loss on non-cash boot given up*)**

Both above formulas should result in the same basis amount for the like-kind property received. However, one formula may be more advantageous to use than the other, depending on the

information known about a given like-kind exchange. Continuing with the [previous example](#), the basis of the like-kind property received in this example like-kind exchange is calculated as follows:

FMV of like-kind property received \$975,000 Less: deferred gain (\$642,500) Plus: deferred loss \$0 <b>Basis of like-kind property received</b> <u><u>\$332,500</u></u>	<b>OR</b>	Adj. basis of like-kind property given up \$332,500 Plus: gain recognized \$175,000 Less: loss recognized \$0 Less: boot received (\$175,000) Plus: boot paid \$0 <b>Basis of like-kind property received</b> <u><u>\$332,500</u></u>
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Note that both of the above calculations result in the same basis amount of like-kind property received.<sup>434</sup> The like-kind property received has a substituted basis—the \$332,500 adjusted basis of the like-kind property given up in the exchange.<sup>435</sup> The first calculation above shows that this is simply the difference between the fair market value of the like-kind property received in the exchange and the deferred gain. By taking a substituted basis in the like-kind property received, the deferred gain is essentially built into the basis of the replacement property.

When the replacement property is ultimately sold or disposed of in a taxable transaction, the deferred gain will be recognized for federal income tax purposes (assuming that the property continues to appreciate in value) because the gain on the subsequent taxable transaction will be measured with reference to the replacement property’s substituted basis, which is *less* than the cost (fair market value) basis that the taxpayer would have otherwise had in the replacement property had the exchange **not** qualified as a like-kind exchange. When this occurs, the taxpayer will file Form 4797 with its tax return for the tax year in which the taxable disposition occurred. Similar to boot gain (see the discussion in the previous Recognized Gain section), the taxpayer will calculate the total gain on the sale of the property (including any portion required to be recognized as ordinary income for federal income tax purposes). The total gain (ordinary and capital) can be traced to page 1 of the taxpayer’s federal return<sup>436</sup> (via Form 4797 and Schedule D, respectively) and should be included in the excise tax base; however, the capital portion of the gain will be added to any other capital gains of the taxpayer and offset against any capital losses, so the net capital gain included on page 1 of the return may not match the capital gain reported on Form 4797, Part I. The total gain to be included on the appropriate sub-J Schedule of the excise tax return should be the same amount that is reported on Form 4797, Line 24 (or 30, if more than one property is being disposed of). Form 8824 will not be filed to report the taxable

disposition; however, it should be confirmed that the basis amount reported on Form 4797, Line 21 for the replacement property in the year of the sale matches the amount originally reported on Form 8824, Line 25 for the replacement property in the year of the exchange.

For example, assume that the taxpayer subsequently sells the replacement property for \$1,000,000. The taxpayer will recognize a total gain of \$667,500 (\$1,000,000 selling price less \$332,500 adjusted (substituted) basis).<sup>437</sup> \$642,500 of this recognized gain is the deferred gain from the previous like-kind exchange; the remaining \$25,000 is the portion of the recognized gain that is attributed to the difference between the current selling price of the replacement property and the basis that the taxpayer would have otherwise had in the replacement property had the previous exchange **not** qualified as a like-kind exchange (\$1,000,000 current selling price less \$975,000 acquisition date fair market value of the replacement property on the date of the like-kind exchange).

### 3. Excise Tax Implications

Like-kind exchanges are governed by the Internal Revenue Code<sup>438</sup> and are a matter of federal tax law. However, like-kind exchanges are relevant to the Tennessee excise tax because they have the potential to impact the excise tax base. This is because the calculation of the excise tax base begins with a taxpayer's federal taxable income, as calculated in accordance with the Internal Revenue Code.<sup>439</sup> There are several excise tax-related implications to consider with respect to like-kind exchanges.

#### *Deferred Gains and Losses*

The excise tax base is a taxpayer's *net earnings (or net losses)*. The calculation of a taxpayer's net earnings subject to excise tax begins with a taxpayer's federal taxable income, followed by certain modifications<sup>440</sup> that are required under Tennessee excise tax law. Because this calculation begins with the taxpayer's federal taxable income calculated in accordance with the Internal Revenue Code, to the extent that a taxpayer defers recognition of gain or loss realized from a like-kind exchange for federal income tax purposes, such gain or loss will be *excluded* from the excise tax base in the year of the exchange. Likewise, to the extent that a taxpayer recognizes gain or loss from a like-kind exchange (e.g., from the receipt or payment of boot), such gain or loss will be *included* in the excise tax base in the year of the exchange.

#### *Recognition of Deferred Gains and Losses*

To the extent that a taxpayer subject to the Tennessee excise tax defers recognition of gain or loss realized from a like-kind exchange for federal income tax purposes, such gain or loss will

effectively be deferred for excise tax purposes as well. Three questions flow from this mirrored tax treatment: **Will** the deferred gain or loss eventually be recognized for excise tax purposes? **When** is the deferred gain or loss recognized for excise tax purposes? **How** is the deferred gain or loss measured for excise tax purposes upon recognition?

- **Will the deferred gain or loss eventually be recognized for excise tax purposes?**
  - A taxpayer whose business activities are *solely* within the state of Tennessee and who has deferred recognition of gain or loss as the result of a like-kind exchange *will* eventually recognize such gain or loss for excise tax purposes upon the ultimate sale or disposition of its replacement property.<sup>441</sup>
  - For a taxpayer who has business activities *both inside and outside* the state of Tennessee (an “apportioning taxpayer”), the deferred gain or loss *may or may not* eventually be recognized for excise tax purposes.
    - If an apportioning taxpayer establishes nexus with Tennessee by receiving replacement property located in Tennessee, and the taxpayer subsequently sells or disposes of that replacement property in a taxable transaction, then the taxpayer *will* recognize the deferred gain or loss for excise tax purposes, regardless of whether the relinquished property<sup>442</sup> was located inside or outside of Tennessee.
    - Similarly, if an apportioning taxpayer has otherwise established nexus with Tennessee but *does not* own or use replacement property located in Tennessee, the taxpayer *still* recognizes any gain or loss previously deferred as the result of a like-kind exchange for excise tax purposes, if it recognizes such gain or loss for federal income tax purposes while having nexus with Tennessee, regardless of where the relinquished or replacement properties from the exchange were located.
    - Conversely, if an apportioning taxpayer enters into a like-kind exchange in which it exchanges Tennessee property for replacement property located in another state and then ceases all business activities in Tennessee (i.e., no longer has nexus with Tennessee), the taxpayer will *not* recognize the deferred gain or loss from the exchange for excise tax purposes, *even* if it subsequently recognizes such gain or loss for federal income tax purposes, if the taxpayer does *not* have nexus with

Tennessee at such time when it recognizes the deferred gain or loss for federal income tax purposes.<sup>443</sup>

- **When is the deferred gain or loss recognized for excise tax purposes?**
  - If deferred gain or loss resulting from a like-kind exchange is recognized for excise tax purposes, it will be recognized on the excise tax return that coincides with the accounting period covered by the federal income tax return in which the gain or loss is recognized.<sup>444</sup>
  
- **How is the deferred gain or loss measured for excise tax purposes upon recognition?**
  - Any gain or loss previously deferred as the result of a like-kind exchange will be measured upon recognition for excise tax purposes in the same manner as it is for federal income tax purposes.
    - Because the calculation of the excise tax base begins with a taxpayer's federal taxable income, as calculated in accordance with the Internal Revenue Code, the gain or loss recognized on the taxpayer's federal return will be included in the computation of net earnings subject to excise tax.

#### 4. Apportionment Implications

Multistate taxpayers that have the right to apportion for franchise and excise tax purposes ("apportioning taxpayers") need to give special consideration to the basis of like-kind property that is includable in the property factor, as well as gross receipts includable in the sales factor.

##### *Property Factor – Basis of Replacement Property*

Apportioning taxpayers that have received replacement property in a like-kind exchange will continue to include the *original cost* of the *relinquished property* given up in the exchange (as opposed to the substituted basis or original cost of the replacement property received), in the denominator of the property factor. If the replacement property is located in Tennessee, this same amount will also be reported in the property factor numerator.

A taxpayer's property factor is based on tax basis records.<sup>445</sup> The "original cost" of property included in the property factor is the basis of the property for federal tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc.<sup>446</sup> Note that depreciation is *not* included in these "federal adjustments."

Because the substituted basis of replacement property received in a like-kind exchange is determined with reference to the adjusted basis of the relinquished property given up in the exchange, it is appropriate to continue reporting the *original cost* of the *relinquished property* in the property factor. Similar to depreciation, which is not deducted from the basis of property included in the property factor, deferred gain or loss (which is taken into account in arriving at the substituted basis of replacement property)<sup>447</sup> is another "federal adjustment" that should be disregarded in determining the basis of replacement property to be included in the property factor for apportionment purposes. For example:

- An apportioning taxpayer enters into a like-kind exchange in which it exchanges real property A, with an original cost to the taxpayer of \$950,000 and an adjusted basis of \$332,500 on the date of the exchange, for real property B, with an original cost of \$800,000 to the other party to the exchange. The taxpayer takes a substituted basis in the like-kind property received. The basis amount that the taxpayer should include in the property factor for the replacement property is \$950,000 (the original cost of property A to the taxpayer).

### *Sales Factor – Gross Receipts from the Exchange*

In the year of the like-kind exchange, if the taxpayer recognizes a partial gain due to the receipt of boot, or to the payment of non-cash boot (e.g., tangible personal property) that has appreciated in value, the taxpayer should include the gross receipts<sup>448</sup> attributed to the boot gain in the sales factor denominator. If the relinquished property (or non-cash boot paid) given up is located in Tennessee, then the boot gain should be sourced to Tennessee and the associated gross receipts included in the sales factor numerator.

Similarly, in the year in which the taxpayer sells or otherwise disposes of the replacement property received in the like-kind exchange in a taxable transaction for which a gain is recognized, the taxpayer should include the gross receipts<sup>449</sup> attributed with the gain in the sales factor denominator. If the replacement property disposed of is located in Tennessee, then the



gain should be sourced to Tennessee and the associated gross receipts included in the sales factor numerator.

There may be instances in which it is appropriate to include the *net gain* (as opposed to the *gross receipts*) attributed to a particular property sale or disposition event in the sales factor.<sup>450</sup> For more information regarding this exception, please see Chapter 14 of this manual.

## 5. Franchise Tax Implications

Like-kind exchanges are a matter of federal tax law. Conversely, the Tennessee franchise tax base is a taxpayer's net worth, as calculated in accordance with generally accepted accounting principles (GAAP).<sup>451</sup> Because the franchise tax base is generally measured in accordance with GAAP,<sup>452</sup> as opposed to federal tax law, like-kind exchanges usually do not have any bearing on the franchise tax. Nevertheless, one potential franchise tax implication of like-kind exchanges concerns the proper valuation of like-kind property received in the exchange (replacement property) for franchise tax purposes.

### *Basis of Replacement Property – Schedule G*

The franchise tax base is a taxpayer's *net worth* (total assets less total liabilities). However, the measure of the franchise tax cannot be less than the actual value of the real or tangible property owned or used by the taxpayer in Tennessee.<sup>453</sup> In other words, for a given accounting period, a taxpayer's franchise tax will be based on the *greater* of the taxpayer's *net worth* or the actual value of the *real or tangible property owned or used by the taxpayer in Tennessee*, as of the balance sheet date; for this purpose, property is valued at *cost less accumulated depreciation*, calculated in accordance with GAAP.<sup>454</sup> The determination of real and tangible property subject to the franchise tax is reported on Schedule G of the franchise and excise tax return.

For taxpayers who receive replacement property located in Tennessee through a like-kind exchange, the question arises as to what basis the taxpayer should report on Schedule G for the replacement property received in the exchange. In this situation, the taxpayer should report as the basis of the replacement property on Schedule G the *cost (fair value) basis* of the property. Generally, this will be the purchase price of the replacement property plus any other expenses that are properly capitalized to the replacement property under GAAP.<sup>455</sup>

The taxpayer will subsequently depreciate the replacement property in accordance with GAAP and report the net book value of the property on Schedule G. The taxpayer should report the cost basis of the replacement property on Schedule G, rather than the federal tax basis

(substituted basis) of the replacement property attained through the like-kind exchange, because Tennessee franchise tax law requires that property be valued in accordance with GAAP. However, there is an exception to this general rule.

Tenn. Code Ann. § 67-4-2108(a)(3) provides that if a taxpayer,<sup>456</sup> does not maintain its books and records in accordance with GAAP, the taxpayer may value property subject to the franchise tax in accordance with the accounting method used by the taxpayer for federal tax purposes.<sup>457</sup> This exception commonly applies, but is not intended to be limited to, small and medium-size, privately-held companies that are not required to maintain financial statements prepared under GAAP. However, if a taxpayer maintains *both* GAAP *and* tax basis books and records, then this exception does **not** apply and the taxpayer **must** use its GAAP books and records to value its property subject to franchise tax.<sup>458</sup> Taxpayers who receive replacement property located in Tennessee through a like-kind exchange **and** who meet the exception to the GAAP valuation requirement for property,<sup>459</sup> will be permitted to report as the basis of the replacement property on Schedule G the *federal tax basis (substituted basis)* of the property. The taxpayer will subsequently depreciate the replacement property in accordance with the Internal Revenue Code and report the adjusted basis of the property on Schedule G.

## 6. Appendix (Like-Kind Exchanges) – Federal Forms and Schedules

The following are examples of federal return forms and schedules that a taxpayer would complete to report a like-kind exchange and the subsequent sale of like-kind property received in an exchange.<sup>460</sup> The figures on these forms and schedules are derived from the example like-kind exchange referenced throughout this section.

**Form 8824 – Like-Kind Exchange**

Form **8824**

Department of the Treasury  
Internal Revenue Service

**Like-Kind Exchanges**  
(and section 1043 conflict-of-interest sales)

▶ Attach to your tax return.

▶ Go to [www.irs.gov/Form8824](http://www.irs.gov/Form8824) for instructions and the latest information.

OMB No. 1545-1190

**2019**

Attachment  
Sequence No. **109**

Name(s) shown on tax return

**EXAMPLE TAXPAYER, INC.**

Identifying number

**XX-XXXXXX**

**Part I Information on the Like-Kind Exchange**

**Note:** Generally, only real property should be described on line 1 or 2. However, you may describe personal and/or real property on line 1 or 2 if you are filing this form to report the disposition of property exchanged in a previously reported related party like-kind exchange. If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.

- 1 Description of like-kind property given up:  
APARTMENT BUILDING (OUTSIDE TN)
- 2 Description of like-kind property received:  
OFFICE BUILDING (IN TN)
- 3 Date like-kind property given up was originally acquired (month, day, year) . . . . . **3** MX/XX/199X
- 4 Date you actually transferred your property to the other party (month, day, year) . . . . . **4** MX/XX/20X1
- 5 Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement . . . . . **5** MX/XX/20X1
- 6 Date you actually received the like-kind property from other party (month, day, year). See instructions **6** MX/XX/20X1
- 7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . .  Yes  No

**Note:** Do not file this form if a related party sold property into the exchange, directly or indirectly (such as through an intermediary); that property became your replacement property; and none of the exceptions in line 11 applies to the exchange. Instead, report the disposition of the property as if the exchange had been a sale. If one of the exceptions on line 11 applies to the exchange, complete Part II.

**Part II Related Party Exchange Information**

8	Name of related party	Relationship to you	Related party's identifying number
	Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)		

- 9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange? . . . . .  Yes  No
- 10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? . . . . .  Yes  No

*If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is not the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 unless one of the exceptions on line 11 applies.*

- 11 If one of the exceptions below applies to the disposition, check the applicable box.
  - a  The disposition was after the death of either of the related parties.
  - b  The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.
  - c  You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation. See instructions.

Name(s) shown on tax return. Do not enter name and social security number if shown on other side.

Your social security number

**EXAMPLE TAXPAYER, INC.**

**XX-XXXXXX**

**Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received**

**Caution:** If you transferred and received (a) more than one group of like-kind properties or (b) cash or other (not like-kind) property, see **Reporting of multi-asset exchanges** in the instructions.

**Note:** Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.

<b>12</b>	Fair market value (FMV) of other property given up . . . . .	<b>12</b>	
<b>13</b>	Adjusted basis of other property given up . . . . .	<b>13</b>	
<b>14</b>	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale . . . . .	<b>14</b>	
<b>Caution:</b> If the property given up was used previously or partly as a home, see <b>Property used as home</b> in the instructions.			
<b>15</b>	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions . . . . .	<b>15</b>	175,000
<b>16</b>	FMV of like-kind property you received . . . . .	<b>16</b>	975,000
<b>17</b>	Add lines 15 and 16 . . . . .	<b>17</b>	1,150,000
<b>18</b>	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses <b>not</b> used on line 15. See instructions . . . . .	<b>18</b>	332,500
<b>19</b>	<b>Realized gain or (loss).</b> Subtract line 18 from line 17 . . . . .	<b>19</b>	817,500
<b>20</b>	Enter the smaller of line 15 or line 19, but not less than zero . . . . .	<b>20</b>	175,000
<b>21</b>	Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions . . . . .	<b>21</b>	35,000
<b>22</b>	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions . . . . .	<b>22</b>	140,000
<b>23</b>	<b>Recognized gain.</b> Add lines 21 and 22 . . . . .	<b>23</b>	175,000
<b>24</b>	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions . . . . .	<b>24</b>	642,500
<b>25</b>	<b>Basis of like-kind property received.</b> Subtract line 15 from the sum of lines 18 and 23 . . . . .	<b>25</b>	332,500

**Part IV Deferral of Gain From Section 1043 Conflict-of-Interest Sales**

**Note:** This part is to be used **only** by officers or employees of the executive branch of the federal government or judicial officers of the federal government (including certain spouses, minor or dependent children, and trustees as described in section 1043) for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used **only** if the cost of the replacement property is more than the basis of the divested property.

<b>26</b>	Enter the number from the upper right corner of your certificate of divestiture. ( <b>Do not</b> attach a copy of your certificate. Keep the certificate with your records.) . . . . .		
<b>27</b>	Description of divested property ▶ _____		
<b>28</b>	Description of replacement property ▶ _____		
<b>29</b>	Date divested property was sold (month, day, year) . . . . .	<b>29</b>	MM/DD/YYYY
<b>30</b>	Sales price of divested property. See instructions . . . . .	<b>30</b>	
<b>31</b>	Basis of divested property . . . . .	<b>31</b>	
<b>32</b>	<b>Realized gain.</b> Subtract line 31 from line 30 . . . . .	<b>32</b>	
<b>33</b>	Cost of replacement property purchased within 60 days after date of sale . . . . .	<b>33</b>	
<b>34</b>	Subtract line 33 from line 30. If zero or less, enter -0- . . . . .	<b>34</b>	
<b>35</b>	Ordinary income under recapture rules. Enter here and on Form 4797, line 10. See instructions . . . . .	<b>35</b>	
<b>36</b>	Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797. See instructions . . . . .	<b>36</b>	
<b>37</b>	<b>Deferred gain.</b> Subtract the sum of lines 35 and 36 from line 32 . . . . .	<b>37</b>	
<b>38</b>	<b>Basis of replacement property.</b> Subtract line 37 from line 33 . . . . .	<b>38</b>	

**Form 4797 – Boot Gain (Shows Ordinary and Capital Portions)**

Form <b>4797</b>  Department of the Treasury Internal Revenue Service	<b>Sales of Business Property</b> (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))  ▶ Attach to your tax return. ▶ Go to <a href="http://www.irs.gov/Form4797">www.irs.gov/Form4797</a> for instructions and the latest information.	OMB No. 1545-0184  <b>2019</b>  Attachment Sequence No. <b>27</b>					
Name(s) shown on return <b>EXAMPLE TAXPAYER, INC.</b>		Identifying number <b>XX-XXXXXX</b>					
1 Enter the gross proceeds from sales or exchanges reported to you for 2019 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions . . . . . <b>1</b>							
<b>Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year</b> (see instructions)							
<b>2</b>	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
<b>3</b>	Gain, if any, from Form 4684, line 39 . . . . .						<b>3</b>
<b>4</b>	Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . .						<b>4</b>
<b>5</b>	Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . .						<b>5</b> <b>140,000</b>
<b>6</b>	Gain, if any, from line 32, from other than casualty or theft . . . . .						<b>6</b>
<b>7</b>	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows . . . . .						<b>7</b> <b>140,000</b>
<b>Partnerships and S corporations.</b> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.							
<b>Individuals, partners, S corporation shareholders, and all others.</b> If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.							
<b>8</b>	Nonrecaptured net section 1231 losses from prior years. See instructions . . . . .						<b>8</b>
<b>9</b>	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions . . . . .						<b>9</b>
<b>Part II Ordinary Gains and Losses</b> (see instructions)							
<b>10</b>	Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):						
<b>11</b>	Loss, if any, from line 7 . . . . .						<b>11</b> ( )
<b>12</b>	Gain, if any, from line 7 or amount from line 8, if applicable . . . . .						<b>12</b>
<b>13</b>	Gain, if any, from line 31 . . . . .						<b>13</b>
<b>14</b>	Net gain or (loss) from Form 4684, lines 31 and 38a . . . . .						<b>14</b>
<b>15</b>	Ordinary gain from installment sales from Form 6252, line 25 or 36 . . . . .						<b>15</b>
<b>16</b>	Ordinary gain or (loss) from like-kind exchanges from Form 8824 . . . . .						<b>16</b> <b>35,000</b>
<b>17</b>	Combine lines 10 through 16 . . . . .						<b>17</b> <b>35,000</b>
<b>18</b> For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.							
<b>a</b> If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040 or Form 1040-SR), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions . . . . .						<b>18a</b>	
<b>b</b> Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040 or Form 1040-SR), Part I, line 4 . . . . .						<b>18b</b>	
For Paperwork Reduction Act Notice, see separate instructions.			Cat. No. 130861		Form <b>4797</b> (2019)		

**Schedule D – Boot Gain (Shows Capital Portion Only)**

<p><b>SCHEDULE D</b> <b>(Form 1120)</b></p> <p>Department of the Treasury Internal Revenue Service</p>	<p><b>Capital Gains and Losses</b></p> <p>▶ Attach to Form 1120, 1120-C, 1120-F, 1120-FSC, 1120-H, 1120-IC-DISC, 1120-L, 1120-ND, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 1120-SF, or certain Forms 990-T.</p> <p>▶ Go to <a href="http://www.irs.gov/Form1120">www.irs.gov/Form1120</a> for instructions and the latest information.</p>	<p>OMB No. 1545-0123</p> <p style="font-size: 2em; font-weight: bold;">2019</p>		
<p>Name <b>EXAMPLE TAXPAYER, INC.</b></p>		<p>Employer identification number <b>XX-XXXXXX</b></p>		
<p>Did the corporation dispose of any investment(s) in a qualified opportunity fund during the tax year? . . . . . <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.</p>				
<p><b>Part I Short-Term Capital Gains and Losses</b> (See instructions.)</p>				
<p><b>See instructions for how to figure the amounts to enter on the lines below.</b> This form may be easier to complete if you round off cents to whole dollars.</p>	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) <b>Gain or (loss)</b> Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b . . . . .				
1b Totals for all transactions reported on Form(s) 8949 with <b>Box A</b> checked . . . . .				
2 Totals for all transactions reported on Form(s) 8949 with <b>Box B</b> checked . . . . .				
3 Totals for all transactions reported on Form(s) 8949 with <b>Box C</b> checked . . . . .				
4 Short-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . .				<b>4</b>
5 Short-term capital gain or (loss) from like-kind exchanges from Form 8824 . . . . .				<b>5</b>
6 Unused capital loss carryover (attach computation) . . . . .				<b>6</b> ( )
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column h . . . . .				<b>7</b>
<p><b>Part II Long-Term Capital Gains and Losses</b> (See instructions.)</p>				
<p><b>See instructions for how to figure the amounts to enter on the lines below.</b> This form may be easier to complete if you round off cents to whole dollars.</p>	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) <b>Gain or (loss)</b> Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b . . . . .				
8b Totals for all transactions reported on Form(s) 8949 with <b>Box D</b> checked . . . . .				
9 Totals for all transactions reported on Form(s) 8949 with <b>Box E</b> checked . . . . .				
10 Totals for all transactions reported on Form(s) 8949 with <b>Box F</b> checked . . . . .				
11 Enter gain from Form 4797, line 7 or 9 . . . . .				<b>11</b> <span style="float: right;">140,000</span>
12 Long-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . .				<b>12</b>
13 Long-term capital gain or (loss) from like-kind exchanges from Form 8824 . . . . .				<b>13</b>
14 Capital gain distributions (see instructions) . . . . .				<b>14</b>
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column h . . . . .				<b>15</b> <span style="float: right;">140,000</span>
<p><b>Part III Summary of Parts I and II</b></p>				
16 Enter excess of net short-term capital gain (line 7) over net long-term capital loss (line 15) . . . . .				<b>16</b>
17 Net capital gain. Enter excess of net long-term capital gain (line 15) over net short-term capital loss (line 7) . . . . .				<b>17</b> <span style="float: right;">140,000</span>
18 Add lines 16 and 17. Enter here and on Form 1120, page 1, line 8, or the proper line on other returns . . . . .				<b>18</b> <span style="float: right;">140,000</span>
<p><b>Note:</b> If losses exceed gains, see <i>Capital Losses</i> in the instructions.</p>				
<p>For Paperwork Reduction Act Notice, see the Instructions for Form 1120.</p>		<p>Cat. No. 11460M</p>	<p>Schedule D (Form 1120) 2019</p>	

**Form 1120 – Tracing Boot Gain to the Federal Return**

<b>1120</b> Form Department of the Treasury Internal Revenue Service	<b>U.S. Corporation Income Tax Return</b> For calendar year 2019 or tax year beginning _____, 2019, ending _____, 20 _____ ▶ Go to <a href="http://www.irs.gov/Form1120">www.irs.gov/Form1120</a> for instructions and the latest information.	OMB No. 1545-0123 <span style="font-size: 24pt; font-weight: bold;">2019</span>
<b>A Check if:</b> 1a Consolidated return (attach Form 851) <input type="checkbox"/> b Life/nonlife consolidated return <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (see instructions) <input type="checkbox"/> 4 Schedule M-3 attached <input type="checkbox"/>		
<b>TYPE OR PRINT</b> Name: <b>EXAMPLE TAXPAYER, INC.</b> Number, street, and room or suite no. If a P.O. box, see instructions. City or town, state or province, country, and ZIP or foreign postal code		<b>B Employer identification number</b> XX-XXXXXX <b>C Date incorporated</b> _____ <b>D Total assets (see instructions)</b> \$ _____
<b>E Check if:</b> (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change		
<b>Income</b>	1a Gross receipts or sales <span style="float: right;">1a</span> b Returns and allowances <span style="float: right;">1b</span> c Balance. Subtract line 1b from line 1a <span style="float: right;">1c</span> 2 Cost of goods sold (attach Form 1125-A) <span style="float: right;">2</span> 3 Gross profit. Subtract line 2 from line 1c <span style="float: right;">3</span> 4 Dividends and inclusions (Schedule C, line 23) <span style="float: right;">4</span> 5 Interest <span style="float: right;">5</span> 6 Gross rents <span style="float: right;">6</span> 7 Gross royalties <span style="float: right;">7</span> 8 Capital gain net income (attach Schedule D (Form 1120)) <span style="float: right;">8 <b>140,000</b></span> 9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797) <span style="float: right;">9 <b>35,000</b></span> 10 Other income (see instructions—attach statement) <span style="float: right;">10</span> 11 <b>Total income.</b> Add lines 3 through 10 <span style="float: right;">11 <b>175,000</b></span>	
<b>Deductions (See instructions for limitations on deductions.)</b>	12 Compensation of officers (see instructions—attach Form 1125-E) <span style="float: right;">12</span> 13 Salaries and wages (less employment credits) <span style="float: right;">13</span> 14 Repairs and maintenance <span style="float: right;">14</span> 15 Bad debts <span style="float: right;">15</span> 16 Rents <span style="float: right;">16</span> 17 Taxes and licenses <span style="float: right;">17</span> 18 Interest (see instructions) <span style="float: right;">18</span> 19 Charitable contributions <span style="float: right;">19</span> 20 Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562) <span style="float: right;">20</span> 21 Depletion <span style="float: right;">21</span> 22 Advertising <span style="float: right;">22</span> 23 Pension, profit-sharing, etc., plans <span style="float: right;">23</span> 24 Employee benefit programs <span style="float: right;">24</span> 25 Reserved for future use <span style="float: right;">25</span> 26 Other deductions (attach statement) <span style="float: right;">26</span> 27 <b>Total deductions.</b> Add lines 12 through 26 <span style="float: right;">27</span> 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11. <span style="float: right;">28</span> 29a Net operating loss deduction (see instructions) <span style="float: right;">29a</span> b Special deductions (Schedule C, line 24) <span style="float: right;">29b</span> c Add lines 29a and 29b <span style="float: right;">29c</span>	
<b>Tax, Refundable Credits, and Payments</b>	30 <b>Taxable income.</b> Subtract line 29c from line 28. See instructions <span style="float: right;">30</span> 31 Total tax (Schedule J, Part I, line 11) <span style="float: right;">31</span> 32 2019 net 965 tax liability paid (Schedule J, Part II, line 12) <span style="float: right;">32</span> 33 Total payments, credits, and section 965 net tax liability (Schedule J, Part III, line 23) <span style="float: right;">33</span> 34 Estimated tax penalty. See instructions. Check if Form 2220 is attached <span style="float: right;">34</span> 35 <b>Amount owed.</b> If line 33 is smaller than the total of lines 31, 32, and 34, enter amount owed <span style="float: right;">35</span> 36 <b>Overpayment.</b> If line 33 is larger than the total of lines 31, 32, and 34, enter amount overpaid <span style="float: right;">36</span> 37 Enter amount from line 36 you want: <b>Credited to 2020 estimated tax</b> ▶ <b>Refunded</b> ▶ <span style="float: right;">37</span>	
<b>Sign Here</b>	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.	
	Signature of officer _____ Date _____ Title _____	May the IRS discuss this return with the preparer shown below? See instructions. <input type="checkbox"/> Yes <input type="checkbox"/> No
<b>Paid Preparer Use Only</b>	Print/Type preparer's name _____ Preparer's signature _____ Date _____ Firm's name ▶ _____ Firm's EIN ▶ _____ Firm's address ▶ _____ Phone no. _____	Check <input type="checkbox"/> if self-employed PTIN _____
For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form <b>1120</b> (2019)		

**Form 4797 – Gain on Taxable Disposition (Shows Ordinary and Capital Portions)**

Form <b>4797</b>  Department of the Treasury Internal Revenue Service	<b>Sales of Business Property</b> (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))  ▶ Attach to your tax return. ▶ Go to <a href="http://www.irs.gov/Form4797">www.irs.gov/Form4797</a> for instructions and the latest information.	OMB No. 1545-0184  <b>2019</b>  Attachment Sequence No. <b>27</b>						
Name(s) shown on return <b>EXAMPLE TAXPAYER, INC.</b>		Identifying number <b>XX-XXXXXX</b>						
1 Enter the gross proceeds from sales or exchanges reported to you for 2019 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions . . . . . <b>1</b>								
<b>Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year</b> (see instructions)								
<b>2</b>	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)	
<b>3</b>	Gain, if any, from Form 4684, line 39 . . . . .						<b>3</b>	
<b>4</b>	Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . .						<b>4</b>	
<b>5</b>	Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . .						<b>5</b>	
<b>6</b>	Gain, if any, from line 32, from other than casualty or theft . . . . .						<b>6</b>	<b>764,228</b>
<b>7</b>	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows . . . . .						<b>7</b>	<b>764,228</b>
<b>Partnerships and S corporations.</b> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.								
<b>Individuals, partners, S corporation shareholders, and all others.</b> If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.								
<b>8</b>	Nonrecaptured net section 1231 losses from prior years. See instructions . . . . .						<b>8</b>	
<b>9</b>	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions . . . . .						<b>9</b>	
<b>Part II Ordinary Gains and Losses</b> (see instructions)								
<b>10</b>	Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):							
<b>11</b>	Loss, if any, from line 7 . . . . .						<b>11</b>	( )
<b>12</b>	Gain, if any, from line 7 or amount from line 8, if applicable . . . . .						<b>12</b>	
<b>13</b>	Gain, if any, from line 31 . . . . .						<b>13</b>	<b>24,182</b>
<b>14</b>	Net gain or (loss) from Form 4684, lines 31 and 38a . . . . .						<b>14</b>	
<b>15</b>	Ordinary gain from installment sales from Form 6252, line 25 or 36 . . . . .						<b>15</b>	
<b>16</b>	Ordinary gain or (loss) from like-kind exchanges from Form 8824 . . . . .						<b>16</b>	
<b>17</b>	Combine lines 10 through 16 . . . . .						<b>17</b>	<b>24,182</b>
<b>18</b> For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.								
<b>a</b> If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040 or Form 1040-SR), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions . . . . .							<b>18a</b>	
<b>b</b> Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040 or Form 1040-SR), Part I, line 4 . . . . .							<b>18b</b>	
<b>For Paperwork Reduction Act Notice, see separate instructions.</b>							Cat. No. 130861	Form <b>4797</b> (2019)



**Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**  
(see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
<b>A</b>	<b>OFFICE BUILDING (ACQUIRED IN 1031 EXCHANGE) - TENNESSEE</b>	<b>XX/XX/199X</b>	<b>XX/XX/20X9</b>
<b>B</b>			
<b>C</b>			
<b>D</b>			

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
<b>20</b>	Gross sales price ( <b>Note:</b> See line 1 before completing.) . . . . .	<b>20</b>	1,000,000		
<b>21</b>	Cost or other basis plus expense of sale . . . . .	<b>21</b>	332,500		
<b>22</b>	Depreciation (or depletion) allowed or allowable. . . . .	<b>22</b>	120,910		
<b>23</b>	Adjusted basis. Subtract line 22 from line 21. . . . .	<b>23</b>	211,590		
<b>24</b>	Total gain. Subtract line 23 from line 20 . . . . .	<b>24</b>	788,410		
<b>25</b>	<b>If section 1245 property:</b>				
<b>a</b>	Depreciation allowed or allowable from line 22 . . . . .	<b>25a</b>			
<b>b</b>	Enter the <b>smaller</b> of line 24 or 25a. . . . .	<b>25b</b>			
<b>26</b>	<b>If section 1250 property:</b> If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.				
<b>a</b>	Additional depreciation after 1975. See instructions . . . . .	<b>26a</b>			
<b>b</b>	Applicable percentage multiplied by the <b>smaller</b> of line 24 or line 26a. See instructions. . . . .	<b>26b</b>			
<b>c</b>	Subtract line 26a from line 24. If residential rental property or line 24 isn't more than line 26a, skip lines 26d and 26e . . . . .	<b>26c</b>			
<b>d</b>	Additional depreciation after 1969 and before 1976. . . . .	<b>26d</b>			
<b>e</b>	Enter the <b>smaller</b> of line 26c or 26d . . . . .	<b>26e</b>			
<b>f</b>	Section 291 amount (corporations only) . . . . .	<b>26f</b>	24,182		
<b>g</b>	Add lines 26b, 26e, and 26f . . . . .	<b>26g</b>	24,182		
<b>27</b>	<b>If section 1252 property:</b> Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.				
<b>a</b>	Soil, water, and land clearing expenses . . . . .	<b>27a</b>			
<b>b</b>	Line 27a multiplied by applicable percentage. See instructions . . . . .	<b>27b</b>			
<b>c</b>	Enter the <b>smaller</b> of line 24 or 27b . . . . .	<b>27c</b>			
<b>28</b>	<b>If section 1254 property:</b>				
<b>a</b>	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions . . . . .	<b>28a</b>			
<b>b</b>	Enter the <b>smaller</b> of line 24 or 28a. . . . .	<b>28b</b>			
<b>29</b>	<b>If section 1255 property:</b>				
<b>a</b>	Applicable percentage of payments excluded from income under section 126. See instructions . . . . .	<b>29a</b>			
<b>b</b>	Enter the <b>smaller</b> of line 24 or 29a. See instructions . . . . .	<b>29b</b>			

**Summary of Part III Gains.** Complete property columns A through D through line 29b before going to line 30.

<b>30</b>	Total gains for all properties. Add property columns A through D, line 24 . . . . .	<b>30</b>	788,410
<b>31</b>	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13 . . . . .	<b>31</b>	24,182
<b>32</b>	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6 . . . . .	<b>32</b>	764,228

**Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less**  
(see instructions)

	(a) Section 179	(b) Section 280F(b)(2)
<b>33</b>	Section 179 expense deduction or depreciation allowable in prior years. . . . .	<b>33</b>
<b>34</b>	Recomputed depreciation. See instructions . . . . .	<b>34</b>
<b>35</b>	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report . . . . .	<b>35</b>

**Schedule D – Gain on Taxable Disposition (Shows Capital Portion Only)**

<p><b>SCHEDULE D</b> <b>(Form 1120)</b></p> <p>Department of the Treasury Internal Revenue Service</p>	<p><b>Capital Gains and Losses</b></p> <p>▶ Attach to Form 1120, 1120-C, 1120-F, 1120-FSC, 1120-H, 1120-IC-DISC, 1120-L, 1120-ND, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 1120-SF, or certain Forms 990-T.</p> <p>▶ Go to <a href="http://www.irs.gov/Form1120">www.irs.gov/Form1120</a> for instructions and the latest information.</p>	<p>OMB No. 1545-0123</p> <p style="font-size: 2em; font-weight: bold;">2019</p>		
<p>Name <b>EXAMPLE TAXPAYER, INC.</b></p>		<p>Employer identification number <b>XX-XXXXXX</b></p>		
<p>Did the corporation dispose of any investment(s) in a qualified opportunity fund during the tax year? . . . . . <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p> <p>If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.</p>				
<p><b>Part I Short-Term Capital Gains and Losses</b> (See instructions.)</p>				
<p><b>See instructions for how to figure the amounts to enter on the lines below.</b> This form may be easier to complete if you round off cents to whole dollars.</p>	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) <b>Gain or (loss)</b> Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b . . . . .				
1b Totals for all transactions reported on Form(s) 8949 with <b>Box A</b> checked . . . . .				
2 Totals for all transactions reported on Form(s) 8949 with <b>Box B</b> checked . . . . .				
3 Totals for all transactions reported on Form(s) 8949 with <b>Box C</b> checked . . . . .				
4 Short-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . .				<b>4</b>
5 Short-term capital gain or (loss) from like-kind exchanges from Form 8824 . . . . .				<b>5</b>
6 Unused capital loss carryover (attach computation) . . . . .				<b>6</b> ( )
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column h . . . . .				<b>7</b>
<p><b>Part II Long-Term Capital Gains and Losses</b> (See instructions.)</p>				
<p><b>See instructions for how to figure the amounts to enter on the lines below.</b> This form may be easier to complete if you round off cents to whole dollars.</p>	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) <b>Gain or (loss)</b> Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b . . . . .				
8b Totals for all transactions reported on Form(s) 8949 with <b>Box D</b> checked . . . . .				
9 Totals for all transactions reported on Form(s) 8949 with <b>Box E</b> checked . . . . .				
10 Totals for all transactions reported on Form(s) 8949 with <b>Box F</b> checked . . . . .				
11 Enter gain from Form 4797, line 7 or 9 . . . . .				<b>11</b> <span style="color: blue;">764,228</span>
12 Long-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . .				<b>12</b>
13 Long-term capital gain or (loss) from like-kind exchanges from Form 8824 . . . . .				<b>13</b>
14 Capital gain distributions (see instructions) . . . . .				<b>14</b>
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column h . . . . .				<b>15</b> <span style="color: blue;">764,228</span>
<p><b>Part III Summary of Parts I and II</b></p>				
16 Enter excess of net short-term capital gain (line 7) over net long-term capital loss (line 15) . . . . .				<b>16</b>
17 Net capital gain. Enter excess of net long-term capital gain (line 15) over net short-term capital loss (line 7) . . . . .				<b>17</b> <span style="color: blue;">764,228</span>
18 Add lines 16 and 17. Enter here and on Form 1120, page 1, line 8, or the proper line on other returns . . . . .				<b>18</b> <span style="color: blue;">764,228</span>
<p><b>Note:</b> If losses exceed gains, see <i>Capital Losses</i> in the instructions.</p>				
<p>For Paperwork Reduction Act Notice, see the Instructions for Form 1120.</p>		<p>Cat. No. 11460M</p>	<p>Schedule D (Form 1120) 2019</p>	

**Form 1120 – Tracing Gain on Sale to the Federal Return**

<b>1120</b> Form Department of the Treasury Internal Revenue Service	<b>U.S. Corporation Income Tax Return</b> For calendar year 2019 or tax year beginning _____, 2019, ending _____, 20 _____ ▶ Go to <a href="http://www.irs.gov/Form1120">www.irs.gov/Form1120</a> for instructions and the latest information.	OMB No. 1545-0123 <div style="font-size: 2em; font-weight: bold; margin-left: 10px;">2019</div>																																																																																
<table border="1" style="width:100%; border-collapse: collapse;"> <tr> <td style="width:30%; vertical-align: top;"> <b>A Check if:</b>            1a Consolidated return (attach Form 851) <input type="checkbox"/>            b Life/nonlife consolidated return <input type="checkbox"/>            2 Personal holding co. (attach Sch. PH) <input type="checkbox"/>            3 Personal service corp. (see instructions) <input type="checkbox"/>            4 Schedule M-3 attached <input type="checkbox"/> </td> <td style="width:35%; text-align: center; vertical-align: middle;"> <b>TYPE OR PRINT</b> </td> <td style="width:35%; vertical-align: top;"> <b>Name</b>            EXAMPLE TAXPAYER, INC.  <b>Number, street, and room or suite no. If a P.O. box, see instructions.</b>    <b>City or town, state or province, country, and ZIP or foreign postal code</b> </td> </tr> <tr> <td colspan="2"></td> <td style="vertical-align: top;"> <b>B Employer identification number</b>            XX-XXXXXX  <b>C Date incorporated</b>    <b>D Total assets (see instructions)</b>            \$         </td> </tr> </table>			<b>A Check if:</b> 1a Consolidated return (attach Form 851) <input type="checkbox"/> b Life/nonlife consolidated return <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (see instructions) <input type="checkbox"/> 4 Schedule M-3 attached <input type="checkbox"/>	<b>TYPE OR PRINT</b>	<b>Name</b> EXAMPLE TAXPAYER, INC. <b>Number, street, and room or suite no. If a P.O. box, see instructions.</b>  <b>City or town, state or province, country, and ZIP or foreign postal code</b>			<b>B Employer identification number</b> XX-XXXXXX <b>C Date incorporated</b>  <b>D Total assets (see instructions)</b> \$																																																																										
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For Paperwork Reduction Act Notice, see separate instructions. <span style="float: right;">Cat. No. 11450Q <span style="margin-left: 100px;">Form 1120 (2019)</span></span>																																																																																		

## Chapter 12: Net Operating Losses

### Schedule K – Loss Carryover

The *current year* net operating loss (“NOL”) amount is shown on Schedule K - Determination of Loss Carryover Available, Line 6. This schedule reverses out certain deductions that were allowed on Schedules J1, J2, and J - in regard to dividends, nonbusiness earnings, earnings subject to self-employment taxes, and payments to a qualified pension or benefit plan.<sup>461</sup> These reversals (add-backs) should never turn an apportioned business loss (Schedule J, Line 33) into income. The current year loss amount shown on Schedule K, Line 6 is after apportionment, and taxpayers will report it on the subsequent year’s Schedule U - Schedule of Loss Carryover.

A common error is mistaking the loss shown on Schedule J, Line 31 - Total Business Income (Loss) or Schedule J, Line 33 - Apportioned Business Income (Loss) as the *current year loss* amount that is available for carryover. However, the current year loss amount is the amount shown on the last line of Schedule K.

More specifically, the deductions made in calculating total business income on Line 29 that must be reversed in arriving at the current year loss available for carryover are:

- Dividends from corporations owned 80%-or-more deducted on Schedule J, Line 18;
- Nonbusiness earnings reported on Schedule J, Line 22 (and on Schedule M, Line 8);
- Earnings subject to self-employment tax deducted on Schedule J1, Line 6 and Schedule J2, Line 8; and
- Payments to a qualified pension or benefit plan deducted on Schedule J1, Line 7.

Schedule J and Sub-J audit work concerning the above expenses may be limited at the auditor’s discretion when there is a current year loss, and the amount will ultimately be reversed on Schedule K.

### Schedule U – Loss Carryover

Any NOL incurred for a fiscal year ending on or after January 15, 1984, may be carried forward 15 years as a NOL carryover.<sup>462</sup> For example, a 2019 loss will expire in 2035, so any loss from 2019 that has not been used by the beginning of 2035 will be unavailable to offset Tennessee

taxable income. Schedule U shows the losses earned, used, expired, and available for carryover by tax year.

**⚠ NOLs may not be carried back to offset net earnings subject to excise tax.**

Losses are always applied to the first available year of earnings and continue each year until the loss carryover is fully utilized. This means the losses are applied to the oldest period first.

At the beginning of an audit, carryover information that the taxpayer reported on Schedule U is compared with the state's computer schedule. Differences in the taxpayer's and the Department's loss carryover schedules are not unusual, but may go unnoticed by the taxpayer, resulting in a debit or credit memo.

The auditor should review not only the current year loss available for carryover but also the total loss carryover available to future periods. The Department's carryover schedule will show a 15-year history of loss carryovers earned and used, along with the current balance, for each tax period. Any differences discovered when this detailed information is compared to the taxpayer's Schedule U should be investigated. The taxpayer's failure to properly claim a loss on Schedule U does not prevent the Department from allowing the earned loss to offset future taxable income. Schedules J and K of the loss year establish the loss carryover amount for that year; so even if the taxpayer fails to include the loss on Schedule U, it would be reflected in the Department's computer system and included in the tax calculation. All increases to the loss carryover balance should come from Schedule K, Line 6.

Any discharge of indebtedness occurring on or after October 1, 2013, as the result of a Chapter 11 reorganization, must reduce net operating losses ("NOLs") by the amount that has been excluded from federal taxable income.<sup>463</sup> See Chapter 13 for further information.

## **Audit Adjustments to Carryover Schedules**

The Department may assess tax in years within the statute of limitations ("SOL") based on changes made to the loss carryover amounts from tax years outside the SOL.

**⚠ The SOL bars the *assessment* of tax in years that are closed, but it *does not bar* the *adjustment* of carryover schedules.**

For example:

- Taxpayer files a return for the year ended December 31, 2008, and reports a current year loss amount of \$1 million.
- Taxpayer reported the loss on Schedule U and carried it forward each year, unused, because Taxpayer continued to have losses.
- In 2020, Taxpayer reports a profit and deducts the 2008 loss carryover amount, resulting in very little excise tax paid.
- During an audit of the current year tax return, the auditor discovers that the \$1 million loss reported on the 2008 return should have been a \$1,000 loss.
- The auditor may correct the carryover schedule and assess additional current year excise tax even though the 2008 tax return is outside the SOL.

The excise tax liability for all tax years after the year in which a carryover schedule is changed needs to be sequentially recalculated, taking into account excise tax add-backs and deductions and the applicable apportionment ratios, to determine the loss carryover balance available to offset net income in tax years open under the SOL. The 15-year carryforward limitation would still apply. Only tax years open under the SOL would be assessed additional tax. For example:

- Auditor corrects the taxpayer's loss carryover schedule by decreasing a 2009 carryover amount by \$10,000.
- There are no statute waivers.
- The excise tax for 2010 is recalculated, resulting in additional excise tax due of \$325.
- However, there is no assessment, because 2010 is outside the SOL.
- The auditor would then recalculate the 2011 excise tax using the adjusted carryover schedule that reflects the 2010 tax recalculation.

Auditors should *not* perform detailed audits of tax years outside the SOL in order to verify a loss carryover amount; however, they *should* scan the schedule for obvious anomalies that are likely

errors. The auditor should confirm the taxpayer agrees that an error was made in the carryover schedule of a year outside the SOL. If the taxpayer states that the carryover schedule is correct, the auditor should accept it and not request detailed records for this tax year.

However, in the event that a *taxpayer changes* the amount of a loss carryover on Schedule U for a tax year outside the SOL, the *auditor should request* detailed support for the adjustment before accepting the change.<sup>464</sup> If accepted, the excise tax liability for all tax years, starting with the year after the change, would be recalculated and the limitations on timing for refunds and assessments would apply.

**⚠ The same rules outlined above that apply to adjusting carryover schedules also apply to the job tax credit and industrial machinery credit carryover schedules.**

## Survivability of NOLs

### 1. Successors and “Shell” Entities

Generally, each taxpayer is considered a separate entity for Tennessee franchise and excise tax purposes. When there is a merger, consolidation, or like transaction the successor entity *cannot* use loss carryovers generated by a predecessor entity. When two or more businesses merge, only losses of the survivor corporation will be allowed.<sup>465</sup> However, if a business merges into a shell entity, where the successor is essentially the same taxpayer as the predecessor, then the successor entity may take a deduction for the predecessor’s loss carryover.<sup>466</sup>

**⚠ A shell entity is one that has no income, expenses, assets, liabilities, equity or net worth, or operations at the time of the restructuring.**

For example:

- **Step 1** – June 15, 2015: Company A formed the Taxpayer as a wholly-owned subsidiary under the laws of Delaware. At that time, the Taxpayer had no income, expenses, assets, liabilities, equity, or net worth.
- **Step 2** – August 30, 2015: Company A contributed all of Company B’s stock to the Taxpayer.
- **Step 3** – August 31, 2015: Company B converted to a single-member LLC of the Taxpayer.

- Because the Taxpayer held Company B's stock prior to the conversion, it was not a shell company, and thus, cannot use Company B's previously generated losses.

## 2. Unitary Groups of Financial Institutions

A unitary group of financial institutions may take a loss carryforward generated by a group member that is a member of the group at the end of the group's tax year, provided the loss carryover was not taken by the member itself before it joined the group or by another unitary group of financial institutions of which the member had previously been a part.<sup>467</sup>

A unitary group of financial institutions may not use a loss carryover generated by a group member that dissolved, merged out of existence, or converted from a corporation to an SMLLC. Furthermore, if a unitary group member that generated losses is sold and becomes a unitary group member of another unitary group, the losses it generated *stay with the original group*.

## 3. Conversion from Corporation to SMLLC Owned by Non-Shell Parent Corporation

After a corporation converts to an SMLLC, even though the predecessor taxpayer is disregarded to the parent, the predecessor's losses cannot be used by the parent. This conversion is equivalent to a merger of a subsidiary corporation out of existence and into the parent corporation, with the taxpayer as the successor entity.

An NOL may only be taken by the entity that created it. Before the conversion, the taxable entity was the predecessor corporation, but after the conversion, it was the predecessor corporation *plus* the parent. Since the predecessor and successor taxable entities are different, the loss carryforward is not allowed.<sup>468</sup>

## 4. "F" Reorganization – U.S.C. §368(a)(1)(F)<sup>469</sup>

Generally, a taxpayer may not use the NOL carryforward of an affiliate that has been party to an "F" reorganization. However, the following circumstances are exceptions to this rule:

- The "F" reorganization is for the reincorporation of the operating company in another state. The reorganization is accomplished using a single operating company and a shell corporation. For example:



- Corporation X, planning to reincorporate in another state, forms Shell Corporation Y in the new state.
  - Corporation X then merges into Corporation Y, with Corporation Y as the surviving entity.
  - The successor taxpayer is a shell company. New Corporation Y may use Corporation X's NOL carryforward.
- If a company that is a member of a financial institution unitary group undergoes an "F" reorganization, the unitary group may continue to use the NOL carryforward generated by the company, provided that the company is in existence as a member of the unitary group at the end of the unitary group's tax year.

### **5. Dissolution of Affiliate**

If a company makes a liquidating distribution of its assets to another company and then goes out of business (dissolves), its net operating losses do not survive the dissolution. The successor taxpayer may not use the dissolved affiliate's NOL carryforward.

### **6. Loss Generated by Taxpayer Making an Entity Election**

An entity may change the way it is taxed for federal income tax purposes. For example, a corporation may elect to be taxed as an S-Corporation. Also, an eligible entity may use federal Form 8832 to elect<sup>470</sup> how it will be classified for federal tax purposes: a corporation, a partnership, or an entity disregarded as separate from its owner. These elections are not the same as a merger, a consolidation or like transaction, and therefore, the entity may continue to use its NOL carryforwards.

### **7. "338(h)(10)" Election Deemed Existence of Two Corporations**

I.R.C. § 338(h)(10) is a joint election that allows a corporation that acquires the *stock* of another corporation to treat the acquisition as a purchase of *assets* instead of stock. The income or loss from such a transaction may be reflected on the consolidated federal return. At the federal level, the mechanics of this election involve a "deemed" asset sale and the "deemed" existence of two corporations. However, because Tennessee has not adopted the federal regulations under Section 338, there is no deemed existence of two corporations and no deemed liquidation. The corporation is the same corporation before and after the transaction that was the subject of the

Section 338(h)(10) election. Therefore, any loss carryforward is allowed in subsequent tax years for excise tax purposes.<sup>471</sup>

## **Audit Procedures – Loss Carryovers**

The following are minimum suggested audit procedures. Modifications may be needed due to the particular facts and circumstances of a given audit and the auditor's judgment.

- Compare yearly details from the taxpayer's Schedules U with the state's computer loss carryforward screens.
  - Investigate differences and solicit the taxpayer's help in explaining how it arrived at its numbers.
- Look at the state's computer loss carryforward schedules to identify keying errors.
  - For example, an unusually large loss for a particular year may be recorded because the Schedule N apportionment schedule was not keyed into the Department's computer system, resulting in a 100% loss to generate instead of an apportioned amount. The erroneous 100% apportionment also could be due to taxpayer oversight in preparing the return.
- Consider whether a merger, consolidation, or like event has occurred in any prior year that would require an adjustment to the schedule.
- Consider whether the Department established or modified an account in error, based on incorrect information, which allowed the losses of one taxpayer to be available to another.

## Chapter 13: Discharge of Indebtedness Income


### Summary

Any discharge of indebtedness occurring on or after October 1, 2013, as the result of a Chapter 11 reorganization,<sup>472</sup> must reduce net operating losses (“NOLs”) by the amount that has been excluded from federal taxable income.<sup>473</sup> The adjustment is made on The [Excise Tax Report of Bankruptcy Discharge](#) form (RBD). The discharge of debt is applied first to the current year’s NOL found on Schedule K of the excise tax return and then to prior year losses shown on a carryover schedule in the order of the taxable years from which each carryforward arose.<sup>474</sup> The adjustment amount cannot reduce the current year loss (Schedule K) below zero. In other words, the adjustment cannot turn a current year loss into income.

The RBD form is used to report an adjustment to the current year loss and loss carryover schedule, if applicable.

### Example – Discharge of Debt

A non-apportioning Tennessee business files for Chapter 11 bankruptcy. The date of discharge is October 31, 2018. A \$100,000 note payable is discharged in the bankruptcy proceedings and is excluded from federal taxable income. This discharge of debt is more than the current year’s loss of \$75,000 (Form FAE170, Schedule K, Line 6). The amount of the debt discharged is added back to the current year’s loss to bring the current year loss carryover amount to zero, but not to create taxable income. The amount discharged that exceeds the current year loss of \$25,000 offsets loss carryovers from prior years in the order they arose (oldest first). In this case, \$10,000 from 2014 and then \$15,000 from 2015. In summary, the \$100,000 debt discharge reduced the 2018 net loss of \$75,000 and the 2014 net loss of \$10,000 to \$0. It also reduced the 2015 net loss by \$15,000. The sum of the reductions total \$100,000, the amount of the bankruptcy debt discharged. The 2018 FAE170 is filed as normal. The adjustments are reported on the RBD form that is filed after the 2018 FAE170. Example of the RBD form entries:

	<b>TENNESSEE DEPARTMENT OF REVENUE</b> <b>Excise Tax Report of Bankruptcy Discharge</b>	RV-F1322601 (4/18)	
Taxpayer Name <b>Example Bankruptcy Discharge</b>	FEIN	Account Number	
<b>Part 1 - Calculation of Discharge of Indebtedness Income Add-Back</b>			
1. Tax year of discharge .....	(1)	<u>2018</u>	
2. Date of discharge .....	(2)	<u>10-31-18</u>	
3. Amount of discharge .....	(3)	<u>\$100,000</u>	
4. Excise tax apportionment ratio for tax year of the discharge .....	(4)	<u>100</u> %	
5. Discharge of indebtedness income add-back amount (multiply Line 3 by Line 4) ....	(5)	<u>\$100,000</u>	
6. Tennessee loss for year of discharge entered as a positive number (from FAE170 or FAE174, Schedule K, Line 6) Enter \$0 on this line if there is a net income in the current year .....	(6)	<u>\$75,000</u>	
7a. Revised Schedule K, Line 6 - reduced loss carryover for year of discharge (subtract Line 5 from Line 6) If Line 5 is more than Line 6, enter zero and continue to Line 7b. If Line 6 is more than Line 5, subtract Line 5 from Line 6 and stop here .....	(7a)	<u>-0-</u>	
7b. Complete Part 2 - remaining discharge of indebtedness income add-back (subtract Line 6 from Line 5) If Line 6 is more than Line 5, do not complete this line or Part 2 .....	(7b)	<u>\$25,000</u>	
<b>Part 2 - Remaining Discharge of Indebtedness Income Add-Back - Revised Schedule U</b>			
a. Period Ended (MM/YY)	b. Loss Carryover Available Before Discharge	c. Remaining Discharge of Indebtedness Income Add-Back Applied	d. Adjusted Balance (subtract Column c from Column b)
<u>12/14</u>	<u>\$10,000</u>	<u>\$10,000</u>	<u>-0-</u>
<u>12/15</u>	<u>\$20,000</u>	<u>\$15,000</u>	<u>\$5,000</u>

## Report of Bankruptcy Discharge (Chapter 11)

The RBD should be submitted to the Franchise and Excise Tax Office Audit and Review Unit in the Department’s Audit Division in a separate mailing from the returns filed on Forms FAE170 or 174, and it should be filed *after* the franchise and excise tax return has been filed for the year of discharge, but *before* the subsequent year is filed. Even though Form FAE170, Schedule K for the year of discharge has already been filed, the adjustment is made on Line 7a of the subsequently filed RBD form and not on Schedule K of the excise tax return.

## Federal Treatment (Chapter 11)

A fundamental goal of the federal bankruptcy laws is to give an honest debtor a financial “fresh start.” This is accomplished through the bankruptcy discharge, which is a court ordered prohibition against the collection of certain debts. Generally, when a debt owed to another entity is canceled, the amount canceled or forgiven is considered income that is taxed to the person owing the debt. However, if a debt is canceled under a bankruptcy proceeding the amount canceled is not income. The canceled debt reduces other tax benefits/attributes to which the debtor would otherwise be entitled, starting with net operating losses.<sup>475</sup> In reducing NOLs, taxpayers are instructed to first reduce the loss for the tax year of the debt cancellation, and then any loss carryovers to that year in the order of the tax years from which the carryovers arose, starting with the earliest year. While the federal discussion of this topic can be complicated, the federal mechanics operate in a manner similar to what is required under Tennessee excise tax law.

A federal [Form 982](#) must be filed with the corresponding income tax return in the year that a discharge of indebtedness was excluded from taxable income. This federal form should be used to verify the accuracy of the information reported on the RBD. The tax year and amount of discharge that is reported on the first section of the RBD should be traceable to federal Form 982. Part 1, Line 1a of this form has a check box for “Chapter 11” and the “total amount of discharged indebtedness excluded from gross income” is reported on Line 2.

For federal tax purposes, if the amount of the discharged indebtedness exceeds the amount of the federal tax attributes (net operating loss carryovers, general business credit carryovers, minimum tax credits, and capital loss carryovers) then the basis of property is reduced under I.R.C. §108(b).

Taxpayers may also make an election on federal Form 982<sup>476</sup> to apply all or a part of the debt discharged amount to first reduce the basis of depreciable property before being applied to tax attributes, such as loss carryovers. If that election is made, the taxpayer’s net income will increase, because depreciation expense will decrease. However, the cancellation of debt income should nonetheless decrease the Tennessee NOL.

If a taxpayer opts for basis reduction treatment under I.R.C. § 108(b)(5), the taxpayer must nevertheless reduce its Tennessee NOLs in the year it receives the cancellation of debt. The effect is that the taxpayer may see Tennessee tax consequences twice from the I.R.C. § 108(b)(5) election:

- First, when it reduces its Tennessee NOLs; and

- Second, when it sells the property, realizing a federal tax gain.

Taxpayers typically balance state tax consequences with their federal tax elections or structuring to determine their most advantageous option.

Federal Schedule M-1 or M-3 reconciles “book” and “tax” net income. The Chapter 11 discharge of indebtedness is generally not traceable to an M-1 or M-3 item. For federal tax purposes, the discharge of indebtedness under Chapter 11 results in a reduction of tax attributes (like loss carryovers) or reduces the basis of property. The impact of these adjustments would be imbedded in other accounts, such as deferred tax, tax expense, and depreciation.

The “book” treatment, discussed below, may result in the gain being included in the Schedule L balance sheet beginning retained earnings amount. Therefore, auditors should not spend a lot of time trying to identify this adjustment on the M-1 or M-3 schedule.

## GAAP Accounting Treatment (Chapter 11)

Entities that file for protection from creditors under Chapter 11 bankruptcy seek to reorganize and emerge as a viable business. The accounting rules attempt to preserve the “going concern value” of the entity. The GAAP guidelines are found at ASC 852 – Reorganizations – and are not fully addressed here. Under Chapter 11 reorganization, the balance sheet accounts may take on new balances to reflect the exchange of stock and the discharge of debt. Also, under “fresh start”<sup>477</sup> reporting, any deficit is eliminated, and retained earnings are set to zero. The initial stockholders may have no interest in the “fresh start” entity; instead, the old creditors may now be the owners. The deferred income tax and tax expense accounts are adjusted because of the IRS “reduction in tax attributes due to the discharge of indebtedness.”

In transitioning to “fresh start” reporting, any adjustments to assets and liabilities are reported in the pre-fresh start entity’s final income statement, along with the effects of debt forgiveness. Also, any deficit would be eliminated before the beginning of the “fresh start” entity.

While franchise and excise tax auditors do not need to fully understand the GAAP treatment of Chapter 11 reorganizations, a basic understanding is helpful. If there is a difference between the amount of discharge of debt reported by GAAP records and federal tax records, the tax documentation (federal Form 982) should prevail for the purpose of making the franchise and excise tax NOL adjustment.

## **Audit Procedures – Discharge of Indebtedness**

- 1) Determine if there has been a Chapter 11 reorganization on or after October 1, 2013, through financial statement footnotes, internet research, and taxpayer inquiry.
- 2) If there *was* a Chapter 11 reorganization, review the Department's computer system to see if the taxpayer filed an RBD form.
- 3) Request federal Form 982 if it is not on the Department's computer system or included in the federal return.
- 4) Agree the information reported on the RBD form with the federal Form 982. If additional understanding of the reorganization is needed, consider reviewing the taxpayer's financial statements, footnotes, and supporting records.
- 5) Make sure the loss carryover schedule in the state's computer system accurately reflects the adjustment from the RBD form.

## Chapter 14: Apportionment

### Introduction to Tax Apportionment

When a business has operations in both Tennessee and other states, the portion of the business' income attributable to its activities in Tennessee must be determined so that the franchise and excise liability applies only to the portion of net worth and net earnings generated by Tennessee operations. Tennessee statutes and rules dictate the acceptable methods for apportioning business earnings for multi-state companies.<sup>478</sup> The state's guidance on apportionment stems largely from language found in the Uniform Division of Income for Tax Purposes Act ("UDITPA") and Multistate Tax Commission ("MTC") Regulations.<sup>479</sup>

The National Conference of Commissioners on Uniform State Laws drafted UDITPA as a model act and approved it in 1957. Its goal is to reduce diversity among states in the allocation and apportionment methods used to determine the several states' respective shares of a corporation's taxable income. Most states with an income tax have adopted UDITPA or UDITPA-like statutes. Tennessee has adopted *most* provisions of UDITPA; however, it did *not* adopt the "throwback provision," in which a sale is thrown back to the sales factor numerator of the state from which the goods were shipped, if the seller is not taxable in the destination state. Because states' apportionment methods differ, the sum of a business's aggregate apportionment ratios in each state in which it is subject to tax will rarely equal 100%.

#### 1. Allocation (Nonbusiness Earnings) Versus Apportionment (Business Earnings)

The word "apportion" refers to *business earnings* and the word "allocation" refers to *nonbusiness earnings*. These two words are not interchangeable. *Business earnings* are earnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property, if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations.<sup>480</sup> *Nonbusiness earnings* are all earnings other than business earnings, and they are allocated and not apportioned.<sup>481</sup>

Tennessee taxes nonbusiness earnings allocated to Tennessee at the full 6.5% excise tax rate. Apportionment does not apply to nonbusiness earnings. Therefore, taxpayers should not report the gross receipts, payroll, and property associated with nonbusiness earnings on the standard apportionment schedule (Schedule N).<sup>482</sup> (See Chapter 8 – Business and Nonbusiness Earnings)



## 2. Right to Apportion

A taxpayer is entitled to apportion its net worth and net business earnings (losses) if it has business activities that are taxable both inside and outside Tennessee. A taxpayer is considered taxable in another state only if the taxpayer is conducting activities in that state that, if conducted in Tennessee, would constitute doing business in Tennessee and would subject the taxpayer to either Tennessee's franchise or excise tax.<sup>483</sup> In other words, a Tennessee taxpayer purposefully engaged in an activity in another state with the object of gain, benefit, or advantage, and having substantial nexus (as defined by Tennessee law<sup>484</sup>) in that state, is entitled to apportion its net worth and net business earnings (losses) for franchise and excise tax purposes.

**⚠ Note, the same “doing business” and “substantial nexus” standards apply to both the determination of nexus and the right to apportion. See Chapter 3 - Nexus.**

Taxpayers that do not meet the above criteria do *not* have the right to apportion. For example:

- If a Tennessee taxpayer's only connection with another state is a sale that does not exceed the substantial nexus bright-line test, the taxpayer does not have the right to apportion.

**⚠ Auditors may request copies of state tax returns filed in other states. However, the fact that a taxpayer filed a tax return in another state, alone, does not necessarily mean that the taxpayer has the right to apportion.**

Taxpayers without the right to apportion should enter 100% on the apportionment ratio lines on the net worth and net earnings schedules (Schedules F1 and J, respectively). See [Revenue Ruling 06-18](#) for an example of a taxpayer having substantial nexus in a state other than Tennessee and the taxpayer's right to apportion for franchise and excise tax purposes.

## 3. Public Law 86-272

Taxpayers claiming exemption from the excise tax under Public Law 86-272 may apportion their net worth subject to franchise tax.<sup>485</sup> Also, a taxpayer that is subject only to franchise tax (or a similar tax) in another state may establish its right to apportion its net earnings subject to Tennessee excise tax, even when the taxpayer is protected from paying an excise tax (or similar tax) in that other state.

As previously stated, a taxpayer is considered taxable in another state only when conducting activities in that state that, if conducted in Tennessee, would constitute doing business in Tennessee and would subject the taxpayer to either the franchise or excise tax. Since Public Law 86-272 applies only to the excise tax, it does not affect franchise tax nexus or right to apportion. See the discussion in Chapter 3 – Nexus – on Public Law 86-272.

For example:

- Corporation X is based in Tennessee but has five full-time sales employees with tangible personal property (car, computer, inventory samples, and advertising materials) based in another state.
- The employees work out of their homes, and all of their activity in the other state falls within the protections for sales solicitation activities provided under Public Law 86-272.
- Corporation X has the right to apportion in Tennessee regardless of whether it files a tax return in the other state because the activities conducted by Corporation X in the other state would result in it being subject to franchise tax if the out-of-state activity was conducted in Tennessee.

## Forms – Apportionment

Most taxpayers will use the standard apportionment formula on Schedule N to calculate their franchise and excise tax apportionment ratios. However, common carriers (e.g., railroads, motor carriers, pipelines, and barges), air carriers, and air express carriers calculate special apportionment ratios on Schedules O, P, and R, respectively.

Any taxpayer that is part of an affiliated group that has elected to compute their net worth on a consolidated basis will calculate its apportionment ratio on Schedule 170NC, 170SF or 170SC. (See Chapter 9 – Franchise Tax – for more information on consolidated net worth.) Taxpayers that are bound by a consolidated net worth election and that have 100% of their business operations within the state will complete one of these apportionment schedules but will not complete an apportionment schedule for excise tax purposes. However, multi-state taxpayers bound by a consolidated net worth election will use Schedules N, O, P, R, or S to apportion their net earnings subject to excise tax.

Manufacturers will use the standard apportionment Schedule N unless they have made the single sales factor election,<sup>486</sup> in which case they will use Schedule S to calculate their franchise and excise tax apportionment ratio.

## Apportionment Ratio Calculation

### 1. Standard Apportionment – Schedule N

As stated previously, most apportioning taxpayers will use the standard apportionment schedule (Schedule N) to calculate the apportionment ratio used to apportion their net worth and net earnings. This schedule computes the ratio based on three factors (property, payroll, and sales) and uses a triple-weighted sales factor.<sup>487</sup> Mechanically, the computation is as follows:

	<b>In Tennessee Dollar Value (a)</b>	<b>Divided By</b>	<b>Everywhere Dollar Value (b)</b>	<b>Percentage (a) / (b)</b>
1	Property - average of beginning and end of year values	÷	Property - average of beginning and end of year values	__ %
2	Payroll	÷	Payroll	__ %
3	Sales	÷	Sales	__ %
4	Sales	÷	Sales	__ %
5	Sales	÷	Sales	__ %
Total of all ratios				__ %
Number of Everywhere Factors				<b>5</b>
Apportionment Ratio				__ %

Taxpayers sum the ratio for each factor (counting the sales factor three times) and then divide by five to arrive at the overall apportionment ratio. However, in some cases, the divisor may be less than five. If the denominator of a factor is zero, eliminate the factor and then compute the overall apportionment ratio from the remaining factor or factors.<sup>488</sup> For example:

- If a company has “0” in everywhere payroll, you will eliminate the payroll factor, and the total of all ratios will be divided by four rather than five.
- If the “everywhere” denominators of a taxpayer’s property, payroll, and sales factors are all zero, then the taxpayer has an overall apportionment ratio of zero.

## 2. Elective Apportionment for Certain Taxpayers

### *Manufacturers – Single Sales Factor*

Manufacturers may elect to apportion their net worth and net earnings subject to Tennessee franchise and excise taxes, respectively, based on a single sales factor (“SSF”).<sup>489</sup> Taxpayers electing the SSF apportionment method will apportion using a fraction:

- The **numerator** of which is the taxpayer’s total gross receipts (sales) in Tennessee during the taxable year; and
- The **denominator** of which is the taxpayer’s total gross receipts from all locations, within or outside Tennessee, during the taxable year.

Property and payroll are not considered.

This election is only for taxpayers whose principal business in Tennessee is manufacturing. A taxpayer is principally in the business of manufacturing if more than 50% of the taxpayer’s revenue from its activities in this state, excluding passive income, is from fabricating or processing tangible personal property for resale and consumption off the premises. Passive income includes dividend income, interest income, income from the sale of securities, and income from the licensing or sale of patents and other intellectual property.

- The franchise and excise tax statutes do not define “manufacturer.” However, the Department will generally apply the same logic, rulings, and judgment used for sales and use tax purposes in defining a manufacturer.<sup>490</sup>
- In addition, the same logic used to determine eligibility for the industrial machinery credit would apply in determining whether an entity is a manufacturer for the purpose of making the SSF election.

### **50% Manufacturing Test**

To determine whether more than 50% of a taxpayer’s revenue from its activities in this state (excluding passive income) is from manufacturing activities, a ratio is taken. The numerator of this ratio includes revenues derived from manufacturing activities occurring in Tennessee, and the denominator includes all revenues (excluding passive income) derived from all activities occurring in Tennessee. The following chart indicates the various revenue streams to be considered in calculating the ratio:

<b>Numerator</b>	Sales of TPP manufactured by taxpayer <i>within</i> TN <i>and</i> sold from a location* <i>within</i> TN
	Sales of TPP manufactured by taxpayer <i>within</i> TN <i>and</i> sold from a location <i>outside</i> TN
<b>Denominator</b>	Sales of TPP manufactured by taxpayer <i>within</i> TN <i>and</i> sold from a location* <i>within</i> TN
	Sales of TPP manufactured by taxpayer <i>within</i> TN <i>and</i> sold from a location <i>outside</i> TN
	Sales of TPP <i>not manufactured</i> by taxpayer <i>and</i> sold from a location <i>within</i> TN
	Sales of services performed by taxpayer <i>and</i> received by customers <i>within</i> TN
	All other sales** derived by taxpayer from activities occurring <i>within</i> TN

\* Sale of manufactured TPP *does not* have to be made directly from the manufacturing location.

\*\* *Excluding* "passive income," which means dividend income, interest income, income derived from the sale of securities, and income derived from the licensing or sale of patents, trademarks, tradenames, copyrights, know-how, or other intellectual property.

If the ratio, as calculated above, is more than 50%, then the taxpayer qualifies as a manufacturer that is eligible to make the SSF election.

### Making the Election

To make the SSF election, a manufacturer makes an election on Form FAE170 for the taxable year to which the election first applies. Taxpayers must make the election on the original return; however, if the taxpayer inadvertently fails to make the election on the original return, the Department will permit the taxpayer to file an amended return for the purpose of making the SSF election, but only if the taxpayer files the amended return with the Department by the extended due date of the return to which the election will first apply. This election, once made, will remain in effect for a minimum of **five years**.<sup>491</sup> A taxpayer may revoke the election after five years and may only make a new election after five years have passed, beginning with the tax year for which the taxpayer revoked the previous election.

See the third example at the end of this chapter for an example of apportionment when a manufacturer makes *both* the consolidated net worth and SSF elections.

### Financial Asset Management Companies

Financial Asset Management Companies ("FAMC") may elect to apportion net earnings and net worth to Tennessee based on a single sales factor.<sup>492</sup> To be an FAMC, the entity must:

- Be treated as a partnership for federal income tax purposes;

- Be in the business of providing financial asset management services; and
- Either have a class of equity requiring it to file with the SEC or be owned by a publicly traded partnership<sup>493</sup> that owns at least 25% of the entity and such ownership constitutes more than 50% of the total assets of the publicly traded partnership.
  - A publicly traded partnership is an entity treated as a partnership for federal income tax purposes, files with the SEC, and its shares are traded on a registered national securities exchange or national securities exchange of a foreign country.<sup>494</sup>

An FAMC provides asset management services with respect to financial investments owned by others. FAMCs derive income on a fee or commission basis. Their services may include managing portfolio assets, rendering investment advice, including investment research and analysis, making determinations as to when investments are to be bought or sold, and making the purchase or sale. Financial investments include investments in stocks, options, bonds, and alternative asset classes (real estate, commodities, debt obligations, and more). A REIT is never an FAMC.

### *Certified Distribution Sales*

Certain large taxpayers may elect to omit *certified distribution sales* from the numerator of their receipts factor for apportionment purposes and pay an alternative excise tax on such receipts.<sup>495</sup> A taxpayer may make this election if it:

- Has made sales in Tennessee of tangible personal property to distributors exceeding \$1,000,000,000 during the tax period; and
- Has a receipts factor, as determined under Tenn. Code Ann. § 67-4-2012 without regard to this election, that exceeds 10%.

“Certified distribution sales” are sales of tangible personal property made in this state by the taxpayer to any distributor, whether the distributor is affiliated with the taxpayer, that are resold for ultimate use or consumption outside the state. The distributor must certify that the property has been resold for ultimate use or consumption outside this state.

Taxpayers pay the alternative excise tax annually based on the total amount of certified distribution sales excluded from the numerator of the taxpayer’s receipts factor. Taxpayer’s compute the amount of tax as follows:

- Exclusion of \$2 billion or less of certified distribution sales for the tax period
  - Tax is 0.5% of the total amount of certified distribution sales
- Exclusion of \$2,000,000,001 – \$3,000,000,000 of certified distribution sales for the tax period
  - Tax is 0.375% of the total amount of certified distribution sales in excess of \$2 billion, plus \$10 million
- Exclusion of \$3,000,000,001 – \$4,000,000,000 of certified distribution sales for the tax period
  - Tax is 0.25% of certified distribution sales in excess of \$3 billion, plus \$13,750,000
- Exclusion of more than \$4,000,000,000 of certified distribution sales for the tax period
  - Tax is 0.125% of certified distribution sales in excess of \$4 billion, plus \$16,250,000

Taxpayers file the [Certified Distribution Sales Election](#) form on or before the due date of the tax return for the period for which the election is to take effect. The election remains in effect until revoked by the taxpayer or until the taxpayer no longer qualifies for the election. A taxpayer may revoke the election by notifying the Department, in writing, on or before the due date of the tax return for the period for which the revocation is to take effect.

Taxpayers should attach the Distributor Certification Statements to the election form prior to mailing. Taxpayers should *not* file the [Certified Distribution Sales Election](#) form annually, but electing taxpayers *should* maintain [Distributor Certification Statements](#) for each year during which the election is in effect. The statement should read as follows:

- “[Distributor’s name] certifies that tangible personal property was purchased from [taxpayer] in this state and it was resold for ultimate use or consumption outside the state.”

**⚠ Auditors will request Distributor Certification Statements from taxpayers for each year that a Certified Distribution Sales Election is in effect.**

### 3. Consolidated Net Worth Apportionment

Please refer to Chapter 9 – Franchise Tax – for a more in-depth discussion on apportioning consolidated net worth between affiliated group members. The standard apportionment schedule (Schedule N) and the consolidated net worth apportionment schedules (170NC, 170SF, 174NC, 174SC) are similar but have the following notable differences:

- Schedule N is prepared based on tax basis books and records, whereas the consolidated net worth apportionment schedules are based on GAAP basis books and records.
- Taxpayers should eliminate intercompany transactions and holdings between affiliated group members and holdings in non-domestic persons<sup>496</sup> when calculating the consolidated net worth apportionment factors, but such transactions and holdings are **not** eliminated from the non-consolidated apportionment factors reported on Schedule N. For example:
  - The most common consolidated net worth elimination is intercompany sales; these sales must *not* be reported in the consolidated net worth sales factor.
  - Taxpayers that are members of a consolidated net worth affiliated group should eliminate intercompany rental expense from the property factor and the corresponding intercompany rental income from the sales factor for consolidated net worth apportionment purposes.

### Pass-through Entity Ownership

When a taxpayer has an ownership interest (either direct or indirect) in a pass-through entity (such as a limited partnership, S corporation, or limited liability company) that is *not* doing business in Tennessee and is *not* subject to the excise tax, the taxpayer's distributive share of the property, payroll, and sales attributes of the pass-through entity should be included in the taxpayer's apportionment factors on Schedule N.<sup>497</sup> Conversely, the taxpayer's distributive share of a pass-through entity's property, payroll, and sales attributes should be *omitted* from the taxpayer's apportionment factors when the pass-through entity *is* doing business in Tennessee and filing a franchise and excise return.

In addition, a franchise and excise taxpayer that is a general partner in a general partnership must reflect its pro rata ownership share of the general partnership's activity on its franchise



and excise tax return. This includes the taxpayer's ownership share of a general partnership's income and expenses in the excise tax base; property and rental expense in the franchise tax base; and property, payroll, and sales in the apportionment formula, if the taxpayer is apportioning.<sup>498</sup> General partnerships are not subject to the franchise and excise tax at the entity level, but their activity is taxed at the owner level if the owner is a type of entity that offers limited liability protection (corporation, LLC, LP, etc.).

A taxpayer that has an ownership interest in a pass-through entity receives a federal Schedule K-1 from the pass-through entity that reports the taxpayer's share of income (loss) from the pass-through entity. The taxpayer will include the Schedule K-1 income (loss) in its federal income tax return. Because the Tennessee excise tax return begins with federal taxable income (loss), the taxpayer's Tennessee excise tax return includes the taxpayer's distributive share of income (loss) from the pass-through entity. However, if the pass-through entity itself is subject to the excise tax and filing an excise tax return, the taxpayer will reverse its distributive share of all income, gains, expenses, and losses received from the pass-through entity (via Schedule K-1) out of the taxpayer's excise tax base on Schedule J.<sup>499</sup> Whenever a pass-through entity's income (loss) is reversed out on Schedule J by the taxpayer, this signifies that the pass-through entity's apportionment attributes will be *omitted* from the taxpayer's apportionment factors on Schedule N. However, if the pass-through entity's income (loss) is *not* reversed out, its property, payroll, and sales attributes will be *included* in the taxpayer's apportionment factors on Schedule N to determine the taxpayer's apportionment ratio.

Below is a table that summarizes the relationship between Schedule J reversals of pass-through items and the corresponding inclusion or exclusion in the apportionment factors on Schedule N. Note, because general partnerships are not subject to franchise and excise tax at the entity level, their net earnings (loss) will *not* be reversed out of the taxpayer's excise tax base on Schedule J, and the taxpayer's distributive share of the general partnership's Tennessee and everywhere apportionment attributes will be included in the taxpayer's apportionment factors on Schedule N.

Taxpayer is a Partner/Shareholder of:	Income/Gain Expense/Loss is <i>Reversed</i> on Taxpayer's Excise Tax Return	Property, Payroll, & Sales Attributes of the Pass-through Entity are <i>Included</i> in the Taxpayer's Apportionment Factors on Schedule N
General Partnership	<b>No</b>	<b>Yes</b>
LP, S corporation, LLC, or other entity treated as a <i>partnership</i> that is subject to excise tax and filing a return	<b>Yes</b>	<b>No</b>
LP, S corporation, LLC, or other entity treated as a <i>partnership</i> that is <b>not</b> subject to excise tax and <b>not</b> filing a return	<b>No</b>	<b>Yes</b>



**Audit Tip:**

**Auditors will request copies of all Schedule K-1s received by the taxpayer. An initial step in auditing apportionment is identifying the taxpayer's direct and indirect ownership interests in pass-through entities. The property, payroll, and sales factors will include attributes from pass-through entities that are not doing business in Tennessee, and thus, are not subject to the franchise or excise tax.**

## Standard Apportionment Factors - Property, Payroll, and Sales

The "In Tennessee" and "Total Everywhere" values for the three apportionment factors reported on Schedule N should be supported by the taxpayer's tax basis books and records. However, these factors, on their own, are not as important as the overall apportionment ratio that is used to calculate the franchise and excise tax bases. For example,

- "In Tennessee" and "Total Everywhere" numbers were reported as \$100 and \$1,000, respectively, but should have been reported as \$1,000 and \$10,000.

- The apportionment ratio as computed from the original numbers would be the same as the apportionment ratio based on the corrected numbers—10%. So, there would be no change to the computed tax liability in this case.

### 1. Property Factor

The property factor includes all owned or rented real and tangible property used during the tax period in the taxpayer's trade or business.<sup>500</sup> This includes property actually in use or available for use and property capable of being used. For example:

- A temporarily idle plant, a closed manufacturing facility held for sale, and raw material reserves not currently being processed should all be included in the property factor.
- Partial utilization of "construction in progress" property may result in a pro rata factor inclusion based on a percentage of the amount utilized, as discussed below.
- The types of property included in the apportionment factor are the same types as those included for franchise tax purposes, (including land, buildings, machinery, equipment, prepaid supplies, partnership property, inventory, and rents).
- **Computer software is considered an intangible asset for franchise and excise tax purposes, and it is not included in the property factor.**

Generally, real and tangible property is sourced based on where the property is located. Mobile property, like construction equipment, trucks, and leased electronic equipment, is sourced based on the percentage of *time* spent in the state. However, the value of a vehicle assigned to a traveling employee will be considered located in Tennessee if the employee's compensation is assigned to Tennessee under the payroll factor or if the vehicle is licensed in Tennessee. Property in transit between various locations will be considered at the destination location for sourcing purposes. Property in transit between a buyer and seller that is included in the taxpayer's balance sheet will be sourced to the state of destination.<sup>501</sup>

#### *Owned Tangible Property*

The standard apportionment values for real and tangible property are reported at their non-depreciated tax (cost) basis.<sup>502</sup> Most taxpayers will have detailed depreciation schedules prepared for both GAAP financial statement and tax reporting purposes. The cost values used for standard apportionment purposes should agree to the tax depreciation schedule.

The following are examples of property valuation for the property factor:

- The taxpayer acquired a factory building in this state at a cost of \$500,000, and 18 months later expended \$100,000 for a major remodeling of the building. The taxpayer files its return for the current tax year on a calendar-year basis. The taxpayer claims a depreciation deduction of \$22,000 for the building on its current year tax return. The value of the building that is includable in the numerator and denominator of the property factor is \$600,000. The depreciation deduction is not considered in determining the value of the building for property factor apportionment purposes.
- During the current taxable year, X Corporation merges into Y Corporation in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, X Corporation owns a factory that X built five years earlier at a cost of \$1,000,000. X has been depreciating the factory at the rate of two percent per year, and the basis of the factory in X's hands at the time of the merger is \$900,000. Since the property is acquired by Y in a tax-free transaction, the property's basis in Y's hands is the same as it is in X's hands. Y includes the property in Y's property factor at X's original cost basis (i.e., \$1,000,000), without adjustment for depreciation.

**⚠ Audit Tip: Auditors will request tax basis depreciation schedules in support of the property values reported on Schedule N.**

### *Property – Like-Kind Exchanges*

Replacement property acquired in a like-kind exchange is valued at the original tax-basis cost of the relinquished property given up in the exchange. Please see Chapter 11 for more information on like-kind exchanges.

### *Rented Property*

Rental values are quantified at eight times the annual rent amounts, regardless of the type of property rented.<sup>503</sup> This differs from the treatment of rents in determining the franchise tax property base, where assets reported on Schedule G are grouped by asset types with rental multiples of one, two, three, and eight.

In many cases, sub-rent receipts will constitute business earnings, and no sub-rent offset or deduction will be allowed for the standard apportionment property factor. Sub-rents are only allowed to offset rent expense if the sub-rent-receipts are non-business earnings. In contrast, sub-rents are not deducted when the sub-rents constitute business earnings (i.e., the property which produces the sub-rents is used in the regular course of the trade or business of the taxpayer when it is producing such earnings).<sup>504</sup> Note, sub-rentals are treated differently when determining the franchise tax property base on Schedule G.<sup>505</sup>

Rent expense deducted on the corresponding federal income tax return in excess of “reasonable rent”<sup>506</sup> for real property owned by an affiliate is added back in arriving at the excise tax base. Because the expense is excluded from the tax base, it is also excluded from the related property apportionment factor.

Rents included in the property factor are annualized on returns covering a period of less than 12 months (this is the same requirement for determining the franchise tax base). However, rents covering a period that is less than the period covered by the short-period return are *not* annualized.<sup>507</sup>

See Chapters 9 and 10 of this manual for topics that apply to both the franchise tax property base and the property factor of the apportionment ratio:

- License vs. lease
- Rents that include a service
- Finance and operating leases
- In lieu of rent payments

### *Inventory*

The standard apportionment schedule (Schedule N) computes an apportionment ratio for both franchise and excise taxes. The only difference between the franchise tax apportionment and excise tax apportionment computation is the treatment of exempt finished goods inventory.<sup>508</sup> For franchise tax apportionment, the property factor excludes the amount of exempt finished goods inventory from the numerator/“In Tennessee” and the denominator/“Total Everywhere” values.<sup>509</sup>

The franchise tax apportionment ratio is less, relatively speaking, when there is exempt finished goods inventory. In contrast, the excise tax property factor does not exclude exempt finished goods inventory from the computation.<sup>510</sup> The property factor ratio for excise tax does not take into account any exempt inventory numbers reported on Schedule N. As a result, the excise tax property factor ratio will not change as the result of exempt inventory.

The tax basis value of inventory is used in the property factor. The amount reported as part of the property factor should generally include the amount reported on federal Form 1125-A – Cost of Goods Sold.<sup>511</sup> In most cases, the beginning and ending inventory balances reported on federal Form 1125-A will match the amounts reported on the balance sheet; however, if there is a difference, the tax basis balances should be used.

See Chapters 9 and 10 for a discussion on the treatment of exempt inventory in the franchise tax base (Schedule G) and for consolidated net worth apportionment (Schedule 170NC).

### *Construction in Progress*

Taxpayers should exclude property or equipment under construction during the tax period (except inventorial goods in process) from the property factor until the taxpayer actually uses such property to produce business earnings. If the taxpayer partially uses the property to produce business earnings while under construction, the value of the property, to the extent used, should be included in the property factor.<sup>512</sup>

### *Nonbusiness Property*

Property used in connection with the production of nonbusiness earnings is excluded from both the numerator and the denominator of the franchise and excise tax property factors. Property used both in the production of business earnings and in the production of nonbusiness earnings is included in the property factor only to the extent the property is used in the production of business earnings. The method of determining the portion of the value to be included in the factor will depend upon the facts of each case.<sup>513</sup>

### *Property Averaging*

Taxpayers must use the average value of owned property in determining the standard apportionment ratio. This is done by averaging the property values as of the beginning and the end of the tax period.

In limited situations, taxpayers may compute the property factor using *monthly averages*.<sup>514</sup> Taxpayers should only use this alternative method if there have been substantial fluctuations in the values of owned property during the tax year and the average of the beginning and ending values for the tax year does not produce a fair result.

Averaging, with respect to rented property, is achieved automatically when the standard apportionment methodology is used. Therefore, monthly averaging would not be applicable to rents.

Taxpayers should not confuse this averaging with the franchise tax base monthly averaging that is required to be utilized by a taxpayer in *final return status*.<sup>515</sup>

*Comparison of standard apportionment values (Schedule N) to franchise tax base values (Schedule G)*

Item	Franchise Tax Base (Schedule G)	Standard Apportionment for Franchise and Excise Taxes (Schedule N)
Property owned is valued at - Tax basis cost	No	Yes
Property owned is valued at - GAAP book value (BV)	Yes	No
Operating lease vs. finance lease	Could be the same or different. Schedule G is GAAP basis and Schedule N is tax basis.	
Rental factor – 1, 2 or 3 multiple	Yes	No <i>all rental property uses multiple 8</i>
Deduction for Certified Pollution Control Equipment (BV)	Yes	No
Deduction for Exempt Required Capital Investment (BV)	Yes	No
Sub-rents (where sublessee has same rights as TP) are netted against rents	Yes	No
Exempt Finished Goods Inventory is Deducted	Yes	Yes – Franchise portion of schedule No – Excise tax portion of schedule
Pass-through entity attributes are included if entity is not filing a return	Yes	Yes

### *Audit Procedures – Property Factor*

A taxpayer may expect an auditor to request some, or all, of the following documents or information and to perform some, or all, of the following activities in their audit of the franchise and excise tax standard apportionment ratio reported on Schedule N:

- Identify the business entities whose property should be included in the property factor, including:
  - Pass-through entities not filing a franchise and excise tax return.
  - Disregarded entities.
- Determine the taxpayer's methodology to source property/rents/inventory to Tennessee. For example, general ledger account numbers indicate activity by location, depreciation software retains asset location information, and lease files track the location of the leased property.
  - Ask that the taxpayer include state-sourcing information, when available, in addition to everywhere information when requesting documents/workpapers.
  - Tie information provided to the federal income tax return.
- Identify all tangible property owned or leased/rented by the taxpayer.
  - Request the tax basis general ledger and trial balance.
  - Request tax basis depreciation schedules.
  - Determine the year-end inventory value from tax basis books.
    - If exempt finished goods inventory is claimed, determine the value of inventory by type and location (finished goods, raw material, etc.).
  - Identify finance and operating type leases by reviewing the tax basis books.
    - Determine that all leases are reported correctly on the schedule as either owned or leased property.



- Obtain taxpayer workpapers that show where the amounts reported on the tax return came from.
  - Determine that the workpapers are complete and accurate by tying information to source documents provided by the taxpayer.
- Based on your audit procedures, determine whether the “In Tennessee” and “Total Everywhere” values for the property factor were correctly reported, and explain any differences.

## 2. Payroll Factor

The payroll factor numerator is the total amount of compensation paid in this state during the tax period and the denominator is the total compensation paid everywhere during the tax period.<sup>516</sup> Compensation<sup>517</sup> means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. A person is generally considered an “employee” if reported by the taxpayer as an employee for payroll taxes imposed by the Federal Insurance Contributions Act (“FICA”). However, there are circumstances under the common law where *an individual for whom FICA is paid may not be considered an employee of that entity.*<sup>518</sup>

In addition to traditional payroll, where an entity hires and utilizes workers for which it incurs payroll expenses, there are labor arrangements where determining who is the employer requires a detailed analysis of the labor arrangement. Below are discussions on determining the employer, sourcing payroll to Tennessee, and other topics related to the payroll factor.

### Key terms used in this section:

- Affiliated Group - Companies with common management or ownership.
- Administrative Service Organization (“ASO”) - Provides human resource and payroll reporting services to its clients. W-2s and other reports remain in the client’s name.
- Common Law Employer - The entity that controls the workers. If control is unclear, it is the entity best classified as the employer based on other common law factors.
- Common Paymaster or Payroll Agent - Issues payroll checks for others.

- Contract Labor - The employee works on a contract basis and is not under the supervision or control of the business that has contracted for the service.
- Direct Payroll - W-2s are issued in the company's name where the employees work.
- Employee or Staff Leasing Company - Provides workers on a temporary or project specific basis for a fee. The leasing company issues W-2s in its own name.
- Indirect Payroll - W-2s are not issued in the company's name where the employees work.
- Partial Utilization - An employee provides services to more than one entity.
- Professional Employer Organization ("PEO") - May act as a co-employer based on a contractual obligation to share employer responsibilities. Both the PEO and taxpayer will have indications of an employer for *some* purposes, but neither party will be the employer for *all* purposes. The W-2 may or may not be in the PEO's name, depending on the agreement. Utilization and control will generally determine which taxpayer will be considered the employer.
- Service Recipient - The location where the laborers actually work.
- Service Provider - The entity furnishing laborers to a separate business entity.
- Third-Party Service Provider - The company providing workers to be utilized by a business not under common control or management.

### *Determining the Employer*

#### **Common Law Employment Rules**

TENN. COMP. R. & REGS. 1320-06-01-.30 ("Rule 30") provides the authority to use "the usual common law rules" in determining the employer-employee relationship and in identifying the common law employer.<sup>519</sup> Under these rules, a person is generally considered an "employee" if the taxpayer includes the person as an employee for payroll taxes imposed by FICA. *However, there are circumstances under the common law where an employee for whom FICA is paid may not be considered an employee of that entity.* The following common law concepts may be considered when determining which entity is the employer for the purpose of the payroll factor. Auditors

will consider the particular facts of each case and use their best judgment in weighing the following factors to decide:

- The *degree of control* exercised over the way the work is performed. This involves the laborer working exclusively for the entity in question and the entity controlling all aspects of the laborer's work duties and responsibilities. This is normally readily apparent in the structure of the labor arrangement and the activities of the workers. **This is the most important factor in the analysis.**
- If after considering the above, it remains unclear as to which entity has ultimate control over the employee, the following factors are then considered:
  - The right to hire and terminate the employee;
  - The right to reassign the employee to another client while the employee is performing services for the service recipient;
  - The entity bears the cost of employee benefits;
  - The entity issues the W-2 and files employment taxes in the entity's name; and
  - Whether the work performed is part of the principal's regular business.

### Utilization/Control

The taxpayer's level of control and involvement with a worker, such as *full utilization*, *partial utilization*, and *no utilization*, is a significant factor in determining payroll. *Exclusive utilization* of a worker where significant managerial control is exercised likely satisfies the *common law* definition of an employee and is thus included in the payroll factor. Although a taxpayer's employees may work on-site providing services at the location of a customer, this does not necessarily mean they are the customer's employees. For example:

- Janitorial and security service contracts require the taxpayer's employees to perform services at the customer's location. These individuals are still the taxpayer's employees since the taxpayer maintains control and all other aspects of the employer-employee relationship.

*Utilization and control* is a key consideration in determining the payroll factor in the following discussions:

- *Never Split One Employee's Wages between Entities* – When computing the payroll factor, an employee's compensation is never split up between various entities. An employee has only one employer for payroll factor purposes. The partial utilization of an employee in an affiliated group, or a temporary worker provided by an agency, would not cause the employee's payroll to be divided between entities. Partial utilization of a worker would exist when an employee, such as a computer technician, provides services to several affiliated members or is provided temporarily by an agency. In this case, the employee would be included in the payroll factor of only one company since an employee's salary is not split in computing the payroll factor. In that case, the employee's payroll would be assigned to the company that exercised the ultimate control of that employee's activities. *Note, an employee's wages may be split between states.* For example, an employee that worked the first half of the year in Tennessee and the second half in Kentucky would have their wages split between these states for payroll factor purposes.
- *Independent contractors* provide contract labor for their customers based on an agreement. *They are not under the supervision or control of the business, which has contracted for their service*, and they do not meet the common law rules for an employer-employee relationship. Expenses for independent contractors or any other labor not properly classified as an employee are excluded from the payroll factor.
- A taxpayer may contract for on-site services, such as consulting, security, landscaping, janitorial, or food services. In such a circumstance, the service provider uses labor to provide the service to the taxpayer, but the taxpayer has no control over the laborer's schedule, assignments, performance, or hiring and firing under the normal common law employee criteria. In this case, services provided to the taxpayer with the independent contractor's own labor is not reported in the taxpayer's payroll factor.
- The revenue received by independent contractors from the companies they contract with is not wages. The independent contractors generally receive a federal Form 1099-MISC with box 7 – Nonemployee Compensation – completed that shows the total payments they received during the tax year from the service recipient. Payroll taxes are not withheld from contract labor earnings.
- Administrative Service Organizations (ASO) are third-parties that provide human resource and *payroll reporting services* for their clients, such as completing payroll forms, tax returns, and other employment paperwork. *The tax returns, W-2s, and other reports remain in the taxpayer's name.* The employees work exclusively for and under the

direction of the taxpayer. The use of an ASO has no bearing on the employer-employee relationship.

- *Third-Party Service Provider, Co-Employer and Staff Leasing* – Contractual agreements with third-party service providers, which include the payment of payroll and related taxes, can vary greatly. The contracting agency may be described as a labor or service provider, Professional Employer Organization (“PEO”), co-employer, or staff leasing company. These agreements may involve full-time, temporary and/or part-time labor provided by the third-party provider, but the main factor in determining the common law employer will be who has primary control over the workers.

**⚠ Audit Tip: Auditors may request contractual agreements with third-party service providers in order to determine the employer-employee relationship.**

Auditors may review labor agreements with third-party providers in order to evaluate them for any employer-employee relationship. The auditor may inquire as to:

- Who utilizes the worker’s services;
- Who instructs the workers on how to do their work;
- Who is named as the employer on the payroll tax returns;
- Who interviews and hires the workers;
- Monetary remuneration between the companies; and
- Who provides employee benefits, like health insurance?

The entity meeting the common law rule of an employer would include those costs in the payroll factor of its apportionment formula, but any mark-up paid to a third-party provider/staff leasing company is *not* included in the factor. A primary example of this arrangement is a third-party provider that provides labor to a taxpayer who completely controls the laborers’ activities as an employer but uses the third-party provider for administrative convenience since they also handle the payroll paperwork.

In some circumstances, the third-party provider may retain control over the workers for purposes of assigning them to the taxpayer, hiring and firing, providing the direct pay and

benefits, and filing all tax returns. This is typical when a third party provides temporary, seasonal or part-time labor. In such a case, if the Department cannot establish that the taxpayer has overall control of the labor, the labor expense will be included in the third-party provider's payroll factor, not the taxpayers.

- ***Affiliated Group*** – Traditional or direct payroll occurs when an entity hires and utilizes workers for which it incurs payroll expenses. Indirect payroll is when the payroll reports and W-2s are issued in the name of a company where the workers are not utilized and controlled. For example, a group of affiliated companies may designate one affiliate to perform the payroll function for all the affiliates. The operating affiliates reimburse the common paymaster for the payroll costs incurred on their behalf with an inter-company charge. These inter-company charges may be classified as management fees, administrative fees, overhead fees, or labor expenses, and would be considered indirect payroll if the operating company exerts control over the employees. The common paymaster affiliate issues the W-2s but does not utilize and control the workers and should not include them in their payroll factor. The affiliate reimbursing the common paymaster has indirect payroll and should report the labor in their payroll factor.

**⚠ Audit Tip**

**Indirect payroll should be included in the payroll factor of the common law employer, even though the direct payroll and payroll taxes are paid by the common paymaster affiliate.**

- Indirect payroll should be included in the payroll factor of the common law employer, even though the direct payroll and payroll taxes are paid by the common paymaster affiliate. It is the common law employer who controls the employee's actions and on whose behalf the employee works. Consequently, the common paymaster affiliate would not be considered the employer and the payroll expense would not be included in its payroll factor even though the payroll affiliate is responsible for the payroll taxes.
- *Auditor allocation of labor between affiliates* – Transactions between affiliates are not always at arms-length, so the inter-company labor charges may be nonexistent or for amounts that do not accurately match the cost of labor utilized. If reasonably accurate labor charges are not made, the auditor may consider allocating reasonable labor costs between affiliates.<sup>520</sup>

- *Administrative overhead services provided to the entire affiliated group by the parent's employees* – Employees of one company in an affiliated group may work for several affiliates. For example, a parent corporation provides services for all of its subsidiaries. An inter-company charge is made for the services, but the parent retains control over the employees and the employees are not exclusively performing services for one subsidiary. *Therefore, since the labor is not controlled by the subsidiary and the laborer performs duties on behalf of various subsidiaries, the inter-company charge between the affiliated companies does not represent indirect payroll.* The payroll costs therefore stay with the entity, normally the parent in this example, which pays and controls the employees.

### Summary – Payroll Factor Denominator

In summary, payroll costs should be included in the payroll factor of the common law employer, which is typically the entity controlling and utilizing the employees. This entity may not be the one filing employment taxes, such as the FICA tax. Therefore, the payroll factor may include:

- Direct payroll expenses where the taxpayer is responsible for the payroll tax liability and is considered the employer under the common law definition; and
- Indirect payroll expenses where the taxpayer meets the common law definition of an employer but may not be responsible for filing the payroll tax returns.

For laborers that are considered employees under the common law rules, the expenses included in the payroll factor may be categorized as salaries, wages, leased labor cost, administrative fees, and other expenses defined as compensation. In addition, an employee's compensation is never split-up between various entities. The compensation is only reported by one entity for the payroll factor.

### Other Topics – Payroll Factor

#### Cash or Accrual Basis

The payroll factor numerator is the total amount of compensation *paid* in this state during the tax period, and the denominator is the total compensation *paid everywhere* during the tax period.<sup>521</sup> Since the code explicitly states “paid” and not “paid and accrued,” we will discuss in the following paragraphs whether the payroll factor must be computed on a cash basis.

State and federal payroll reports (941, 940, W-2, SUTA) are reported on a cash basis. Federal income tax returns and financial statements can be based on either the “cash” or “accrual” methods of accounting, but larger businesses generally use the accrual method.

For purposes of the payroll factor, the total amount “paid” to employees is based on the taxpayer’s accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued is deemed to have been paid. However, at the *election of the taxpayer*, compensation paid to employees may be included in the payroll factor by use of the *cash method* if the taxpayer is required to report such compensation under the cash method for unemployment compensation purposes.<sup>522</sup> A taxpayer elects the cash method by consistently completing the apportionment schedule, each year, using the cash method.

Auditors may accept the otherwise correct payroll values reported on the apportionment schedule, regardless of whether the cash or accrual method was used, as long as they are consistently applied and do not adversely affect the ratio in such a way that the tax computation does not fairly represent the extent of the taxpayer’s business activity within the state.

The formula to reconcile cash basis payroll to accrual basis payroll is:

- **(cash basis payroll) + (current year-end accrued wages payable) – (prior year-end accrued wages payable) = accrued payroll**

The formula to reconcile accrual basis payroll to cash basis payroll is:

- **(accrual basis payroll) + (prior year-end accrued wages payable) – (current year-end accrued wages payable) = cash basis payroll**

### Unemployment Reports

Generally, state and federal unemployment tax reports provide helpful support for the apportionment factor values when the common law employer is also the employer who files the state and federal unemployment tax reports. In this case, there is a presumption that the amounts reported for unemployment purposes in each state represent compensation in that state for taxpayers using the cash method. Schedule A of the annual federal unemployment tax return (Form 940) shows every state in which a taxpayer had to pay state wages and lists the FUTA taxable wages by state.

### Capitalized In-house Labor

In-house labor used in the construction of a depreciable asset should be included in the payroll factor. For example:



- A taxpayer used some of its employees in the construction of a storage building that, upon completion, is used in the regular course of taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer. The amount of such wages is included in the payroll factor.<sup>523</sup>

### Imputing Payroll

Generally, auditors should *not* impute payroll where none has been paid or accrued. Two conditions normally exist for payroll factor inclusion: 1) there is control and utilization of the laborers and 2) the taxpayer ultimately bears the labor cost.

If the taxpayer's books and records do not reflect an expense for labor, the auditor generally should *not* impute payroll. However, if the auditor finds that a strict adherence to the apportionment statutes results in an apportionment ratio that does not fairly represent the extent of the taxpayer's business activity in this state, the auditor may request an adjustment under the variance statute.<sup>524</sup> **Variance requests should be rare and infrequent.**

### Apportionment Amount and Payroll Deductions

The payroll factor is computed using compensation values *before* any deductions for contributions to a 401(k) or similar deferred compensation plan, cafeteria plans, and sick pay.

#### *Numerator of the Payroll Factor*<sup>525</sup>

Compensation is paid in this state if any one of the following tests, applied consecutively, are met:<sup>526</sup>

- The service is performed entirely in Tennessee;
- The service is performed inside and outside Tennessee, but the service performed outside Tennessee is incidental to the Tennessee service; or
- The service is performed inside and outside Tennessee; and
  - The employee's base of operations<sup>527</sup> (or if there is no base of operations, the place from which the service is directed or controlled) is in the state; or

- The employee’s base of operations (or if there is no base of operations, the place from which the service is directed or controlled) is not in a state in which some part of the service is performed, but the employee’s residence is in Tennessee.

The above description of “In Tennessee” payroll is almost identical to payroll that is subject to Tennessee’s unemployment insurance, commonly referred to as SUTA. The following chart compares payroll sourcing under the franchise and excise tax apportionment statute and the Tennessee SUTA Handbook for Employers (2019).<sup>528</sup>

<b>Compensation is paid in this state, if:</b>	
<b>Tenn. Code Ann. §67-4-2012(f)</b>	<b>SUTA Handbook</b>
(1) The individual's service is performed entirely inside the state	<i>TEST (1) - the localization of services test; Wages are reported and premiums are paid to the state in which the service is performed.</i>
(2) The individual's service is performed both inside and outside the state, but the service performed outside the state is incidental to the individual's service inside the state; or	Example: An employer in Tennessee has a store in Tennessee and a store in Kentucky with employees at each store. The employer will need a state unemployment insurance Employer Account Number for each state. Employees working in Tennessee will be reported to Tennessee, since their services are localized in Tennessee. The employees working in Kentucky will be reported to Kentucky, since their services are localized in Kentucky. If an employee works the first six months of the year in Tennessee and the last six months in Kentucky, the employer will report the employee to Tennessee for the first two calendar quarters of the calendar year and to Kentucky for the last two calendar quarters.

<b>Compensation is paid in this state, if:</b>	
<b>Tenn. Code Ann. §67-4-2012(f)</b>	<b>SUTA Handbook</b>
<p>(3) Some of the service is performed in the state; and</p> <p>(A) The base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state; or</p>	<p><i>TEST (2) - employee base of operations test; Wages are reported and premiums are paid to the state in which the employee has his base of operations and performed some services.</i>            Example: An employer in Tennessee has a salesman working out of his home in Alabama. This salesman calls on customers in Alabama, Georgia, and Mississippi. Since there is no localization of service (TEST 1), the employer will need an Alabama unemployment insurance Employer Account Number and will report all of this salesman's wages to Alabama, since the employee's base of operations is in Alabama and the employee performs some services in Alabama.</p> <p><i>TEST (3) - employer base of operations test; Wages are reported and premiums are paid to the state from which the service is directed or controlled if the employee performed some service in that state.</i>            Example: An employer in Tennessee is a construction contractor. All employees are hired by, paid by, and receive instructions from the home office in Tennessee. The employees live in various states and work on construction sites as needed in Tennessee, Alabama, and Georgia. Since there is no localization of service (TEST 1) and no employee base of operation (TEST 2), the employer would report these workers to Tennessee, since the employer's base of operations is in Tennessee and the employees performed some services in Tennessee.</p>

Compensation is paid in this state, if:	
Tenn. Code Ann. § 67-4-2012(f)	SUTA Handbook
<p>(3) Some of the service is performed in the state; and</p> <p>(B) The base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state</p>	<p><i>TEST (4) - place of residence test;</i>  <i>Wages are reported and premiums are paid to the state in which the employee lives if some service is performed in that state.</i>            Example: An employer in Tennessee hires a guitarist who lives in Alabama to perform with a band playing at gigs in Alabama, Georgia and Mississippi. Since there is no localization of service (TEST 1), and no employee base of operation (TEST 2), and the employee did not perform any services in Tennessee, the employer's base of operations (TEST 3), the employer will need an Alabama unemployment insurance Employer Account Number and the employer will report the employee's wages to Alabama, since the employee's place of residence is in Alabama and the employee performed some services in Alabama.</p>

### Real Estate Construction Project Located in Tennessee

All labor associated with a real estate construction project located in Tennessee should be included in the numerator of the payroll factor, in addition to the denominator. The work of management level employees located outside of the state should be included in the "In Tennessee" numerator for the time spent on real estate projects/jobs located in Tennessee. Labor costs capitalized to the cost of a project are included in the payroll factor of the state in which the project is located and should be included in the payroll factor in the same year in which the related payroll expenses are deducted for federal income tax purposes.<sup>529</sup>

### Nonbusiness Payroll

The compensation of any employee on account of activities which are connected with the production of nonbusiness earnings is excluded from both the numerator and the denominator of the franchise and excise tax payroll factors.<sup>530</sup>

- For example, a taxpayer owns various securities which it holds as an investment separate and apart from its trade or business. The management of the taxpayer's

investment portfolio is the only duty of Mr. X, an employee. The salary paid to Mr. X is excluded from the payroll factor.

### *Documents that Support the Payroll Factor Amounts*

Auditors may ask for the following documents in an audit of the payroll factor:

- A narrative from the taxpayer that explains:
  - the methodology and records used in arriving at the “In Tennessee” and “Total Everywhere” amounts
  - any indirect labor used
  - any direct labor not used (including copies of any referenced documents, workpapers, or schedules)
- Copy of the federal income tax return with all schedules and attachments, to identify all labor costs
- Detailed trial balance, to search for accounts that may represent charges for direct and indirect labor (e.g., salaries and wages, management fees, and cost of goods sold labor) and costs for common law employees
- Listing of the “Total Everywhere” payroll factor broken down by state
- State and federal unemployment reports: 940 (FUTA), 940 Schedule A, TN Dept. of Labor and Workforce Development Premium & Wage Report (SUTA).
  - Form 940 – Employer’s Annual Federal Unemployment Tax Return, Line 3 shows the total of all wage payments to employees. The related Form 940 Schedule A reports every state in which unemployment tax was paid.
  - The TN SUTA form is filed quarterly, but the 4th quarter report will provide sufficient information to arrive at the annual “direct” payroll for a calendar year filer.
  - Information from SUTA and FUTA forms are helpful, but when these forms are examined in isolation, they are inadequate to identify amounts for direct payroll that should *not* be included in the payroll factor and indirect payroll that *should* be included in the payroll factor.

- If needed, detailed listing of employees that ties, in total, to the federal income tax return and lists each employee's job description, work location, and compensation for the audit period
- If applicable, labor agreements regarding payments made for labor used and controlled by the taxpayer as a common law (indirect) employer. The auditor may need to review journal entries and general ledger accounts to identify any non-labor charges, such as administrative markups that should be excluded from the payroll factor.
  - If the taxpayer has an ownership interest in a pass-through entity that is not subject to or filing a franchise and excise return, all of the above-listed information would be needed for the pass-through entity in addition to the K-1 showing the taxpayer's ownership interest.

#### *Audit Procedures – Payroll Factor*

- Obtain the applicable documents discussed in the previous section “Documents that Support the Payroll Factor Amounts.”
- Identify all direct and indirect payroll costs, including payroll costs from pass-through entities (not subject to the excise tax), that should be included in the payroll factor.
  - Search the federal income tax return and trial balance of the taxpayer and any pass-through entities not subject to Tennessee excise tax. If needed, review general ledger accounts to better understand the accounting entries made in relation to payroll.
- Determine which costs, identified above, meet the common law test and should be included in the payroll factor. When applicable, obtain labor contracts/agreements.
- Based on the taxpayer's narrative and other information obtained, determine whether the cash or accrual method of accounting was used for payroll factor purposes, and if this method was consistently applied.
- Once all sources of “Total Everywhere” payroll have been identified, verify the corresponding “In Tennessee” amounts. The TN state unemployment data (SUTA) should provide the bulk of the support. However, the following adjustments may be needed

(similar adjustments should be made to the “Everywhere” values) if the taxpayer uses the accrual method for reporting the payroll factor or if there is indirect payroll.

For Taxpayer *and* applicable pass-through entities (to the extent (%) owned):

<b>TN wages from SUTA reports</b>	\$ _____
<i>Add:</i> Payments for “Non-W-2” labor controlled and utilized	\$ _____
<i>Subtract:</i> SUTA wages for employees not controlled and utilized	\$ _____
<i>Add or subtract:</i> cash/accrual adjustment for consistent reporting	\$ _____
<b>“In TN” Payroll Apportionment Factor</b>	\$ _____

- Write an audit memo explaining the audit work done, documents reviewed, conclusions reached, and adjustments made. If applicable, discuss direct payroll omitted, indirect payroll included, flow-through payroll, and the consistent application of the cash or accrual method.

**⚠ Audit Tip: An employee for the payroll factor will also be a position/job for purposes of the job tax credit.**

### 3. Sales Factor

Sales included in the apportionment factor are **all gross receipts** from transactions and activity in the regular course of the taxpayer’s trade or business.<sup>531</sup> Gross receipts means all receipts from whatever sources derived before any deductions, but not including actual sales returns and allowances.<sup>532</sup>

However, there are two exceptions where sales are “thrown out” and excluded from both the numerator and denominator of the apportionment ratio:

- Gain from the sale of goodwill<sup>533</sup>
  - Taxpayers using the standard apportionment formula must exclude from both the numerator and the denominator of the sales factor *any gain on the sale of an asset that is designated as goodwill and required to be reported for federal tax purposes as Class VII assets*. When assets that constitute a trade or business are sold, Internal Revenue Code §§ 1060 and 338(b)(5) require that the sales price be allocated among the assets. Federal Form 8594 – Asset Acquisition Statement – shows the allocation, and it is attached to the federal income tax return (Forms

1040, 1041, 1065, 1120, 1120S, etc.) of both the buyer and the seller. This form categorizes the deemed or actual assets transferred into seven classes, with the allocated sales price reported for each class. Goodwill is reported as a Class VII asset. The gain on the sale of goodwill, reported as a Class VII asset, must be excluded from both the numerator and the denominator of the apportionment formula receipts factor. This "throw out" provision excludes any recognition of the sale of goodwill in the sales factor of the standard apportionment formula. Rather, the sales factor includes the sale of the underlying real, tangible, and intangible assets of the business.

- Sales other than sales of tangible personal property to which the state of assignment cannot be determined under the franchise and excise tax law or Rule 42 and cannot be reasonably approximated<sup>534, 535</sup>
  - In the event a taxpayer cannot ascertain the state or states to which a sale should be assigned, pursuant to Rule 42 (including using a method of reasonable approximation), using a reasonable amount of effort undertaken in good faith, the sale should be excluded from the numerator and the denominator of the taxpayer's sales factor. For example:
    - Investment interest and dividend income is "thrown out" and not included in the numerator or denominator of the sales factor.
    - See the discussion below on the sourcing of sales other than sales of tangible personal property for tax periods beginning on or after July 1, 2016.

In addition, there are two exceptions to the requirement that *gross* instead of *net* receipts be reported in the sales factor.

- The first exception allows *net* sales to be used when large transactions distort the sales factor. This exception applies when:<sup>536</sup>
  - The gross receipt from an asset disposition is substantial in relation to all other regular business receipts; and
  - The use of the gross receipt amount would cause a distortion to the sales factor.



Under this provision, the apportionment formula more fairly apportions to this state the business earnings of the taxpayer's trade or business. For example, where substantial amounts of gross receipts arise from the sale of fixed assets used in the taxpayer's trade or business, such as the sale of a factory or plant, the taxpayer will exclude the gross receipts from the sales factor. To give proper recognition to the apportionment of business earnings (losses) in such instances, the net gain arising from transaction or activity will be included in the sales factor.

The analysis of whether to use the net profit exception should be made for a specific disposition event and would only apply to that transaction. The Rule addresses using the net gain instead of gross receipts but is silent with regard to a sale that results in a net loss. If gross receipts on an asset sale distort the sales factor, and there is a net loss, then no value (zero) would be included in the sales factor.

- The second exception also prevents a distortion in the sales factor and concerns cash management or treasury functions.
  - Gains from working capital investments should be reported in the denominator of the sales factor, rather than the returned amounts of principal invested in the working capital investments.<sup>537</sup>

### *Total Everywhere – Denominator*

The sales factor includes all gross receipts (except those thrown out) and includes receipts from inventory sales (less returns and allowances), service fees, rents, royalties, the sale of tangible and intangible property, and other activities. Generally, the gross receipt amounts are traceable to the federal income tax return. Federal forms and schedules that report gross receipts or proceeds include:

- Form 1040 Sch's. C (Profit or Loss from Business – Sole Proprietorship), D (Capital Gains and Losses), E (Supplemental Income and Loss), and F (Profit or Loss From Farming)
- Form 4797 – Sales of Business Property
- Form 1065/1120/1120S Schedule D (Capital Gains and Losses)
- Form 6252 – Installment Sale Income
- Form 8594 – Asset Acquisition Statement

- Form 8825 – Rental Real Estate Income & Expenses of a Partnership or S Corporation
- Form 8883 – Asset Allocation Statement
- Form 8949 – Sales and Other Dispositions of Capital Assets

Specifically, the denominator of the sales factor includes:<sup>538</sup>

### Sale of Inventory

For purposes of the sales factor, a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, “sales” include all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers. Gross receipts for this purpose means gross sales, less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) should be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product.

### Sale of Equipment

For purposes of the sales factor, if a taxpayer derives receipts from the sale of equipment used in its business, such receipts constitute “sales.” For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The *gross receipts* from the sales of the trucks are included in the sales factor.

The sale of business assets is generally reported on federal Form 4797 – Sale of Business Property. Details of the transaction, including the gross sales price, are reported on that form and the “net gain or loss” is reported on the applicable federal income tax return (Form 1120, 1065, etc.). Since the apportionment ratio requires that the gross proceeds be used, Form 4797 is usually the best source for populating the denominator of the sales factor.

#### Audit Tip

**The total income line from a federal income tax return generally does not reflect gross receipts/proceeds and should not be reported as the denominator of the sales factor.**

### Sale – Capital Assets

Sales of capital assets are reported on federal Schedule D. Capital assets include all types of property, but do not include inventory and depreciable or real property used in the business. The face of the federal income tax return will show the net gain or loss from the sale of capital assets. However, the gross proceeds/sales price that is needed for the sales factor is found on Schedule D. Note, the previous discussion concerning the use of net sales when there is factor distortion may apply to certain capital asset sales.

### Sale – Like-Kind Exchanges

The gross sales price<sup>539</sup> of replacement property received in a like-kind exchange is included in the sales factor in the year the associated gain or loss is recognized on the federal income tax return. For example, Property A with a book value of \$100 and a fair market value of \$200 is exchanged for Property B with a fair market value of \$200. The taxpayer will report \$200 in the sales factor in the year the replacement property (B) is sold, not in the year of the exchange. Federal Form 8824, Part III may show a recognized gain on Line 23 and a deferred gain on line 24. The gross proceeds associated with the deferred gain are not recognized until the like-kind replacement property is sold or otherwise disposed of in a subsequent taxable transaction. Please see Chapter 11 for more information on like-kind exchanges.

### Sale – Installment Sale Income

Generally, an installment sale is a disposition of property where at least one payment is received after the end of the tax year in which the disposition occurs. The ordinary and capital gain from an installment sale is computed on federal Form 6252 and reported on Schedule D and Form 4797. Form 6252 is completed for each year of the installment agreement, including the year of final payment, even if a payment wasn't received during the year.

Because installment gain income is included in federal taxable income it is automatically included in the income subject to excise tax. The sales factor of the apportionment ratio will include the installment sale proceeds received in the current year. For example:

- An asset with a basis of \$100,000 was sold for \$250,000. The proceeds are received in two installments of \$125,000; one in the current tax year and one in the subsequent year. The chart below shows where this information is found on federal form 6252. Note form 6252 will be prepared for both years.
- The amount included in the everywhere factor of the apportionment ratio is \$125,000 for both years. This is found on Form 6252, Part II, Line 22.

Description	Form	Amount
Selling price	Form 6252, Part I, Line 5	\$250,000
Adjusted basis	Form 6252, Part I, Line 13	\$100,000
Gross profit	Form 6252, Part I, Line 16	\$150,000
Gross profit percentage ( $\$150,000 / \$250,000$ )	Form 6252, Part II, Line 19	60%
Payment received during year (without interest)	Form 6252, Part II, Line 22	\$125,000
Installment sale income (reported on Schedule D and/or Form 4797) <i>This is \$125, 000 times 60%.</i>	Form 6252, Part II, Line 24	\$75,000

### Sale – Entire Business

Generally, federal Form 8594 – Asset Acquisition Statement – is filed by both the purchaser and the seller when there is a transfer of a group of assets that make up a trade or business where goodwill or going concern value could, under any circumstances, attach to such assets and the purchaser's basis in such assets is determined solely by the amount paid for the assets. The information reported on this form is not part of the income tax calculation, but it provides good information concerning the sale/purchase of a business. For example, the form names both parties to the transaction, discloses the total sales price, date of sale, and allocation of the sales price by asset class. Class VII includes goodwill.

### Sale – Cost Plus Fixed Fee Contracts

In the case of cost-plus fixed fee contracts, such as the operation of a government-owned plant for a fee, “sales” include the entire reimbursed cost, plus the fee.<sup>540</sup>

### Sale of Services

In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency or the performance of an equipment service contract or research and development contracts, “sales” include the gross receipts from the performance of such services/contracts including fees, commissions, and similar items.

### Rent Receipts

In the case of a taxpayer engaged in renting real or tangible property, “sales” include the gross receipts from the rental, lease, or licensing of the property. All rental income reported on the

federal income tax return is includable in the sales factor at its gross amount before rental expenses. However, a taxpayer receiving excess rents<sup>541</sup> from an affiliate reduces its income subject to the excise tax to the extent that excess rent was added back to net earnings of the affiliate. When excess rents received are removed from Tennessee apportioned income, they are also excluded from the sales factor. Receipts received from sub-rentals are included in the sales factor at their gross amounts.

### Receipts - Interest Income

Interest on accounts receivable is not “thrown out,” but should be sourced in the same manner as the sale that generated the receivable.<sup>542</sup> However, as mentioned above, *investment* interest income reported on the federal income tax return is “thrown out” and not included in the numerator or denominator of the sales factor. For example, bank interest income and interest income from a loan to an affiliate is thrown out under the market-based sourcing rule. See the Rule 42 discussion below.

### Receipts – Related to Intangible Property (Royalties)

In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, “sales” include the gross receipts therefrom. All royalty receipts are included in the sales factor. However, an adjustment may be needed if the taxpayer received intangible income, such as royalties, from an affiliate and the affiliate was not allowed to deduct the corresponding intangible expense on its return.<sup>543</sup> In other words, if an affiliate’s deduction of an intangible expense incurred in connection with a transaction with the taxpayer is disallowed as the result of an audit conducted by the Department, then the corresponding intangible income shown on the taxpayer’s separate entity, pro forma federal return should be reversed out of the taxpayer’s excise tax base and excluded from its sales factor.<sup>544</sup>

### Reimbursed Expenses

Receipts received from an affiliate as a reimbursement of costs are included in the sales factor, even if they are posted as a credit to the respective expense account. Note that standard apportionment (Schedule N) and consolidated net worth apportionment (Schedule 170NC) differ in their treatment of these expenses. The consolidated net worth computation requires that transactions between affiliates be eliminated, so there would be no inclusion if Schedule F2 – Consolidated Net Worth – is filed.

For example, a parent allocates to its subsidiary the overhead costs incurred by the parent in managing and overseeing the subsidiary. This transaction could be reported as receipts of

management fees or as a reduction of the expenses incurred by the parent; either way, the receipts are included in the receipts factor.

### *In Tennessee – Numerator*

The gross receipts attributable to Tennessee are determined differently for sales of tangible personal property and all other sales.<sup>545</sup>

#### **Tangible Personal Property Sales**

Sales of tangible personal property occur in (sourced to) Tennessee if: (1) the property is delivered or shipped to a purchaser, other than the United States government, inside Tennessee, regardless of the F.O.B. point or other conditions of the sale, or (2) the property is shipped from a Tennessee office, store, warehouse, factory, or other place of storage, and the purchaser is the United States government.<sup>546</sup>

In other words, if the purchaser is the U.S. government, the sale is sourced to Tennessee if it *originates* in TN, no matter where it is shipped. Property shipped from Tennessee to the U.S. Government is considered a Tennessee sale. Only sales made directly to the U.S. Government are applicable. Sales by a subcontractor to the prime contractor (the party with the contract with the government) do not constitute government sales.<sup>547</sup>

Nongovernment sales of tangible personal property with a Tennessee *destination* are sourced to Tennessee and would be included in the numerator of the sales/receipts factor. The *destination* of the sale of tangible personal property determines its sourcing. The destination of the taxpayer's shipment or delivery is determinative for the sourcing of the taxpayer's sales. Thus, when tangible personal property is shipped by the taxpayer to a purchaser in Tennessee, the sale is sourced to Tennessee even if the property is ordered from outside the state or the purchaser subsequently moves the property out of state.

A sale of tangible personal property will be sourced to Tennessee if the taxpayer delivers or has the products shipped directly to an ultimate recipient in Tennessee at the direction of a purchaser who does not take possession of the property, regardless of where the purchaser is located (drop shipment). The fact that title was transferred to the out-of-state purchaser prior to the shipment is not determinative for purposes of sourcing the taxpayer's sales. It is also irrelevant which party arranges for the shipment of the products to the ultimate recipient via common carrier. Furthermore, sales made to an in-state purchaser but shipped by the taxpayer directly to an out-of-state ultimate recipient are not sourced to Tennessee.<sup>548</sup> However, if a taxpayer begins shipment of merchandise to a destination outside of Tennessee, but due to

unforeseen complications the delivery is diverted while in route to the purchaser's place of business in Tennessee, for apportionment purposes the sale is a Tennessee sale.<sup>549</sup>

It makes no difference whether the merchandise is shipped by common carrier from the seller's Tennessee location to the initial out-of-state purchaser, or whether the initial out-of-state purchaser sends his own truck to Tennessee to pick up the merchandise at the Tennessee seller's place of business and takes it to the purchaser's out-of-state location. In both these examples, the sales would not be included in the seller's Tennessee apportionment sales factor. Likewise, an out-of-state seller having tax nexus in Tennessee must include in his apportionment Tennessee sales factor numerator, sales to initial purchasers located in Tennessee. It makes no difference that the Tennessee purchaser sends his trucks to pick up the merchandise at the seller's out-of-state place of business, or that the merchandise was shipped to the Tennessee customer by common carrier, F.O.B. shipping point, from the seller's out-of-state location.<sup>550</sup>

If a purchaser picks up a sales order at the seller's location and the seller cannot determine the destination of the goods by the purchaser, then the sale will be apportioned to the seller's location.

If a seller is not taxable in the destination state, the sales are included in the denominator but not the numerator.

**⚠ Audit Tip**

**Tennessee does not have a "throwback provision" (i.e., a sale is thrown back to the sales factor numerator of the state from which the goods were shipped, if the seller is not taxable in the destination state).**

- Examples of sales/receipts sourced to Tennessee:
  - Company A sold property to the central purchasing department of Company B, which is located in Alabama, but the goods were shipped directly to B's affiliates located in Tennessee, Kentucky, and Alabama. The portion of the sales shipped to the Tennessee affiliate would be considered Tennessee sales.<sup>551</sup>
  - A taxpayer makes a sale to a purchaser who maintains a warehouse in Tennessee. The warehouse receives purchases before they are reshipped to branch stores in other states for sale to customers. All sales shipped to the warehouse are considered Tennessee sales, because they are considered property "delivered or shipped to a purchaser within Tennessee."<sup>552</sup> It is

irrelevant which party arranges for the shipment of the products via common carrier.<sup>553</sup>

- A Tennessee taxpayer sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in Tennessee pursuant to purchaser's instructions. The sale by the taxpayer is sourced to Tennessee.<sup>554</sup>
  - o Gross receipts from the sale of tangible personal property (except sales to the United States Government) are in Tennessee if the property is delivered or shipped to a *purchaser within Tennessee* regardless of the f.o.b. point or other conditions of sale. The term "purchaser within Tennessee" includes the ultimate recipient of the property if the taxpayer in Tennessee, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within Tennessee.
- The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While en route the produce is diverted to the purchaser's place of business in Tennessee where the taxpayer is subject to tax. The sale by the taxpayer is attributed to this Tennessee.<sup>555</sup>
  - o When property is being shipped by a seller from the state of origin to a consignee in another state is diverted while en route to a purchaser in Tennessee, the sales are in Tennessee.

### Other Than Tangible Property Sales - Tax Years Beginning on or after July 1, 2016

Market-based sourcing was adopted for sourcing sales, other than sales of tangible personal property, as part of the Revenue Modernization Act of 2015, effective for tax years beginning on and after July 1, 2016.<sup>556</sup> Market-based sourcing replaced the "cost of performance" (COP) method previously used. The statutes and rules were amended to reflect the legislative change.<sup>557</sup>

*As a brief overview*, sales of other than tangible personal property (other-than-TPP) are sourced to Tennessee if the taxpayer's market for the sale is in Tennessee. This is interpreted as follows:

- A sale, rental, lease, or license of real or personal property is sourced to Tennessee to the extent the property is located in Tennessee.



- A service is sourced to Tennessee to the extent the service was delivered to a location in Tennessee.
- Receipts from intangible property that is rented, leased, or licensed and receipts from the sale of intangible property that is contingent on its productivity, use, or disposition is sourced to Tennessee to the extent that it is used in Tennessee. If the intangible is used in marketing a good or service, the sale is in Tennessee to the extent the good or service is purchased by a Tennessee consumer.
- Intangible property that is a contract right, government license, etc. is sourced to Tennessee to the extent that it is used in Tennessee. Intangible property used in marketing is considered used in Tennessee if the related good or service is purchased by a Tennessee consumer.
- Receipts from intangible property sales that are contingent on productivity, use, or disposition of the intangible property are sourced to the customer location.
- If intangible property gives authorization to *conduct business in a specific geographical location, it is sourced to Tennessee if the geographical area includes all or part of the state.*
- If the sourcing of receipts by state for other-than-TPP cannot be determined, as provided above, the assignment may be *reasonably approximated*. If it cannot be reasonably approximated, the receipts are *omitted from both the numerator and denominator*.<sup>558</sup>
- Taxpayers may elect to use the prior law cost-of-performance rules if the result is a *higher* apportionment ratio and the taxpayer has net earnings for the year rather than a net loss.<sup>559</sup>

**Rule 42- Sales Factor-Sales Other than Sales of Tangible Personal Property in this State**<sup>560</sup>

(market-based sourcing rule) generally states that sales, other than sales of tangible personal property, are in Tennessee if and to the extent that the taxpayer's market for the sales is in Tennessee. The rule discusses: 1) determining whether and to what extent the market for a sale is in Tennessee, 2) reasonably approximating the state or states of assignment where such state or states cannot be determined, and 3) excluding the sale where the state or states of assignment cannot be determined or reasonably approximated.

The Rule establishes uniform *guidance for determining the market* for sourcing purposes. It identifies many types of other-than-TPP receipts and provides *many sourcing examples*. The Rule and this manual discuss:

1. General principles, rule of reasonable approximation, exclusion of sales
2. Rental/license/lease of real property
3. Rental/license/lease of personal property
4. Sales of service
5. License/lease of intangible property
6. License of intangible property
7. Special rules including those for software/digital transactions

#### 1.a. General principles of application<sup>561</sup>

A taxpayer's application of the market-based sourcing rules should be based on objective criteria and should consider all sources of information reasonably available to the taxpayer at the time of its tax filing including, without limitation, the taxpayer's books and records kept in the normal course of business. A taxpayer's method of assigning its sales should be determined in good faith, applied in good faith, and applied consistently with respect to similar transactions and year to year. A taxpayer should *retain contemporaneous records* that explain the determination and application of its method of assigning its sales, including its underlying assumptions. These records should be retained so that they can be submitted to the Department if requested.

There are various *assignment rules that apply sequentially in a hierarchy*. For each sale to which a hierarchical rule applies, a taxpayer must make a reasonable effort to apply the primary rule applicable to the sale before seeking to apply the next rule in the hierarchy (and must continue to do so with each succeeding rule in the hierarchy, where applicable). For example, in some cases, the applicable rule first requires a taxpayer to determine the state or states of assignment, and where the taxpayer cannot do so, the rule then requires the taxpayer to reasonably approximate such state or states. In such cases, the taxpayer must in good faith and with reasonable effort attempt to determine the state or states of assignment (i.e., apply the primary rule in the hierarchy) before it may reasonably approximate such state or states.

### 1.b. Reasonable approximation<sup>562</sup>

If a taxpayer finds that the Rule does not sufficiently address their business operations they should nonetheless make a good faith effort to source receipts based on all available objective criteria available at the time of filing the return and retain contemporaneous records to support their determination, including a narrative that explains their methodology and underlying assumptions. Taxpayers must follow the Rule's guidance as best they can. More specifically:

- Determining whether and to what extent the market for a sale other than the sale of tangible personal property is in Tennessee is generally found in Rule 42. However, the Rule has provisions for “*reasonable approximation*,” which apply where the state or states of assignment cannot be determined. In some instances, the reasonable approximation must be made in accordance with specific guidance found in Rule 42; like pertaining to professional services.<sup>563</sup> In other cases, the applicable section of the Rule permits a taxpayer to reasonably approximate the state or states of assignment, using a method that reflects an effort to approximate the results that would be obtained under the applicable standards set forth in the Rule.
- Reasonable approximation may be based upon known sales for the sales of services.<sup>564</sup> When a taxpayer can ascertain the state or states of assignment of a substantial portion of its sales of substantially similar services (“assigned sales”), but not all of such sales, and the taxpayer reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of such sales generally tracks that of the assigned sales, it should include those sales which it believes track the geographic distribution of the assigned sales in its sales factor in the same proportion as its assigned sales.
  - This guidance on reasonable approximation also applies in the context of licenses and sales of intangible property where the substance of the transaction resembles a sale of goods or services.<sup>565</sup>

#### **Audit Tip**

**A taxpayer's method of assigning its sales, including the use of a method of approximation, where applicable, must reflect an attempt to obtain the most accurate assignment of sales consistent with the standards of Rule 42, rather than an attempt to lower the taxpayer's tax liability. A method of assignment that is reasonable for one taxpayer may not necessarily be reasonable for another taxpayer, depending upon the applicable facts.**

### 1.c. Exclusion of sales<sup>566</sup>

Exclusion of sales from the numerator and the denominator of the sales factor is required in any case in which a taxpayer cannot ascertain the state or states to which a sale is to be assigned pursuant to Rule 42 (including through the use of a method of reasonable approximation, where relevant) using a reasonable amount of effort undertaken in good faith.

For example, when a taxpayer initially tries to determine sales sourcing under the rule, but cannot:

- The taxpayer's next step is to "reasonably approximate" the state(s) of assignment, as provided for in Rule 42. The taxpayer must, in good faith and with reasonable effort, attempt to determine the state(s) of assignment.
- If a taxpayer can ascertain the state(s) of assignment of a substantial portion of its sales of substantially similar services ("assigned sales"), but not all of sales, and the taxpayer reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of such sales generally tracks that of the assigned sales, it should include those sales which it believes track the *geographic distribution of the assigned sales* in its sales factor in the same proportion as its assigned sales.
- As a last resort, if a taxpayer cannot determine the state(s) to source a receipt pursuant to Rule 42 (including use of the reasonable approximation method) and using a reasonable amount of effort undertaken in good faith, the sale should be *excluded from both the numerator and the denominator* of the taxpayer's sales factor.
  - Interest and dividend income that are *business earnings* are *not* sourced based on commercial domicile. A taxpayer filing Form FAE170 (non-financial institutions) should throw out *investment* interest and dividend income.

**⚠ *Investment dividend and interest income, to the extent they are business earnings received by non-financial institutions, are not included in the numerator or denominator of the sales/receipts factor because Rule 42 does not include specific guidance regarding the sourcing of this type of income. Interest from accounts receivable is not thrown out.***

### 2. The sale, rental, lease, or license of real property

To the extent that rental, lease or license of real property is in Tennessee, the sale is in Tennessee.

### 3. The rental, lease, or license of tangible personal property

In the case of a rental, lease or license of tangible personal property, the sale is in Tennessee if and to the extent that the property is in Tennessee. If property is mobile property that is located both within and without Tennessee during the period of the lease or other contract, the receipts assigned to Tennessee shall be the receipts from the contract period multiplied by the fraction *used by the taxpayer for property factor purposes*<sup>567</sup> (as adjusted when necessary to reflect differences between usage during the contract period and usage during the taxable year).

### 4. The sale of a service

The sale of a service is in Tennessee if and to the extent that the service is *delivered* at a location in Tennessee.

**a) In general, the term “delivered”** means the location of the taxpayer’s market for the service provided and is not to be construed by reference to the location of the property or payroll of the taxpayer as otherwise determined for corporate apportionment purposes. The rules to determine the location of the delivery of the following types of service are discussed below:

- In-person services (b)
- Services Delivered to the Customer or on Behalf of the Customer, or Delivered Electronically Through the Customer (c)
- Professional Services (d)
- Broadcast Advertising (e)

**b) In-Person Services** generally are services that are physically provided in person by the taxpayer, where the customer or the customer’s real or tangible property upon which the services are performed is in the same location as the service provider at the time the services are performed.

This rule includes situations where the services are provided on behalf of the taxpayer by a third-party contractor.

- Examples of in-person services include, without limitation, warranty and repair services; cleaning services; plumbing services; carpentry; construction contractor

services; pest control; landscape services; medical and dental services, including medical testing and x-rays and mental health care and treatment; child care; hair cutting and salon services; live entertainment and athletic performances; and in-person training or lessons.

In-person services include services within the description above that are performed at a *location*:

- that is owned or operated by the service provider; or
- of the customer, including the location of the customer's real or tangible personal property. Various professional services, including legal, accounting, financial and consulting services, and similar professional services,<sup>568</sup> although they may involve some amount of in-person contact, are not treated as in-person services within the meaning of this section.

*Assignment of sales for in-person service* is the location where the service is received, with the exception noted below. The delivery of the service is at the location where the service is received. Therefore, the sale is in Tennessee if and to the extent the customer receives the in-person service in Tennessee. In assigning sales of in-person services, a taxpayer must consider the "rule of determination" and the "rule of reasonable approximation."

Under the "rule of determination", a taxpayer should first attempt to determine the location where a service is received, as follows:

- Where the service is performed with respect to the body of an individual customer in Tennessee (e.g., hair cutting or x-ray services) or in the physical presence of the customer in Tennessee (e.g., live entertainment or athletic performances), the service is received in Tennessee.

 **Definition**

**"Individual customer" means any customer who is not a business customer.**

- Where the service is performed with respect to the customer's real estate in Tennessee or where the service is performed with respect to the customer's tangible

personal property at the customer's residence or in the customer's possession in Tennessee, the service is received in Tennessee.

- Where the service is performed with respect to the customer's tangible personal property and the tangible personal property is to be shipped or delivered to the customer, whether the service is performed in Tennessee or outside Tennessee, the service is received in Tennessee if such property is shipped or delivered to the customer in Tennessee.

Under the "*rule of reasonable approximation*," any instance in which the state or states where a service is actually received cannot be determined, but the taxpayer has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, the taxpayer shall reasonably approximate such state or states.

c) **Sales of services delivered to the customer or on behalf of the customer, or delivered electronically through the customer**<sup>569</sup> where the service provided by the taxpayer is not an in-person service<sup>570</sup> or a professional service<sup>571</sup> and the service is delivered to or on behalf of the customer, or delivered electronically through the customer, the sale is in Tennessee if and to the extent that the service is delivered in Tennessee.

- For purposes of this section, a service that is delivered "to" a customer is a service in which the customer and not a third party is the recipient of the service. A service that is delivered "on behalf of" a customer is one in which a customer contracts for a service but one or more third parties, rather than the customer, is the recipient of the service, such as fulfillment services or the direct/indirect delivery of advertising to the customer's intended audience; both discussed below.

A service that is delivered electronically "through" a customer is a service that is delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to an end user or other third-party recipient. Except in the instance of a service that is delivered through a customer (where the service must be delivered electronically), a service is included within the meaning of this section, irrespective of the method of delivery, e.g., whether such service is delivered by a physical means or through an electronic transmission.

The assignment of a sale to a state or states in the instance of a service that is delivered to the customer or on behalf of the customer, or delivered electronically through the customer,

depends upon the method of delivery of the service and the nature of the customer. Separate rules of assignment apply to services delivered by physical means and services delivered by electronic transmission. (For purposes of this section, a service delivered by an electronic transmission shall not be considered a delivery by a physical means). In any instance where, applying the rules set forth in this section, the rule of assignment depends on whether the customer is an individual or a business customer, and the taxpayer acting in good faith cannot reasonably determine whether the customer is an individual or business customer, the taxpayer shall treat the customer as a business customer.

**⚠ Definition**

**“Business customer” means a customer that is a business operating in any form, including an individual who operates a business through the form of a sole proprietorship. Sales to a non-profit organization, to a trust, to the U.S. Government, to any foreign, state or local government, or to any agency or instrumentality of such government shall be treated as sales to a business customer and shall be assigned consistent with the rules that apply to such sales.”**

■ *Delivery to or on Behalf of a Customer by Physical Means, Whether to an Individual or Business Customer*

Services delivered to a customer or on behalf of a customer through a physical means include, for example, product delivery services where property is delivered to the customer or to a third party on behalf of the customer; the delivery of brochures, fliers or other direct mail services; the delivery of advertising or advertising-related services to the customer’s intended audience in the form of a physical medium; and the sale of custom software (e.g., where software is developed for a specific customer in a case where the transaction is properly treated as a service transaction for purposes of corporate taxation) where the taxpayer installs the custom software at the customer’s site. The rules in this subsection apply whether the taxpayer’s customer is an individual customer or a business customer.

- Rule of Determination - In assigning the sale of a service delivered to a customer or on behalf of a customer through a physical means, a taxpayer must first attempt to determine the state or states where such services are delivered. Where the taxpayer can determine the state or states where the service is delivered, it shall assign the sale to such state or states.



- Rule of Reasonable Approximation - Where the taxpayer cannot determine the state or states where the service is actually delivered but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the service is delivered, it shall reasonably approximate such state or states.
- Examples - Assume in each of the following six examples that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.

**Example 1:** Direct Mail Corp, a corporation based outside Tennessee, provides direct mail services to its customer, Business Corp. Business Corp transacts with Direct Mail Corp to deliver printed fliers to a list of customers that is provided to it by Business Corp. Some of Business Corp's customers are in Tennessee and some of those customers are in other states. Direct Mail Corp will use the postal service to deliver the printed fliers to Business Corp's customers. The sale of Direct Mail Corp's services to Business Corp is assigned to Tennessee to the extent that the services are delivered on behalf of Business Corp to Tennessee customers (i.e., to the extent that the fliers are delivered on behalf of Business Corp to Business Corp's intended audience in Tennessee).

**Example 2:** Ad Corp is a corporation based outside Tennessee that provides advertising and advertising-related services in Tennessee and in neighboring states. Ad Corp enters into a contract at a location outside Tennessee with an individual customer who is not a Tennessee resident to design advertisements for billboards to be displayed in Tennessee, and to design fliers to be mailed to Tennessee residents. All the design work is performed outside Tennessee. The sale of the design services is in Tennessee because the service is physically delivered on behalf of the customer to the customer's intended audience in Tennessee.

**Example 3:** Same facts as Example 2, except that the contract is with a business customer that is based outside Tennessee. The sale of the design services is in Tennessee because the services are physically delivered on behalf of the customer to the customer's intended audience in Tennessee.

**Example 4:** Fulfillment Corp, a corporation based outside Tennessee, provides product delivery fulfillment services in Tennessee and in neighboring states to Sales Corp, a corporation located outside Tennessee that sells tangible personal property through a mail order catalog and over the Internet to customers. In some cases when a customer purchases tangible personal property from Sales Corp to be delivered in Tennessee, Fulfillment Corp will, pursuant to its contract with Sales Corp, deliver that property from its fulfillment warehouse located outside Tennessee. The sale of the fulfillment services of Fulfillment Corp to Sales Corp is assigned to Tennessee to the extent that Fulfillment Corp's deliveries on behalf of Sales Corp are to recipients in Tennessee.

**Example 5:** Software Corp, a software development corporation, enters into a contract with a business customer, Buyer Corp, which is physically located in Tennessee, to develop custom software to be used in Buyer Corp's business. Software Corp develops the custom software outside Tennessee, and then physically installs the software on Buyer Corp's computer hardware located in Tennessee. The development and sale of the custom software is properly characterized as a service transaction, and the sale is assigned to Tennessee because the software is physically delivered to the customer in Tennessee.

**Example 6:** Same facts as Example 5, except that Buyer Corp has offices in Tennessee and several other states but is commercially domiciled outside Tennessee and orders the software from a location outside Tennessee. The receipts from the development and sale of the custom software service are assigned to Tennessee because the software is physically delivered to the customer in Tennessee.

- **Delivery to a Customer by Electronic Transmission**  
Services delivered by electronic transmission include, without limitation, services that are transmitted through the means of wire, lines, cable, fiber optics, electronic signals, satellite transmission, audio or radio waves, or other similar means, whether or not the service provider owns, leases or otherwise controls the transmission equipment. In the case of the delivery of a service by electronic transmission to a customer, the following rules apply.
  - Services Delivered by Electronic Transmission to an Individual Customer

- Rule of Determination - In the case of the delivery of a service to an individual customer by electronic transmission, the service is delivered in Tennessee if and to the extent that the taxpayer's customer receives the service in Tennessee. If the taxpayer can determine the state or states where the service is received, it shall assign the sale to such state or states.
- Rules of Reasonable Approximation - If the taxpayer cannot determine the state or states where the customer actually receives the service but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, it shall reasonably approximate such state or states. Where a taxpayer does not have sufficient information from which it can determine or reasonably approximate the state or states in which the service is received, it shall reasonably approximate such state or states using the customer's billing address.

**⚠ "Billing address" means the location indicated in the books and records of the taxpayer as the primary mailing address relating to a customer's account as of the time of the transaction as kept in good faith in the normal course of business and not for tax avoidance purposes.**

- Services Delivered by Electronic Transmission to a Business Customer
  - Rule of Determination - In the case of the delivery of a service to a business customer by electronic transmission, the service is delivered in Tennessee if and to the extent that the taxpayer's customer receives the service in Tennessee. If the taxpayer can determine the state or states where the service is received, it shall assign the sale to such state or states. For purposes of this section, it is intended that the state or states where the service is received reflect the location at which the service is directly used by the employees or designees of the customer.
  - Rules of Reasonable Approximation - If the taxpayer cannot determine the state or states where the customer actually receives

the service but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, it shall reasonably approximate such state or states.

- Secondary Rule of Reasonable Approximation - In the case of the delivery of a service to a business customer by electronic transmission where a taxpayer does not have sufficient information from which it can determine or reasonably approximate the state or states in which the service is received, such state or states shall be reasonably approximated as set forth in this section. In such cases, unless the taxpayer can apply the safe harbor shown in the section below,<sup>572</sup> the taxpayer shall reasonably approximate the state or states in which the service is received as follows:
  - First, by assigning the sale to the state where the contract of sale is principally managed by the customer;
  - Second, if the state where the customer principally manages the contract is not reasonably determinable, by assigning the sale to the customer's place of order; and

**⚠ Definition**

**“State where a contract of sale is principally managed by the customer” means the primary location at which an employee or other representative of a customer serves as the primary contact person for the taxpayer with respect to the implementation and day-to-day execution of a contract entered into by the taxpayer with the customer.**

**“Place of order” means the physical location from which a customer places an order for a sale other than a sale of tangible personal property from a taxpayer, resulting in a contract with the taxpayer.**

- Third, if the customer's place of order is not reasonably determinable, by assigning the sale using the customer's billing address; provided, however, that in any instance in

which the taxpayer derives more than 5% of its sales of services from a customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by that customer.

- **Safe Harbor**<sup>573</sup> - In the case of the delivery of a service to a business customer by electronic transmission a taxpayer may not be able to determine, or reasonably approximate,<sup>574</sup> the state or states in which the service is received. In these cases, the taxpayer may, in lieu of the secondary rule of reasonable approximation<sup>575</sup>, apply the safe harbor stated in this section. Under this safe harbor, a taxpayer may assign its sales to a particular customer *based upon the customer's billing address* in any taxable year in which the taxpayer
  - engages in substantially similar service transactions with more than 250 customers, whether business or individual, and
  - does not derive more than 5% of its sales of services from such customer. This safe harbor applies only for purposes of Rule to services delivered by electronic transmission to a business customer, and not otherwise.<sup>576</sup>
- Assume in the following examples that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012. Assume where relevant, unless otherwise stated, that the safe harbor described above and set forth at Rule 1320- 06-01-.42(4)(c)2(ii)(II)IV does not apply.

**Example 1:** Support Corp, a corporation that is based outside Tennessee, provides software support and diagnostic services to individual and business customers that have previously purchased certain software from third-party vendors. These individual and business customers are located in Tennessee and other states. Support Corp supplies its services on a case-by-case basis when directly contacted by its customer. Support Corp generally provides these services through the Internet but sometimes provides these services by phone. In all cases, Support Corp verifies the customer's account information before providing any service. Using the information that Support

Corp verifies before performing a service, Support Corp can determine where its services are received, and therefore must assign its sales to these locations. The sales made to Support Corp's individual and business customers are in Tennessee to the extent that Support Corp's services are received in Tennessee.<sup>577</sup>

**Example 2:** Online Corp, a corporation based outside Tennessee, provides web-based services through the means of the Internet to individual customers who are residents of Tennessee and other states. These customers access Online Corp's web services primarily in their states of residence, and sometimes, while traveling, in other states. For a substantial portion of its sales, Online Corp either can determine the state or states where such services are received, or, where it cannot determine such state or states, it has sufficient information regarding the place of receipt to reasonably approximate such state or states. However, Online Corp cannot determine or reasonably approximate the state or states of receipt for all such sales. Assuming that Online Corp reasonably believes, based on all available information, that the geographic distribution of the sales for which it cannot determine or reasonably approximate the location of the receipt of its services generally tracks those for which it does have this information, Online Corp must assign to Tennessee the sales for which it does not know the customers' location in the same proportion as those sales for which it has this information.<sup>578</sup>

**Example 3:** Same facts as in Example 2, except that Online Corp reasonably believes that the geographic distribution of the sales for which it cannot determine or reasonably approximate the location of the receipt of its web-based services do not generally track the sales for which it does have this information. Online Corp must assign the sales of its services for which it lacks information as provided to its individual customers using the customers' billing addresses.<sup>579</sup>

**Example 4:** Net Corp, a corporation based outside Tennessee, provides web-based services to a business customer, Business Corp, a company with offices in Tennessee and two neighboring states. Particular employees of Business Corp access the services from computers in each Business Corp office. Assume that Net Corp determines that Business Corp employees in Tennessee were responsible for 75% of Business Corp's use of Net Corp's services, and Business Corp employees in other states were responsible for

25% of Business Corp's use of Net Corp's services. In such case, 75% of the sale is received in Tennessee, and therefore 75% of the sale is in Tennessee.<sup>580</sup> Assume alternatively that Net Corp lacks sufficient information regarding the location or locations where Business Corp's employees used the services to determine or reasonably approximate such location or locations. Under these circumstances, if Net Corp derives 5% or less of its sales from Business Corp, Net Corp must assign the sale in accordance with the "Secondary Rule of Reasonable Approximation in the case of the delivery of a service to a business customer by electronic transmission,"<sup>581</sup> to the state where Business Corp principally managed the contract, or if that state is not reasonably determinable, to the state where Business Corp placed the order for the services, or if that state is not reasonably determinable, to the state of Business Corp's billing address. If Net Corp derives more than 5% of its sales of services from Business Corp, Net Corp is required to identify the state in which its contract of sale is principally managed by Business Corp and must assign the receipts to that state.

**Example 5:** Net Corp, a corporation based outside Tennessee, provides web-based services through the means of the Internet to more than 250 individual and business customers in Tennessee and in other states. Assume that for each customer Net Corp cannot determine the state or states where its web services are actually received and lacks sufficient information regarding the place of receipt to reasonably approximate such state or states. Also, assume that Net Corp does not derive more than 5% of its sales of services from any single customer. Net Corp may apply the safe harbor<sup>582</sup> and may assign its sales using each customer's billing address.

- *Services Delivered Electronically Through or on Behalf of an Individual or Business Customer*

A service delivered electronically "on behalf of" the customer is one in which a customer contracts for a service to be delivered electronically but one or more third parties, rather than the customer, is the recipient of the service, such as the direct or indirect delivery of advertising on behalf of a customer to the customer's intended audience. A service delivered electronically "through" a customer to third-party recipients is a service that is delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to end users or other third-party recipients.

- Rule of Determination - In the case of the delivery of a service by electronic transmission, where the service is delivered electronically to end users or other third-party recipients through or on behalf of the customer, the service is delivered in Tennessee if and to the extent that the end users or other third-party recipients are in Tennessee. For example, in the case of the direct or indirect delivery of advertising on behalf of a customer to the customer's intended audience by electronic means, the service is delivered in Tennessee to the extent that the audience for such advertising is in Tennessee. In the case of the delivery of a service to a customer that acts as an intermediary in reselling the service in substantially identical form to third-party recipients, the service is delivered in Tennessee to the extent that the end users or other third-party recipients receive such services in Tennessee. The rules in this subsection apply whether the taxpayer's customer is an individual customer or a business customer and whether the end users or other third-party recipients to whom the services are delivered through or on behalf of the customer are individuals or businesses.
  
- Rule of Reasonable Approximation - If the taxpayer cannot determine the state or states where the services are actually delivered to the end users or other third-party recipients either through or on behalf of the customer but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the services are delivered, it shall reasonably approximate such state or states.
  
- Select Secondary Rules of Reasonable Approximation - Where a taxpayer's service is the direct or indirect electronic delivery of advertising on behalf of its customer to the customer's intended audience, if the taxpayer lacks sufficient information regarding the location of the audience from which it can determine or reasonably approximate such location, the taxpayer shall reasonably approximate the audience in a state for such advertising using the following secondary rules of reasonable approximation. Where a taxpayer is delivering advertising directly or indirectly to a known list of subscribers, the taxpayer shall reasonably approximate the audience for advertising in a state using a percentage that reflects the ratio of the state's subscribers in the specific geographic area in which the advertising is delivered relative to the total subscribers in such area. For a taxpayer with less information about its audience, the taxpayer shall reasonably approximate the audience in a state using the percentage that reflects the



ratio of the state's population in the specific geographic area in which the advertising is delivered relative to the total population in such area.

Where a taxpayer's service is the delivery of a service to a customer that then acts as the taxpayer's intermediary in reselling such service to end users or other third-party recipients, if the taxpayer lacks sufficient information regarding the location of the end users or other third-party recipients from which it can determine or reasonably approximate such location, the taxpayer shall reasonably approximate the extent to which the service is received in a state by using the percentage that reflects the ratio of the state's population in the specific geographic area in which the taxpayer's intermediary resells such services, relative to the total population in such area.

Assume in each of the following examples that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.

**Example 1:** Web Corp, a corporation that is based outside Tennessee, provides Internet content to viewers in Tennessee and other states. Web Corp sells advertising space to business customers pursuant to which the customers' advertisements will appear in connection with Web Corp's Internet content. Web Corp receives a fee for running the advertisements that is determined by reference to the number of times the advertisement is viewed or clicked upon by the viewers of its website. Web Corp's sale of advertising space to its business customers is assigned to Tennessee to the extent that the viewers of the Internet content are in Tennessee, as measured by viewings or clicks.<sup>583</sup> If Web Corp is unable to determine the actual location of its viewers, and lacks sufficient information regarding the location of its viewers to reasonably approximate such location, Web Corp must approximate the amount of its Tennessee sales by multiplying the amount of such sales by a percentage that reflects the Tennessee population in the specific geographic area in which the content containing the advertising is delivered relative to the total population in such area.<sup>584</sup>

**Example 2:** Retail Corp, a corporation that is based outside of Tennessee, sells tangible property through its retail stores located in Tennessee and other states, and through a mail order catalog. Answer Co, a corporation that operates call centers in multiple states, contracts with Retail Corp to answer telephone calls from individuals placing orders for products found in Retail

Corp's catalogs. In this case, the phone answering services of Answer Co are being delivered to Retail Corp's customers and prospective customers. Therefore, Answer Co is delivering a service electronically to Retail Corp's customers or prospective customers on behalf of Retail Corp and must assign the proceeds from this service to the state or states from which the phone calls are placed by such customers or prospective customers. If Answer Co cannot determine the actual locations from which phone calls are placed and lacks sufficient information regarding the locations to reasonably approximate such locations, Answer Co must approximate the amount of its Tennessee sales by multiplying the amount of its fee from Retail Corp by a percentage that reflects the Tennessee population in the specific geographic area from which the calls are placed relative to the total population in such area.<sup>585</sup>

**Example 3:** Web Corp, a corporation that is based outside of Tennessee, sells tangible property to customers via its Internet website. Design Co designed and maintains Web Corp's website, including making changes to the site based on customer feedback received through the site. Design Co.'s services are delivered to Web Corp, the proceeds from which are assigned pursuant to the section on "(delivery to customer by electronic transmission).<sup>586</sup> The fact that Web Corp's customers and prospective customers incidentally benefit from Design Co.'s services and may even interact with Design Co in the course of providing feedback, does not transform the service into one delivered "on behalf of" Web Corp to Web Corp's customers and prospective customers.

**Example 4:** Wholesale Corp, a corporation that is based outside Tennessee, develops an Internet-based information database outside Tennessee and enters into a contract with Retail Corp whereby Retail Corp will market and sell access to this database to end users. Depending on the facts, the provision of database access may be either the sale of a service or the license of intangible property or may have elements of both. Assume that on the particular facts applicable in this example Wholesale Corp is selling database access in transactions properly characterized as involving the performance of a service. When an end user purchases access to Wholesale Corp's database from Retail Corp, Retail Corp in turn compensates Wholesale Corp in connection with that transaction. In this case, Wholesale Corp's services are being delivered through Retail Corp to the end user. Wholesale Corp must assign its sales to Retail Corp to the state or states in which the end users

receive access to Wholesale Corp's database. If Wholesale Corp cannot determine the state or states where the end users actually receive access to Wholesale Corp's database, and lacks sufficient information regarding the location from which the end users access the database to reasonably approximate such location, Wholesale Corp must approximate the extent to which its services are received by end users in Tennessee by using a percentage that reflects the ratio of the Tennessee population in the specific geographic area in which Retail Corp regularly markets and sells Wholesale Corp's database relative to the total population in such area.<sup>587</sup> Note that it does not matter for purposes of the analysis whether Wholesale Corp's sale of database access constitutes a service or a license of intangible property, or some combination of both.<sup>588</sup>

**d) Professional Services**

Except as otherwise provided in the next section,<sup>589</sup> professional services are services that require specialized knowledge and, in some cases, require a professional certification, license or degree. Professional services include, without limitation, management services, bank and financial services, financial custodial services, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting services, lending and credit card services, legal services, consulting services, video production services, graphic and other design services, engineering services, and architectural services.

*When there is an overlap with other categories of services:*

- Certain services that fall within the definition of "professional services" (described above)<sup>590</sup> are nevertheless treated as "in-person services" within the meaning of the rule concerning "in-person services,"<sup>591</sup> and are assigned under rule section on in-person services.<sup>592</sup> Specifically, professional services that are physically provided in person by the taxpayer such as carpentry, certain medical and dental services or child care services, where the customer or the customer's real or tangible property upon which the services are provided is in the same location as the service provider at the time the services are performed, are "in-person services" and are assigned as such, notwithstanding that they may also be considered to be "professional services". However, professional services where the service is of an intellectual or intangible nature, such as legal, accounting, financial and consulting services, are assigned as professional services under rule section on professional services<sup>593</sup> notwithstanding the fact that such services may involve some amount of in-person contact.

- Professional services may in some cases include the transmission of one or more documents or other communications by mail or by electronic means. However, in such cases, despite this transmission, the assignment rules that apply are those described in the section on professional services,<sup>594</sup> and not those set forth in the section on “services delivered to the customer or on behalf of the customer, or delivered electronically through the customer”<sup>595</sup>, pertaining to services delivered to a customer or through or on behalf of a customer.

*Assignment of Sales:*

- In the case of a professional service, it is generally possible to characterize the location of delivery in multiple ways by emphasizing different elements of the service provided, no one of which will consistently represent the market for the services. Therefore, for purposes of consistent application of the market-sourcing rule stated in Tenn. Code Ann. § 67-4-2012, the Commissioner has concluded that the location of delivery in the case of professional services is not susceptible to a general rule of determination and must be reasonably approximated. The assignment of a sale of a professional service depends in many cases upon whether the customer is an individual or business customer. In any instance in which the taxpayer, acting in good faith, cannot reasonably determine whether the customer is an individual or business customer, the taxpayer shall treat the customer as a business customer. For purposes of assigning the sale of a professional service, a taxpayer’s customer is the person who contracts for such service, irrespective of whether another person pays for or also benefits from the taxpayer’s services.
  - General Rule – Sales of professional services other than architectural and engineering services,<sup>596</sup> discussed in the next section, are assigned as follows:
    - *Professional Services Delivered to Individual Customers.* Except as otherwise provided in this section (professional services), in any instance in which the service provided is a professional service and the taxpayer’s customer is an individual customer, the state or states in which the service is delivered shall be reasonably approximated as set forth above in this section. In particular, the taxpayer should assign the sale to the customer’s state of primary residence, or, if the taxpayer cannot reasonably identify the customer’s state of primary residence, to the state of the customer’s billing address; provided,

however, in any instance in which the taxpayer derives more than 5% of its sales of services from an individual customer, the taxpayer is required to identify the customer's state of primary residence and must assign the receipts from the service or services provided to that customer to that state.

- *Professional Services Delivered to Business Customers.* Except as otherwise provided in this section<sup>597</sup> in any instance in which the service provided is a professional service and the taxpayer's customer is a business customer, the state or states in which the service is delivered shall be reasonably approximated as set forth in this section.<sup>598</sup> In particular, unless the taxpayer may use the safe harbor, described below, the taxpayer should assign the sale as follows:

**First**, by assigning the receipts to the state where the contract of sale is principally managed by the customer;

**Second**, if such place of customer management is not reasonably determinable, to the customer's place of order; and

**Third**, if such customer's place of order is not reasonably determinable, to the customer's billing address;

However, in any instance in which the taxpayer derives more than 5% of its sales of services from a customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by the customer.

- *Safe Harbor; Large Volume of Transactions.* Notwithstanding the rules set forth in the two prior sections<sup>599</sup> a taxpayer may assign its sales to a particular customer based on the customer's billing address in any taxable year in which the taxpayer
  - engages in substantially similar service transactions with more than 250 customers, whether individual or business, and

- does not derive more than 5% of its sales of services from such customer.

This safe harbor applies only for purposes of sale of professional services other than architectural and engineering<sup>600</sup> not otherwise.

- *Architectural and Engineering Services with Respect to Real or Tangible Personal Property*

Architectural and engineering services with respect to real or tangible personal property are professional services within the meaning of this section.<sup>601</sup> However, unlike in the case of the general rule that applies to professional services,

- the sale of such an architectural service is assigned to a state or states if and to the extent that the services are with respect to real estate improvements located, or expected to be located, in such state or states; and
- the sale of such an engineering service is assigned to a state or states if and to the extent that the services are with respect to tangible or real property located in such state or states, including real estate improvements located in, or expected to be located in, such state or states. These rules apply whether the customer is an individual or business customer. In any instance in which architectural or engineering services are not described in this section<sup>602</sup> the sale of such services shall be assigned under the general rule for professional services.

**Example 1:** Architecture Corp provides building design services as to buildings located, or expected to be located, in Tennessee to individual customers who are residents of Tennessee and other states, and to business customers that are based in Tennessee and other states. Architecture Corp's sales are assigned to Tennessee because the locations of the buildings to which its design services relate are in Tennessee or are expected to be in Tennessee. For purposes of assigning these sales, it is not relevant where, in the case of an individual customer, the customer primarily resides or is billed for such services, and it is not relevant where, in the case of a business customer, the customer principally manages the contract, placed the order

for the services or is billed for such services. Further, such sales are assigned to Tennessee even if Architecture Corp's designs are either physically delivered to its customer in paper form in a state other than Tennessee or are electronically delivered to its customer in a state other than Tennessee.<sup>603</sup>

**Example 2:** Law Corp provides legal services to individual clients who are residents of Tennessee and other states. In some cases, Law Corp may prepare one or more legal documents for its client as a result of these services and/or the legal work may be related to litigation or a legal matter that is ongoing in a state other than where the client is resident. Assume that Law Corp knows the state of primary residence for many of its clients, and where it does not know this state of primary residence, it knows the client's billing address. Also assume that Law Corp does not derive more than 5% of its sales of services from any one individual client. Where Law Corp knows its client's state of primary residence, it shall assign the sale to that state. Where Law Corp does not know its client's state of primary residence, but rather knows the client's billing address, it shall assign the sale to that state. For purposes of the analysis, it is irrelevant whether the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or the litigation or other legal matter that is the underlying predicate for the services is in another state.<sup>604</sup>

**Example 3:** Law Corp provides legal services to several multistate business clients. In each case, Law Corp knows the state in which the agreement for legal services that governs the client relationship is principally managed by the client. In one case, the agreement is principally managed in Tennessee; in the other cases, the agreement is principally managed in a state other than Tennessee. Where the agreement for legal services is principally managed by the client in Tennessee, the sale of the services shall be assigned to Tennessee; in the other cases, the sale is not assigned to Tennessee. In the case of the sale that is assigned to Tennessee, the sale shall be so assigned even if (1) the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or (2) the litigation or other legal matter that is the underlying predicate for the services is in another state.<sup>605</sup>

**Example 4:** Consulting Corp, a company that provides consulting services to law firms and other customers, is hired by Law Corp in connection with legal representation that Law Corp provides to Client Co. Specifically, Consulting Corp is hired to provide expert testimony at a trial being conducted by Law Corp on behalf of Client Co. Client Co pays for Consulting Corp's services directly. Assuming that Consulting Corp knows that its agreement with Law Corp is principally managed by Law Corp in Tennessee, the sale of Consulting Corp's services shall be assigned to Tennessee. It is not relevant for purposes of the analysis that Client Co is the ultimate beneficiary of Consulting Corp's services, or that Client Co pays for Consulting Corp's services directly.<sup>606</sup>

**Example 5:** Advisor Corp, a corporation that provides investment advisory services, provides such advisory services to Investment Co. Investment Co is a multistate business client of Advisor Corp that uses Advisor Corp's services in connection with investment accounts that it manages for individual clients, who are the ultimate beneficiaries of Advisor Corp's services. Assume that Investment Co.'s individual clients are persons that are residents of numerous states, which may or may not include Tennessee. Assuming that Advisor Corp knows that its agreement with Investment Co is principally managed by Investment Co in Tennessee, the sale of Advisor Corp's services shall be assigned to Tennessee. It is not relevant for purposes of the analysis that the ultimate beneficiaries of Advisor Corp's services may be Investment Co.'s clients, who are residents of numerous states.<sup>607</sup>

**Example 6:** Design Corp is a corporation based outside Tennessee that provides graphic design and similar services in Tennessee and in neighboring states. Design Corp enters into a contract at a location outside Tennessee with an individual customer to design fliers for the customer. Assume that Design Corp does not know the individual customer's state of primary residence and does not derive more than 5% of its sales of services from the individual customer. All the design work is performed outside Tennessee. The sale is in Tennessee if the customer's billing address is in Tennessee.<sup>608</sup>



e) **Broadcast Advertising Services**

Notwithstanding anything herein to the contrary, receipts from a broadcaster's sale of advertising services to a broadcast customer are assigned to Tennessee if the commercial domicile of the broadcast customer is in Tennessee. For purposes of this provision, "advertising services" means an agreement to include the broadcast customer's advertising content in the broadcaster's film programming.

**⚠ Definition**

**"Broadcast customer" means a person, corporation, partnership, limited liability company, or other entity, such as an advertiser or a platform distribution company, that has a direct connection or contractual relationship with the broadcaster under which revenue is derived by a broadcaster.**

**"Broadcaster" means a taxpayer that is a television broadcast network, a cable program network, or a television distribution company. The term "broadcaster" does not include a platform distribution company.**

**"Commercial domicile" means the principal place from which the trade or business of a business entity is directed or managed.**

**"Film programming" means one or more performances, events, or productions (or segments of performances, events, or productions) intended to be distributed for visual and auditory perception, including but not limited to news, entertainment, sporting events, plays, stories, or other literary, commercial, educational, or artistic works.**

[5. Rental, lease, or license of intangible property](#)

a) **General rule**

The receipts from the rental, lease, or license of intangible property are in Tennessee if and to the extent the intangible is used in Tennessee. In general, the term "use" shall be construed to refer to the location of the taxpayer's market for the use of the intangible property that is being rented, leased, or licensed and is not to be construed to refer to the location of the property or payroll of the taxpayer.

In general, a rental, lease, or license of intangible property that conveys all substantial rights in such property is treated as a sale of intangible property for tax purposes.<sup>609</sup> See section on the license of intangible property below. Note, however, that for purposes of this section and the following section (“license of intangible property,”<sup>610</sup> a sale or exchange of intangible property is treated as a license of such property where the receipts from the sale or exchange derive from payments that are contingent on the productivity, use or disposition of the property.

Intangible property rented, leased, or licensed as part of the sale or lease of tangible property is treated under Rule 1320-06-01-.42 as the sale or lease of tangible property.

**b) License of a Marketing Intangible**

Where a license is granted for the right to use intangible property in connection with the sale, rental, lease, license, or other marketing of goods, services, or other items (i.e., a marketing intangible), the royalties or other licensing fees paid by the licensee for such right are assigned to Tennessee to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by customers in Tennessee. Examples of a license of a marketing intangible include, without limitation, the license of a service mark, trademark, or trade name; certain copyrights and a franchise agreement. In each of these instances the license of the marketing intangible is intended to promote consumer sales. In the case of the license of a marketing intangible, where a taxpayer has actual evidence of the amount or proportion of its receipts that is attributable to Tennessee, it shall assign such amount or proportion to Tennessee. In the absence of actual evidence of the amount or proportion of the licensee's receipts that are derived from Tennessee customers, the portion of the licensing fee to be assigned to Tennessee shall be reasonably approximated by multiplying the total fee by a percentage that reflects the ratio of the Tennessee population in the specific geographic area in which the licensee makes material use of the intangible property to regularly market its goods, services or other items relative to the total population in such area. Where the license of a marketing intangible is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the portion of the licensing fee to be assigned to Tennessee shall be reasonably approximated by multiplying the total fee by a percentage that reflects the ratio of the Tennessee population in the specific geographic area in which the

licensee's goods, services, or other items are ultimately marketed using the intangible property relative to the total population of such area.

**c) License of a Production Intangible**

Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, and the license is to be used in a production capacity (a “production intangible”), the licensing fees paid by the licensee for such right are assigned to Tennessee to the extent that the use for which the fees are paid takes place in Tennessee. Examples of a license of a production intangible include, without limitation, the license of a patent, a copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominately in its use in such process. In the case of a license of a production intangible, it shall be presumed that the use of the intangible property takes place in the state of the licensee's commercial domicile (where the licensee is a business) or the licensee's state of primary residence (where the licensee is an individual) unless the taxpayer or the Commissioner can reasonably establish the location(s) of actual use. Where the Commissioner can reasonably establish that the actual use of intangible property pursuant to a license of a production intangible takes place in part in Tennessee, it shall be presumed that the entire use is in Tennessee except to the extent that the taxpayer can demonstrate that the actual location of a portion of the use takes place outside Tennessee.

**d) License of a Broadcasting Intangible**

Where a broadcaster grants a license to a broadcast customer for the right to use film programming, the licensing fees paid by the licensee for such right are assigned to Tennessee to the extent that the broadcast customer is located in Tennessee. In the case of business customers, the broadcast customer's location shall be determined using the broadcast customer's commercial domicile. In the case of individual customers, the broadcast customer's location shall be determined using the address of the broadcast customer listed in the broadcaster's records.

**e) License of a Mixed Intangible**

Where a license of intangible property includes both a license of a marketing intangible and a license of a production intangible (a “mixed intangible”) and the fees to be paid in each instance are separately and reasonably stated in the licensing contract, the Commissioner will accept such separate statement for purposes of this

section if it is reasonable. Where a license of intangible property includes both a license of a marketing intangible and a license of a production intangible and the fees to be paid in each instance are not separately and reasonably stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of the marketing intangible except to the extent that the taxpayer or the Commissioner can reasonably establish otherwise.

f) **License of Intangible Property where Substance of Transaction Resembles a Sale of Goods or Services**

- ***In general.*** In some cases, the license of intangible property will resemble the sale of an electronically-delivered good or service rather than the license of a marketing intangible or a production intangible. In such cases, the receipts from the licensing transaction shall be assigned by applying the rules set forth in the section on “sales of services delivered to the customer or on behalf of the customer, or delivered electronically through the customer”<sup>611</sup> as if the transaction were a service delivered to an individual or business customer or delivered electronically through an individual or business customer, as applicable. Examples of transactions to be assigned under this section include, without limitation, the license of database access, the license of access to information, the license of digital goods<sup>612</sup> and the license of certain software (e.g., where the transaction is not the license of pre-written software that is treated as the sale of tangible personal property, discussed in the section on special rules.<sup>613</sup>
- ***Sublicenses.*** Pursuant to the above paragraph (general guidance), the earlier section of the rule on “services delivered electronically through or on behalf of an individual or business customer”<sup>614</sup> may apply where a taxpayer licenses intangible property to a customer that in turn sublicenses the intangible property to end users as if the transaction were a service delivered electronically through a customer to end users. In particular, the rules<sup>615</sup> that apply to services delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to end users or other recipients may also apply with respect to licenses of intangible property for purposes of sublicense to end users, provided that for this purpose the intangible property sublicensed to an end user shall not fail to be substantially identical to the property that was licensed to the sublicensor merely because the sublicense transfers a reduced bundle of

rights with respect to such property (e.g., because the sublicensee's rights are limited to its own use of the property and do not include the ability to grant a further sublicense), or because such property is bundled with additional services or items of property.

**g) Examples**

*Assume in each of the following examples that the taxpayer that licenses the intangible property is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.*

**Example 1:** Crayon Corp and Dealer Co enter into a license contract under which Dealer Co as licensee is permitted to use trademarks that are owned by Crayon Corp in connection with Dealer Co.'s sale of certain products to retail customers. Under the contract, Dealer Co is required to pay Crayon Corp a licensing fee that is a fixed percentage of the total volume of monthly sales made by Dealer Co of products using the Crayon Corp trademarks. Under the contract, Dealer Co is permitted to sell the products at multiple store locations, including store locations that are both within and without Tennessee. Further, the licensing fees that are paid by Dealer Co are broken out on a per-store basis. The licensing fees paid to Crayon Corp by Dealer Co represent fees from the license of a marketing intangible. The portion of the fees to be assigned to Tennessee shall be determined by multiplying the fees by a percentage that reflects the ratio of Dealer Co.'s receipts that are derived from its Tennessee stores relative to Dealer Co.'s total receipts.<sup>616</sup>

**Example 2:** Network Corp is a broadcaster that licenses rights to its film programming to both platform distribution companies and individual customers. Platform distribution companies pay licensing fees to Network Corp for the rights to distribute Network Corp's film programming to the platform distribution companies' customers. Network Corp's individual customers pay access fees to Network Corp for the right to directly access and view Network Corp's film programming. Network Corp's receipts from each platform distribution company will be assigned to Tennessee if the broadcast customer's commercial domicile is in Tennessee. Network Corp's receipts from each individual broadcast customer will be assigned to Tennessee if the address of the broadcast customer listed in the broadcaster's records is in Tennessee.<sup>617</sup>

**⚠ Definition**

**“Platform distribution company” means a cable service provider, a direct broadcast satellite system, an Internet content distributor, or any other distributor that directly charges viewers for access to any film programming.**

**Example 3:** Moniker Corp enters into a license contract with Wholesale Co. Pursuant to the contract Wholesale Co is granted the right to use trademarks owned by Moniker Corp to brand sports equipment that is to be manufactured by Wholesale Co or an unrelated entity, and to sell the manufactured equipment to unrelated companies that will ultimately market the equipment to consumers in a specific geographic region, including a foreign country. The license agreement confers a license of a marketing intangible, even though the trademarks in question will be affixed to property to be manufactured. In addition, the license of the marketing intangible is for the right to use the intangible property in connection with sales to be made at wholesale rather than directly to retail customers. The component of the licensing fee that constitutes the Tennessee sales of Moniker Corp is determined by multiplying the amount of the fee by a percentage that reflects the ratio of the Tennessee population in the specific geographic region relative to the total population in such region.<sup>618</sup>

**Example 4:** Formula, Inc. and Appliance Co enter into a license contract under which Appliance Co is permitted to use a patent owned by Formula, Inc. to manufacture appliances. The license contract specifies that Appliance Co is to pay Formula, Inc. a royalty that is a fixed percentage of the gross receipts from the products that are later sold. The contract does not specify any other fees. The appliances are both manufactured and sold in Tennessee and several other states. Assume the licensing fees are paid for the license of a production intangible, even though the royalty is to be paid based upon the sales of a manufactured product (i.e., the license is not one that includes a marketing intangible). Because the Commissioner can reasonably establish that the actual use of the intangible property takes place in part in Tennessee, the royalty is assigned based on the location of such use rather than to location of the licensee’s commercial domicile, in accordance with the rule on the license of a production intangible<sup>619</sup>. It is presumed that the entire use is in Tennessee except to the extent that the taxpayer can demonstrate that the actual location of some or all of the use takes place outside Tennessee. Assuming that Formula, Inc. can demonstrate the percentage of manufacturing that takes place in Tennessee using the patent relative to such manufacturing in other states, that

percentage of the total licensing fee paid to Formula, Inc. under the contract will constitute Formula, Inc.'s Tennessee sales.<sup>620</sup>

**Example 5:** Axel Corp enters into a license agreement with Biker Co in which Biker Co is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell such scooters by marketing the fact that the scooters were manufactured using the special technology. The contract is a license of both a marketing and production intangible, i.e., a mixed intangible. The scooters are manufactured outside Tennessee. Assume that Axel Corp lacks actual information regarding the proportion of Biker Co.'s receipts that are derived from Tennessee customers. Also assume that Biker Co is granted the right to sell the scooters in a U.S. geographic region in which the Tennessee population constitutes 25% of the total population during the period in question. The licensing contract requires an upfront licensing fee to be paid by Biker Co to Axel Corp and does not specify what percentage of the fee derives from Biker Co.'s right to use Axel Corp's patented technology. Because the fees for the license of the marketing and production intangible are not separately and reasonably stated in the contract, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible, unless either the taxpayer or Commissioner reasonably establishes otherwise. Assuming that neither party establishes otherwise, 25% of the licensing fee constitutes Tennessee sales.<sup>621</sup>

**Example 6:** Same facts as Example 5, except that the license contract specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing contract constitutes both the license of a marketing intangible and the license of a production intangible. Assuming that the separately stated fees are reasonable, the Commissioner will: (1) assign no part of the licensing fee paid for the production intangible to Tennessee, and (2) assign 25% of the licensing fee paid for the marketing intangible to Tennessee.<sup>622</sup>

**Example 7:** Better Burger Corp, which is based outside Tennessee, enters into franchise contracts with franchisees who agree to operate Better Burger restaurants as franchisees in various states. Several of the Better Burger Corp franchises are in Tennessee. In each case, the franchise contract between the individual and Better Burger provides that the franchisee is to pay Better Burger Corp an upfront fee for the receipt of the franchise and monthly franchise fees, which cover, among other things, the right to use the Better Burger name and service marks, food processes and cooking know-how, as well as fees for management services. The upfront fees

for the receipt of the Tennessee franchises constitute fees paid for the licensing of a marketing intangible. These fees constitute Tennessee sales because the franchises are for the right to make Tennessee sales. The monthly franchise fees paid by Tennessee franchisees constitute fees paid for (1) the license of marketing intangibles (the Better Burger name and service marks), (2) the license of production intangibles (food processes and expertise) and (3) personal services (management fees). The fees paid for the license of the marketing intangibles and the production intangibles constitute Tennessee sales because in each case the use of the intangibles is to take place in Tennessee.<sup>623</sup> The fees paid for the personal services are to be assigned pursuant to the above section on sale of a service.<sup>624</sup>

**Example 8:** Online Corp, a corporation based outside Tennessee, licenses an information database through the means of the Internet to individual customers that are residents of Tennessee and other states. These customers access Online Corp's information database primarily in their states of residence, and sometimes, while traveling, in other states. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned in accordance with the above section on license of intangible property where substance of the transaction resembles a sale of goods or services.<sup>625</sup> If Online Corp can determine or reasonably approximate the state or states where its database is accessed, then it must do so. Assuming that Online Corp cannot determine or reasonably approximate the location where its database is accessed, Online Corp must assign the sales made to the individual customers using the customers' billing addresses to the extent known. Assume, for purposes of this example that Online Corp knows the billing address for each of its customers. In this case, Online Corp's sales made to its individual customers are in Tennessee in any case in which the customer's billing address is in Tennessee.<sup>626</sup>

**Example 9:** Net Corp, a corporation based outside Tennessee, licenses an information database through the means of the Internet to a business customer, Business Corp, a company with offices in Tennessee and two neighboring states. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned in accordance with the above section on "license of intangible property where substance of the transaction resembles a sale of goods or services."<sup>627</sup> Assume that Net Corp cannot determine where its database is accessed but reasonably approximates that 75% of Business Corp's database access took place in Tennessee, and 25% of Business Corp's database access took place in other states. In such case, 75% of the receipts from database access is in Tennessee. Assume alternatively that Net Corp lacks sufficient information regarding the



location where its database is accessed to reasonably approximate such location. Under these circumstances, if Net Corp derives 5% or less of its receipts from database access from Business Corp, Net Corp must assign the sale under the above section on “services delivered by electronic transmission to a business customer”<sup>628</sup> to the state where Business Corp principally managed the contract, or if that state is not reasonably determinable to the state where Business Corp placed the order for the services, or if that state is not reasonably determinable to the state of Business Corp’s billing address. If Net Corp derives more than 5% of its receipts from database access from Business Corp, Net Corp is required to identify the state in which its contract of sale is principally managed by Business Corp and must assign the receipts to that state.<sup>629</sup>

**Example 10:** Net Corp, a corporation based outside Tennessee, licenses an information database through the means of the Internet to more than 250 individual and business customers in Tennessee and in other states. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned in accordance with the above section “license of intangible property where substance of the transaction resembles a sale of goods or services.”<sup>630</sup> Assume that Net Corp cannot determine or reasonably approximate the location where its information database is accessed. Also, assume that Net Corp does not derive more than 5% of its sales of database access from any single customer. Net Corp may apply the safe harbor stated above concerning services delivered by electronic transmission to a business customer,<sup>631</sup> and may assign its sales to a state or states using each customer’s billing address.

**Example 11:** Web Corp, a corporation based outside of Tennessee, licenses an Internet-based information database to business customers who then sublicense the database to individual end users that are residents of Tennessee and other states. These end users access Web Corp’s information database primarily in their states of residence, and sometimes, while traveling, in other states. Web Corp’s license of the database to its customers includes the right to sublicense the database to end users, while the sublicenses provide that the rights to access and use the database are limited to the end users’ own use and prohibit the individual end users from further sublicensing the database. Web Corp receives a fee from each customer based upon the number of sublicenses issued to end users. The license is a license of intangible property that resembles a sale of goods or services and shall be assigned by applying the rules set forth in the prior section “services delivered electronically through or on behalf of an individual or business customer.”<sup>632</sup> See the prior section “license of intangible property where substance of the transaction resembles a sale

of goods or services.”<sup>633</sup> If Web Corp can determine or reasonably approximate the state or states where its database is accessed by end users, then it must do so. Assuming that Web Corp lacks sufficient information from which it can determine or reasonably approximate the location where its database is accessed by end users, Web Corp must approximate the extent to which its database is accessed in Tennessee using a percentage that represents the ratio of the Tennessee population in the specific geographic area in which Web Corp’s customer sublicenses the database access relative to the total population in such area.<sup>634</sup>

## 6. Sale of intangible property

### **a) Assignment of Sales**

The assignment of a sale to a state or states in the instance of a sale or exchange of intangible property depends upon the nature of the intangible property sold. For purposes of this section, a sale or exchange of intangible property includes a license of such property where the transaction is treated, for tax purposes, as a sale of all substantial rights in the property and the receipts from transaction are not contingent on the productivity, use or disposition of the property. For the rules that apply where the consideration for the transfer of rights is contingent on the productivity, use or disposition of the property.<sup>635</sup>

- Contract Right or Government License that Authorizes Business Activity in Specific Geographic Area
  - In the case of a sale or exchange of intangible property where the property sold or exchanged is a contract right, government license or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, the sale is assigned to a state if and to the extent that the intangible property is used or otherwise associated with the state. Where the intangible property is used in, or otherwise associated with, only Tennessee, the taxpayer shall assign the sale to Tennessee. Where the intangible property is used in or is otherwise associated with Tennessee and one or more other states, the taxpayer shall assign the sale to Tennessee to the extent that the intangible property is used in, or associated with, Tennessee, through the means of a reasonable approximation.
- Agreement Not to Compete

- An agreement or covenant not to compete in a specified geographic area requires the contract party to refrain from conducting certain business activity in that specified area. In the case of an agreement or covenant not to compete, the receipts are to be assigned to a state based upon the percentage that reflects the state's population in the U.S. geographic area specified in the contract relative to the total population in such area.
- Sale that Resembles a License (Receipts are Contingent on Productivity, Use or Disposition of the Intangible Property)
  - In the case of a sale or exchange of intangible property where the receipts from the sale or exchange are contingent on the productivity, use or disposition of the property, the receipts from the sale shall be assigned by applying the rules set forth in Rule 1320-06-01-.42(5) (pertaining to the license or lease of intangible property).
- Sale that Resembles a Sale of Goods and Services
  - In the case of a sale or exchange of intangible property where the substance of the transaction resembles a sale of goods or services and where the receipts from the sale or exchange do not derive from payments contingent on the productivity, use or disposition of the property, the receipts from the sale shall be assigned by applying the rules set forth in Rule 1320-06-01-.42(5)(f) (relating to licenses of intangible property that resemble sales of goods and services). Examples of such transactions include those that are analogous to the license transactions cited as examples in Rule 1320-06-01-.42(5)(f).
- Except as otherwise provided in this section, the sale of intangible property that is not referenced in the first, second and fourth bulleted sections above should be excluded from the numerator and the denominator of the taxpayer's sales factor.

b) **Examples**

Assume, in each of these examples, that the taxpayer that provides the service is taxable in Tennessee and is to apportion its income pursuant to Tenn. Code Ann. § 67-4-2012.

**Example 1:** Airline Corp, a corporation based outside Tennessee, sells its rights to use several gates at an airport located in Tennessee to Buyer Corp, a corporation that is based outside Tennessee. The contract of sale is negotiated and signed outside of Tennessee. The sale is in Tennessee because the intangible property sold is a contract right that authorizes the holder to conduct a business activity solely in Tennessee. See the first item in section (6)(a) above.<sup>636</sup>

**Example 2:** Wireless Corp, a corporation based outside Tennessee, sells a license issued by the Federal Communications Commission (FCC) to operate wireless telecommunications services in a designated area in Tennessee to Buyer Corp, a corporation that is based outside Tennessee. The contract of sale is negotiated and signed outside of Tennessee. The sale is in Tennessee because the intangible property sold is a government license that authorizes the holder to conduct business activity solely in Tennessee. See the first item in section (6)(a) above.

**Example 3:** Same facts as in Example 2 except that Wireless Corp sells to Buyer Corp an FCC license to operate wireless telecommunications services in a designated area in Tennessee and an adjacent state. Wireless Corp must attempt to reasonably approximate the extent to which the intangible property is used in or associated with Tennessee. For purposes of making this reasonable approximation, Wireless Corp may rely upon credible data that identifies the percentage of persons that use wireless telecommunications in the two states covered by the license.<sup>637</sup>

**Example 4:** Sports League Corp, a corporation that is based outside Tennessee, sells the rights to broadcast the sporting events played by the teams in its league in all 50 U.S. states to Network Corp. Although the games played by Sports League Corp will be broadcast in all 50 states, the games are of greater interest in the southeast region of the country, including Tennessee. Because the intangible property sold is a contract right that authorizes the holder to conduct a business activity in a specified geographic area, Sports League Corp must attempt to reasonably approximate the extent to which the intangible property is used in or associated with Tennessee. For purposes of making this reasonable approximation, Sports League Corp may rely

upon audience measurement information that identifies the percentage of the audience for its sporting events in Tennessee and the other states.<sup>638</sup>

**Example 5:** Business Corp, a corporation based outside Tennessee engaged in business activities in Tennessee and other states, enters into a covenant not to compete with Competition Corp, a corporation that is based outside Tennessee, in exchange for a fee. The agreement requires Business Corp to refrain from engaging in certain business activity in Tennessee and other states. The component of the fee that constitutes a Tennessee sale is determined by multiplying the amount of the fee by a fraction represented by the percentage of the Tennessee population over the total population in the specified geographic region.<sup>639</sup>

**Example 6:** Inventor Corp, a corporation that is based outside Tennessee, sells patented technology that it has developed to Buyer Corp, a business customer that is based in Tennessee. Assume that the sale is not one in which the receipts derive from payments that are contingent on the productivity, use or disposition of the property. See the discussion on “sale that resembles a sale of goods and services” discussed in the prior section.<sup>640</sup> Inventor Corp understands that Buyer Corp is likely to use the patented technology in Tennessee, but the patented technology can be used anywhere (i.e., the rights sold are not rights that authorize the holder to conduct a business activity in a specific geographic area). The sale of the patented technology shall be excluded from the numerator and denominator of Inventor Corp’s sales factor. See the prior section on when the sale of intangible property is excluded from both the numerator and denominator.<sup>641</sup>

## 7. Special rules

### **a) Software Transactions**

A license or sale of pre-written software for purposes other than commercial reproduction (or other exploitation of the intellectual property rights), when transferred on a tangible medium, is treated as the sale of tangible personal property, rather than as either the license or sale of intangible property or the performance of a service. In such cases, the receipts are assigned to Tennessee as a sale of tangible personal property. In all other cases, the receipts from a license or sale of software are to be assigned to Tennessee as determined otherwise under this market-based sourcing rule.<sup>642</sup>

***For example***, depending on the facts, as the *development and sale of custom software* see the above section on “sale of a service – services delivered to the customer or on behalf of the customer or delivered electronically through the customer”,<sup>643</sup> as a *license of a marketing intangible*, see the above section on “rental, lease, or license of intangible property – license of a marketing intangible,”<sup>644</sup> as a *license of a production intangible*, see the above section on “rental, lease, or license of intangible property – license of a production intangible,”<sup>645</sup> as a license of intangible property where the substance of the transaction *resembles a sale of goods or services*, see the above section on “rental, lease, or license of intangible property – license of intangible property where substance of transaction resembles a sale of goods or services,”<sup>646</sup> or as a *sale of intangible property*, see the above section on “sale of intangible property.”<sup>647</sup>

**b) Sales or Licenses of Digital Goods or Services**

In the case of a sale or license of digital goods or services, including, among other things, the sale of various video, audio and software products or similar transactions, the receipts from the sale or license should be assigned by applying the guidance discussed in the prior section on “sales of services delivered to the customer or on behalf of the customer, or delivered electronically through the customer – delivery to customer by electronic transmission and – services delivered electronically through or on behalf of an individual or business customer,” as if the transaction were a service delivered to an individual or business customer or delivered through or on behalf of an individual or business customer. For purposes of the analysis, it is not relevant what the terms of the contractual relationship are or whether the sale or license might be characterized, depending upon the particular facts, as, for example, the sale or license of intangible property or the performance of a service.<sup>648</sup>

**c) Enforcement of Legal Rights**

Receipts attributable to the protection or enforcement of legal rights of a taxpayer through litigation, arbitration, or settlement of legal disputes or claims, including the filing and pursuit of claims under insurance contracts, shall be excluded from the numerator and denominator of the taxpayer’s sales factor. For purposes of this rule, in the case of a settlement agreement, it shall not be relevant how the parties to the agreement characterize the payment made under the agreement.

## Other Than Tangible Property Sales – Tax Years Beginning before July 1, 2016

Before the Revenue Modernization Act of 2015 other-than-TPP sales were in this state if the “*earnings producing activity*” was performed: 1) in this state, or 2) both in and outside this state, and a greater proportion of the earnings producing activity was performed in this state than in any other state, based on “*costs of performance*” (COP).<sup>649</sup> The statutory test is an “all or nothing” proposition. If the earnings producing activity is performed entirely in Tennessee or the greater proportion of the earnings producing activity is performed in Tennessee, then the entire sale proceeds are sourced to Tennessee. Otherwise, the entire gross proceeds are sourced to another state. However, as explained below, a taxpayer may have numerous earnings producing activities, and each would be evaluated separately.

- “*Earnings producing activity*” means the transactions and activity *directly* engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit but does not include transactions and activities performed on behalf of a taxpayer (e.g., activities conducted by an independent contractor). It applies to each separate item of income.<sup>650</sup>
- Earnings producing activity includes:
  - The rendering of personal services by employees or the use of tangible and intangible property by the taxpayer in performing a service.
  - The sale, rental, leasing, or licensing or other use of real property.
  - The rental, leasing, licensing or other use of tangible personal property.
  - The sale, licensing or other use of intangible personal property. However, simply holding intangible personal property is not, of itself, an earnings producing activity.
- “*Costs of performance*” means direct costs as determined by GAAP and in accordance with accepted conditions or practices in the trade or business of the taxpayer. Direct costs do not include transactions and activities performed on behalf of a taxpayer (e.g., activities conducted by an independent contractor). “Outsourcing” costs are also excluded from the analysis since they are, by definition, not direct costs.

### “In TN” Gross Receipts for Other-Than-TPP (Tax Years Beg. before July 1, 2016):

- Gross receipts from the rental, lease, licensing of real and tangible personal property are “in Tennessee” if the property is located in the state.<sup>651</sup>
- The rental or other use of tangible personal property in this state is a *separate earnings producing activity* from the use of the same property while located in another state.
  - For example, Taxpayer is the owner of 10 railroad cars. During the year, the total of the days each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income.
  - **Tennessee Receipts =  $((10 \times 50 = 500) / 3,650) \times \text{Total Receipts}$**
- When services are performed in more than one state, the services performed in each state will often constitute a *separate earnings producing activity*. The gross receipts for the performance of services attributable to this state are determined by the ratio of time spent in performing the services in this state to the total time spent in performing such services everywhere.
- Time spent in performing services includes the amount of the time expended in the performance of a contract or other obligation that gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation (e.g., time expended in negotiating the contract) is excluded from the computation.
  - Taxpayer gave theatrical performances at various locations in State X and in Tennessee during the tax period. All gross receipts from performances given in this state are attributed to this state.
  - Taxpayer, a public opinion survey corporation, conducted a poll by its employees in State X and in Tennessee for the sum of \$9,000. The project required 600 man-hours to obtain the basic data and prepare the survey report. 200 of the 600 man-hours were expended in Tennessee. The receipts attributable to Tennessee are:



$$\text{\$3,000} = \frac{\text{(200 man-hours X \$9,000)}}{\text{600 man-hours}}$$

- A taxpayer receiving royalty/license income based on Tennessee sales or activities should source the royalty/license fee income to Tennessee. Usually, royalty/license agreements provide that a certain percentage of product sales will be paid to the holder of the intellectual property as a royalty or license fee. These fees for products sold to Tennessee customers would be sourced to Tennessee.<sup>652</sup>
- The numerator value of interest and dividend income that are business earnings are generally sourced to the taxpayer's commercial domicile,<sup>653</sup> in other words, where the investments are managed and controlled.

**⚠ For tax periods beginning on and after July 1, 2016, investment interest and dividend income that are business earnings are excluded from both the numerator and denominator of the sales/receipts factor by non-financial institution taxpayers, pursuant to Rule 42(1)(f).**

### Telecommunication Industry – Special Sales Sourcing Rules

The telecommunication industry computes Tennessee other-than-TPP receipts for the standard apportionment factor by using an average of the cost-of-performance and market-based sourcing methods.<sup>654, 655</sup> The “In TN” sales factor is:

- Receipts from sales of tangible personal property, plus
- The *average* of receipts from other-than-TPP sales calculated under the cost-of-performance method<sup>656</sup> and the market-based sourcing method.<sup>657</sup>

The above methodology applies only to those who principally sell telecommunication services, internet access, video programming, satellite-television, etc. and are in an affiliated group that either incurs qualified expenditures greater than \$150 million during the tax period or makes sales subject to the sales & use tax in excess of \$150 million (qualified members<sup>658</sup> of a qualified group).<sup>659</sup> Qualified expenditures are purchases of tangible personal property placed in Tennessee or payroll for employees in Tennessee.

**⚠ Audit Tip**  
**Telecom taxpayers should retain detailed records to support their unique calculation of the sales factor.**

Telecom taxpayers report Tennessee and everywhere receipts for tangible and other-than-tangible sales on Schedule N and retain detailed records to support their calculations.

The cost of performance method was used by all taxpayers to source other-than-TPP sales prior to July 1, 2016, but after this date this method is only used by taxpayers providing telecommunication and similar services. Rule 34, revised September 2016, discusses the cost of performance methodology, but it now only applies to qualified members of a qualified group; namely those providing telecommunication and similar services.

### Dealer in Securities

A taxpayer that is a dealer in securities under 26 USC §475 is subject to a specific apportionment provision of the Tennessee code.<sup>660</sup> The net gain or income from the sale of a security is sourced to Tennessee if the dealer's customer is located in Tennessee. If the residence or commercial domicile of the customer is unknown, the receipt is sourced based on the billing address as shown in the dealer's records.

In other words, receipts equal to the net gain or income from the sale of a security made by a person who is a dealer in such security (26 U.S.C. § 475) should be attributed to Tennessee if such person's customer is located in Tennessee and such receipt is not otherwise attributed under the Tennessee code as a receipt from the sale of an asset (tangible or intangible).<sup>661</sup> A customer is in this state if the customer is an individual, trust, or estate that is a resident of this state and, for all other customers, if the customer's commercial domicile is in this state. Unless the dealer has actual knowledge of the residence or commercial domicile of a customer during a taxable year, the customer shall be deemed to be a customer in this state if the billing address of the customer, as shown in the records of the dealer, is in this state.

### Audit Procedures – Sales Factor – Standard Apportionment (Schedule N)

- Identify the business entities that should be included in the sales factor. Consider:
  - Owned pass-through entities not filing excise tax returns on their own
  - Disregarded entities

- Determine that the correct apportionment schedule was used. Consider if the taxpayer is required to file on a non-standard apportionment schedule (Schedules O, P, R, S) or if the taxpayer is a qualified member in the telecommunication industry, and therefore, has special apportionment calculation requirements.
- Identify all sources of income (e.g., product sales, service sales, rents, interest, property disposition, dividends, other).
- Determine that receipts reported in the sales factor were valued at their gross amounts. If applicable, include a narrative in the audit file to explain the use of net receipts.
- Identify sources of income from other-than-TPP sales.
  - For tax years beginning before July 1, 2016, determine whether the greater of “costs of performance” occurred in Tennessee.
  - For tax years beginning on or after July 1, 2016, verify that the receipts were sourced based on Rule 42 for market-based sourcing.<sup>662</sup>
  - Include a narrative in the audit workpapers to explain the audit work done, documents relied on, and the conclusions reached regarding the sourcing.
- Document how you determined the “In Tennessee” receipts for tangible property sales. Describe what documents you relied on and any errors or weaknesses you found in the taxpayer’s supporting schedules.
- Determine whether the apportionment methodology used fairly represents the taxpayer’s business activity within the state; if it does not, consider requesting a variance, pursuant to Tenn. Code Ann. §§ 67-4-2014 and 67-4-2112.

### *Nonbusiness Receipts*

Nonbusiness receipts are excluded from both the numerator and the denominator of the franchise and excise tax sales factors.<sup>663</sup>

### *GILTI (Global Intangible Low-Taxed Income)*

The federal Tax Cuts and Jobs Act of 2017 introduced a new source of taxable income, referred to as *global intangible low-taxed income* – or *GILTI*, which is required to be included in the gross income of U.S. shareholders of controlled foreign corporations, pursuant to IRC §951A.

Tennessee taxes 5% of a taxpayer's GILTI inclusion for Tennessee excise tax purposes. However, *no amount* of a taxpayer's GILTI inclusion is included in the taxpayer's sales factor numerator or denominator for apportionment purposes. GILTI is excluded from the sales factor, pursuant to F&E Rule 42(1)(f), because such intangible income is not enumerated in the state's market-based sourcing rule.<sup>664</sup> For more information about the excise tax treatment of GILTI, see Chapter 11 of this manual.

## Variations from the Standard Apportionment Formula

The franchise and excise tax statutes<sup>665</sup> provide for the use of alternative tax computation, allocation or apportionment methods, which are referred to as *variances*. These provisions of the tax code are not routine and are seldom used. However, they *are* applied when application of the law does not result in an equitable tax calculation, based on the taxpayer's unique circumstances. Establishing that a variance is necessary is often a subjective determination. Variations can either be requested by the taxpayer or imposed by the Department. The notion that a variance will increase or decrease a taxpayer's tax liability is not, in and of itself, a reasonable basis for requesting a variance. Variations are usually requested based on an odd or unique fact pattern that causes a hardship or unusual result in the computation of the taxpayer's franchise and excise tax liability.

A variance may apply to all or any part of a taxpayer's business activity and may result in:

- Separate accounting;
- The exclusion of any one or more of the apportionment factors;
- The inclusion of one or more additional apportionment factors that will fairly represent the taxpayer's business activity in this state;
- The use of any other method to source receipts for purposes of the sales factor of the apportionment formula numerator; or
- The employment of any other method to effectuate an equitable computation, allocation and apportionment of the taxpayer's net worth and net earnings (or losses) that fairly represents the extent of the taxpayer's business activity in Tennessee.

A departure from the statutory tax computation, allocation and apportionment provisions is only permitted in limited and specific cases where unusual fact patterns (which ordinarily will be unique and nonrecurring) produce incongruous results under the provisions contained in the franchise and excise tax laws. The Commissioner may require combined reports covering members of an affiliated group of corporations. For example, in the event of intercompany activity in the manufacture, production or sale of products, the Commissioner may require a combined report, if necessary, to obtain an equitable and appropriate result.

Variance requests from taxpayers must be addressed to the Commissioner with the filing of a petition, in writing, setting forth the reasons why application of the statutory tax computation, allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state. It must be shown by clear and cogent evidence that peculiar or unusual circumstances exist that would cause application of the said statutory provisions to work a hardship or injustice against the taxpayer. Such application must also include a proposed alternative method of tax computation, allocation or apportionment to be used by the taxpayer and be submitted by the taxpayer on or before the statutory due date of the return. In the event that a variation from the statutory provisions is adopted, then such method will continue in effect so long as the circumstances justifying the variation remain substantially unchanged. It is the duty of the taxpayer to furnish each subsequent year such information with the filing of its return as will establish the fact that the circumstances remain substantially unchanged.<sup>666</sup>

## Special Apportionment for Common Carriers

Taxpayers may not use the standard apportionment formula reflected on Schedule N, as discussed above, if their principal business in the state (more than 50%) is that of a common carrier of property or persons. Common carriers serve the public. Schedule O, P, or R should be used if the business is that of a common carrier (railroads, motor carriers, pipelines, and barges), air carrier, or air express carrier, respectively. All of these schedules use two-factor apportionment formulas involving revenue and miles factors.<sup>667</sup>

A carrier that does not offer services to the public is not a common carrier. For example, an LLC owns an airplane and transports related parties across the country. The LLC is not a common carrier because its services are not offered to the public. Apportionment guidance for this situation is not addressed in the code. However, the Department has allowed non-common carriers to use the standard, three-factor apportionment formula on Schedule N; however, when computing the revenue/sales factor, the guidance for air carriers reporting on Schedule P should be followed.<sup>668</sup>

## 1. Schedule O – Apportionment – Common Carriers

The standard, three-factor apportionment formula (Schedule N) is not used when the taxpayer's principal business in the state is that of a common carrier of persons or property for hire. Railroads, motor carriers, pipelines, and barges that are common carriers apportion on Schedule O<sup>669</sup> by computing the average of two ratios:

- In-state to everywhere miles; and
- Intrastate receipts to everywhere receipts.

Miles operated in the state are the actual miles traveled within the state, and the origin or destination of the load is not an issue.<sup>670</sup> Common carriers generally will have detailed computer printouts of the miles traveled by state for a variety of reasons, including state and federal reporting.<sup>671</sup> The miles reported on Schedule O should agree with these printouts and filings and should correlate to the applicable gross receipts, since carriers often charge their customers by the mile.

### **Audit Tip**

**Auditors may request a printout of odometer miles for the tax period. Also, they may request copies of federal and state reports filed that substantiate the in-state and everywhere miles. Similar documents may be requested for non-motor carrier common carriers filing on Schedule O.**

*Mileage* by type of common carrier:

- Railroad miles are mileage “owned and operated” plus mileage “leased and operated.”
- Pipeline miles are miles owned, operated, or owned and operated.
- Barge miles are miles operated.
  - Miles operated in Tennessee is 50% of the miles operated on the Mississippi River adjacent to the Tennessee shoreline, plus all miles operated on inland waterways within the state;
  - "Mile operated" means one mile of movement of each barge.

The second ratio is the taxpayer's gross receipts from business operations beginning and ending entirely within this state (intrastate), as compared with its entire gross receipts from such operations within and without Tennessee. For example, the gross receipts from a load picked up in Memphis and delivered to Nashville would be included in the numerator as an "In Tennessee" intrastate receipt. Receipts from travel entering or passing through any other state are not intrastate receipts for this ratio. Motor carriers may have limited Tennessee intrastate receipts because most loads may either originate or end outside of the state.

For barges, the gross receipts ratio is the revenue from the transportation of cargo loaded in Tennessee compared with the entire revenue from the transportation of cargo loaded in and outside the state.

**⚠ Audit Tip: Auditors may request a schedule of intrastate activity to verify the total intrastate receipts reported on Schedule O.**

If a common carrier is part of an affiliated group that has elected to use *consolidated net worth* (Schedule F2)<sup>672</sup> to compute their franchise tax net worth base, the common carrier affiliated group member should compute the numerator of its property factor on Schedule 170NC as follows:

- The numerator should include the average value of the taxpayer's real and tangible personal property, excluding exempt inventory,<sup>673</sup> that is owned or rented and used in this state during the tax period;
- In determining the average value of mobile property to be included in the numerator, the value of such property will be multiplied by a fraction, the numerator of which is the total in-state miles of similarly-classified mobile property and the denominator of which is the total everywhere miles of similarly-classified mobile property; and
  - In-state miles and everywhere miles should be calculated in the same manner as the miles reported on Schedule O.<sup>674</sup>
  - Mobile property should be similarly-classified as the groupings used for the excise tax apportionment ratio.<sup>675</sup> The classification groupings enumerated in Tenn. Code Ann. § 67-4-2013(a)(1)-(7) should be used.

## 2. Schedule P – Apportionment – Air Carriers

Air carriers also apportion using a two-factor apportionment formula.<sup>676</sup> The first factor is the originating revenue within Tennessee divided by the entire originating revenue both within and without Tennessee. The “In Tennessee” amount will be receipts from all flights originating in the state, regardless of where the flights terminate. The second factor is the ratio of the total air miles flown within Tennessee to the total air miles flown within and without Tennessee. Air miles flown within the state should only include miles in Tennessee from flights originating from and/or ending in the state.

## 3. Schedule R – Apportionment – Air Express Carriers

Air express carriers operate in the air and on the ground in making deliveries. The apportionment ratio is calculated by taking the average of the following ratios:

- The originating revenue within the state divided by the entire originating revenue within and without the state.
- The total air miles flown and ground miles traveled within Tennessee divided by the total air miles flown and ground miles traveled within and without Tennessee.
  - Air miles flown within the state only include miles in Tennessee from flights originating from and/or ending in Tennessee.
  - Ground miles traveled within Tennessee or traveled within and without Tennessee only include miles traveled with respect to the actual common carriage of persons or property for hire.<sup>677</sup>

## Apportionment Examples

A taxpayer’s apportionment formula will differ depending on the type of taxpayer and whether certain elections are made. Below are four apportionment examples and a chart detailing the scenarios covered. Note that these examples do not discuss the apportionment formula used by financial institutions or financial institution affiliated group members, or taxpayers that are common carriers, air carriers or air express carriers.

The **first example** shows the standard apportionment formula calculation that is applied to both the franchise and excise tax bases when no elections have been made by the taxpayer. The **second example** shows the apportionment calculation for the franchise tax base when a



consolidated net worth election is in effect and an affiliated group member (not the taxpayer) has elected to use a single sales factor (“SSF”). The **third example** shows the franchise and excise tax apportionment calculations for a manufacturer that is a member of a consolidated net worth affiliated group and the manufacturer has made the SSF election. The **fourth example** shows the apportionment calculations for a manufacturer that has made the SSF election but is not a member of an affiliated group electing to use consolidated net worth.

Example	Taxpayer Type	Standard Apportionment	Taxpayer is a member of a consolidated net worth affiliated group and an affiliate elected SSF	Taxpayer is a member of a consolidated net worth affiliated group and taxpayer elected SSF	Taxpayer elected SSF and is not a member of a consolidated net worth affiliated group	FAE170 Apportionment Schedule
1	Any Type	X				Sch. N (franchise & excise tax)
2	Any Type		X			Sch. 170NC (franchise) Sch. N (excise)
3	Mfr. electing SSF			X		Sch. 170SC (franchise) Sch. S (excise)
4	Mfr. electing SSF				X	Sch. S (franchise & excise tax)

## 1. Example - Standard Apportionment - Franchise and Excise Tax for ABC, LLC

Taxpayers with the right to apportion, that have not made any special elections, will compute their apportionment ratio by averaging their "in state" to "everywhere" apportionment factors, as shown below. This computation is made on Form FAE170, Schedule N.

### I. ABC, LLC net worth before apportionment is \$150,000

Assets	\$200,000
Liabilities	<u>50,000</u>
Equity (net worth)	<b>150,000</b>

### II. Apportionment Factors for ABC, LLC

#### Factors in Tennessee:

Property (tax basis cost) – beginning of year	\$400,000
Property (tax basis cost) – end of year	400,000
Payroll	10,000
Sales	15,000

#### Factors Everywhere:

Property (tax-basis cost) – beginning of year	\$800,000
Property (tax-basis cost) – end of year	800,000
Payroll	20,000
Sales	100,000

### III. Franchise apportionment ratio (Schedule F1, Line 5)- ABC, LLC

	<u>In TN</u>	<u>Everywhere</u>	Ratio <u>TN / Everywhere</u>
Property (average)	\$400,000	\$800,000	0.500000
Payroll	10,000	20,000	0.500000

Sales	15,000	100,000	.0150000
Sales	15,000	100,000	.0150000
Sales	15,000	100,000	<u>.0150000</u>
			1.450000
Divide by the number of factors with everywhere values			<u>5</u>
Apportionment ratio			0.290000
ABC, LLC franchise tax base (\$150,000 x .290000) =			\$43,500

#### IV. Excise apportionment ratio (standard apportionment) - ABC, LLC

*ABC, LLC had taxable net income of \$20,000 before apportionment.*

	<u>In TN</u>	<u>Everywhere</u>	<u>Ratio</u> <u>TN / Everywhere</u>
Property (average)	\$400,000	\$800,000	0.500000
Payroll	10,000	20,000	0.500000
Sales	15,000	100,000	.0150000
Sales	15,000	100,000	.0150000
Sales	15,000	100,000	<u>.0150000</u>
			1.450000
Divide by the number of factors with everywhere values			<u>5</u>
Apportionment ratio			0.290000
ABC, LLC taxable net income before apportionment			<u>\$20,000</u>
ABC, LLC excise tax base (\$20,000 x .290000) =			\$5,800

## 2. Example – Franchise Tax Consolidated Net Worth Apportionment - ABC, Inc.

*Taxpayers that are members of an affiliated group that has made the consolidated net worth election will compute their apportionment ratio by averaging their "in state" to "the group's everywhere" apportionment factors, as shown below. This computation is made on Form FAE170, Schedule 170NC.*

In this example, the consolidated net worth affiliated group is comprised of ABC, Inc. (non-manufacturer) and MFG, Inc. (manufacturer). Both corporations will file their own franchise tax returns and compute their franchise tax based on their respective Form FAE170 Schedules F2. The following calculations are for ABC's franchise and excise tax return and will not change if MFG, Inc. makes the SSF election.

### I. Consolidated net worth before apportionment is \$430,000

	<u>ABC, Inc.</u>	<u>MFG, Inc.</u>	<u>Consolidated</u>
Assets	\$200,000	\$300,000	\$500,000
Liabilities	50,000	20,000	70,000
Equity (net worth)	150,000	280,000	<b>430,000</b>

### II. Apportionment factors of consolidated net worth Affiliated Group Members

	<u>ABC, Inc.</u>	<u>MFG, Inc.</u>	<u>Total</u>
<u>Factors in Tennessee:</u>			
Property (tax basis cost)			
– beginning of year	\$400,000	\$900,000	\$1,300,000
Property (tax basis cost)			
– end of year	400,000	900,000	1,300,000
Payroll	10,000	40,000	50,000
Sales	15,000	60,000	75,000

#### Factors Everywhere:

Property (tax basis cost)

- beginning of year	\$800,000	\$900,000	\$1,700,000
Property (tax basis cost)			
- end of year	800,000	900,000	1,700,000
Payroll	20,000	80,000	100,000
Sales	100,000	120,000	220,000

### III. Franchise apportionment ratio reported on Schedule F2 by ABC, Inc.

	<u>ABC, Inc.</u>	Total all members <u>everywhere</u>	<u>Ratio</u>
Property (average)	\$400,000	\$1,700,000	0.235294
Payroll	10,000	100,000	0.100000
Sales	15,000	220,000	0.068182
Sales	15,000	220,000	0.068182
Sales	15,000	220,000	<u>0.068182</u>
			0.539840
Divide by			<u>5</u>
			0.107968

ABC, LLC franchise tax base (\$430,000 x .107968) = \$46,426

### IV. Excise apportionment ratio (standard apportionment) - ABC, Inc.

*ABC, LLC had taxable net income of \$20,000 before apportionment.*

	<u>In TN</u>	<u>Everywhere</u>	Ratio <u>TN/Everywhere</u>
Property (average)	\$400,000	\$800,000	0.235294
Payroll	10,000	20,000	0.100000
Sales	15,000	100,000	0.068182
Sales	15,000	100,000	0.068182
Sales	15,000	100,000	<u>0.068182</u>
			1.450000
Divide by			<u>5</u>
Apportionment ratio			0.290000
ABC, Inc. net income before apportionment			<u>\$20,000</u>
ABC, Inc. excise tax base (\$20,000 x .290000) =			\$5,800

### 3. Example – Consolidated Net Worth and Single Sales Factor Elections

Manufacturers<sup>678</sup> may make a five-year election to apportion based solely on a single sales/gross receipts factor. In the following example, MFG, Inc., a consolidated net worth affiliated group member, has made the SSF election.

#### I. Consolidated net worth before apportionment is \$430,000

	<u>ABC, Inc.</u>	<u>MFG, Inc.</u>	<u>Consolidated</u>
Assets	\$200,000	\$300,000	\$500,000
Liabilities	50,000	20,000	70,000
Equity (net worth)	150,000	280,000	<b>430,000</b>

#### II. Apportionment factors of consolidated net worth affiliated group members

	<u>ABC, Inc.</u>	<u>MFG, Inc.</u>	<u>Total</u>
<u>Factors in Tennessee:</u>			
Property (book basis cost)			
– beginning of year	\$400,000	\$900,000	\$1,300,000
Property (book basis cost)			
– end of year	400,000	900,000	1,300,000
Payroll	10,000	40,000	50,000
Sales	15,000	60,000	75,000
<u>Factors in Everywhere:</u>			
Property (book basis cost)			
– beginning of year	\$800,000	\$900,000	\$1,700,000
Property (book basis cost)			
– end of year	800,000	900,000	1,700,000
Payroll	20,000	80,000	100,000
Sales	100,000	120,000	220,000

#### III. Franchise apportionment ratio calculated on Schedule 170SC and reported on Schedule F2 by MFG, Inc.

In TN	Total all members
-------	-------------------

	<u>MFG, Inc.</u>	<u>everywhere</u>	<u>Ratio</u>
Property (average)	n/a	\$1,700,000	n/a
Payroll	n/a	100,000	n/a
Sales	60,000	220,000	<u>0.272727</u>
			0.272727
MFG, Inc. franchise tax base (\$430,000 x .272727) =			\$117,273

**IV. Excise apportionment ratio calculated on Schedule S and reported on Schedule J of MFG, Inc.'s excise tax return**

*MFG, Inc. had taxable net income of \$20,000 before apportionment*

	<u>In TN</u> <u>MFG, Inc.</u>	<u>Everywhere</u> <u>MFG, Inc.</u>	<u>Ratio</u>
Property (average)	n/a	\$1,700,000	n/a
Payroll	n/a	100,000	n/a
Sales	60,000	120,000	<u>0.500000</u>
			0.500000
MFG, Inc. net income before apportionment			<u>\$20,000</u>
MFG, Inc. excise tax base (SSF elected) (\$20,000 x .500000) =			\$10,000

The consolidated net worth election does not impact the excise tax calculation of a taxpayer electing SSF.

#### 4. Example – Manufacturer Single Sales Factor Apportionment

Manufacturers<sup>679</sup> may make a five-year election to apportion based solely on a single sales/gross receipts factor. In the following example, MFG, Inc. is not a consolidated net worth affiliated group member but has made the SSF election.

##### I. MFG, Inc. net worth before apportionment is \$280,000

Assets	\$300,000
Liabilities	<u>20,000</u>
Equity (net worth)	<b>280,000</b>

##### II. Apportionment Factors for MFG, Inc.

###### Factors in Tennessee:

Property	n/a
Payroll	n/a
Sales	60,000

###### Factors Everywhere:

Property (tax basis cost) – beginning of year	n/a
Payroll	n/a
Sales	120,000

##### III. Franchise apportionment ratio calculated on Schedule S and reported on Schedule F1

	In TN <u>MFG, Inc.</u>	<u>Everywhere</u>	TN/Everywhere <u>Ratio</u>
Property	n/a	n/a	n/a
Payroll	n/a	n/a	n/a
Sales	60,000	120,000	<u>0.500000</u>
			0.500000
MFG, Inc. franchise tax base (\$280,000 x .500000) =			\$140,000



**IV. Excise apportionment ratio calculated on Schedule S and reported on Schedule J**

*MFG, Inc. had taxable net income of \$20,000 before apportionment.*

	In TN <u>MFG, Inc.</u>	Everywhere <u>MFG, Inc.</u>	TN/Everywhere <u>Ratio</u>
Property	n/a	n/a	n/a
Payroll	n/a	n/a	n/a
Sales	60,000	120,000	<u>0.500000</u> 0.500000
MFG, Inc. net income before apportionment			<u>\$20,000</u>
MFG, Inc. excise tax base (\$20,000 x .500000) =			\$10,000

## Chapter 15: Credits and Overpayments

### Tax Credits

Tax credits offset tax liability. Franchise and excise tax credits currently in effect are found at Tenn. Code Ann. §§ 67-4-2009 and 67-4-2109. *Depending on the type of credit and the year being audited, the credit may offset both franchise and excise tax or just one of these taxes. Any unused credit may or may not be allowed to offset future tax liabilities. When an audit does not change the credit earned in the audited year, other audit changes may impact the current credit used to offset current tax and the amount of carryover credits available for later years.*

Tennessee law does not specify the order in which credits should be applied. The Department applies credits that do not have a carryover provision first. For instance, the state applies the Additional Annual Job Tax Credit first and then any remaining credits in the same order as they are listed on Schedule D of the tax return. For example:

- The Gross Premiums Tax Credit and the Tennessee Income Tax Credit (Schedule D, Lines 1 and 2) may only be claimed in the current tax year.
- As such, claiming these credits before credits with carryover provisions is advantageous to the taxpayer.
- It is the Department's intention to apply credits in a manner that is most favorable to the taxpayer.

The Department is barred from making assessments and refunds on tax periods outside the statute of limitations. However, the statute of limitations does not prevent auditors from verifying and adjusting credits carried forward from closed periods to be utilized in open periods. The Department can adjust the carryover schedules of closed years and make assessments in open tax years resulting from adjustments made to the schedule. Audits may verify that credits, including carryovers from a closed period, are valid.

Credits generated by a predecessor taxpayer will not be allowed to be used by the surviving taxpayer in the case of mergers, consolidations, and like transactions. However, an exception is provided in the case of a merger into a shell entity. A shell entity is one that has no income, expenses, assets, liabilities, equity, or net worth.<sup>680</sup>

### Example

TP, Inc. is being audited for the tax year ended December 31, 2010. TP's return reported franchise tax of \$2,000, excise tax of \$0, and a credit of \$1,000. The state's credit carryover schedule shows that a \$5,000 credit was earned in 2009, and \$1,000 was used to offset tax in tax years 2009, 2010, 2011, and 2012. No additional credit was earned in the December 31, 2010, audit year. The only audit change was that the excise tax increased to \$9,000. As a result, the 2010 credit limitation is recalculated and the 2009 credit carryover and 2010 credit are "reapplied" to the 2010 tax liability (as audited), without regard to the amount of the 2009 credit carryforward utilized in subsequent tax years, and the credit carryover schedule is adjusted accordingly. The credit in this example is limited to 50% of the combined franchise and excise tax liability [ $50\% \times (\$2,000 + \$9,000) = \$5,500$  credit offset limit].

Therefore, the credit amount used to offset tax liability in the audited year would be \$5,000 (2009 credit carryforward of \$4,000 plus 2010 credit of \$1,000). Note that the audit change to the 2010 tax year will cause the tax liability to change in tax years 2011 and 2012 as well, because the credit carryforwards that were previously applied to the 2011 and 2012 tax years have now been fully utilized in the 2010 tax year and are no longer available to offset tax liability in later tax years.

## 1. Gross Premiums Tax Credit

A taxpayer may take a credit against both franchise and excise taxes in the net amount of gross premiums tax paid to the Department of Commerce and Insurance during the period covered by the franchise and excise tax return.<sup>681</sup> The credit also includes any amount used to offset payment to the Tennessee Insurance Guaranty Association that has not otherwise been recovered.<sup>682</sup> The credit does not include the gross premiums receipts tax paid by fire insurance companies for the purpose of executing the fire marshal law.<sup>683</sup> There is no provision for carryover of excess credit to any other year. The amount of the credit does not include the .4% TOSHA surcharge.

Gross premiums tax is incurred by self-insurers of worker's compensation. Member of self-insured compensation pools are not entitled to claim this credit. Persons subject to this tax are given the option of expensing the amount of the gross premiums tax paid to the state or taking the gross premiums tax credit. If the credit is taken on Schedule D of the franchise and excise return, an add-back of the same amount should be reported on Schedule J of the excise tax return, pursuant to Tenn. Code Ann. §§ 67-4-2109(c), 67-4-2009(1), and 56-4-217.

## 2. Tennessee (Hall) Income Tax Credit (Through 2021)

Tennessee imposes a limited income tax, known as the Hall income tax, on individuals, partnerships, associations, and trusts that are legally domiciled in Tennessee.<sup>684</sup> The tax rate is 2% for tax years beginning January 1, 2019, and the tax applies to interest income received from bonds and notes and dividend income received from stocks. The first \$1,250 of income of an individual or entity (\$2,500 for married persons filing jointly) is exempt from the tax. The tax rate drops to 1% for tax years beginning on or after January 1, 2020, **and the tax has been repealed for tax years beginning on or after January 1, 2021.**

A non-corporate entity that is subject to **both** the Hall income tax *and* the franchise and excise tax may take a credit against its excise tax liability for any Hall income tax paid for the applicable tax year.<sup>685</sup> This credit is limited to the taxpayer's excise tax liability only, and there is no carryover of excess credit to subsequent tax years.

### *Applicability of Credit to Single-member LLCs Owned by Individuals*

If an individual is subject to the Hall income tax based on taxable dividend or interest income received by the individual and such individual is the single member of a single-member LLC that is subject to the franchise and excise tax, the single-member LLC **cannot** take a credit against its excise tax liability for any Hall income tax paid by the individual. The purpose of this credit is to prevent income that is subject to the Hall income tax from being taxed again as income that is also subject to the excise tax. Thus, the credit may only be taken by the *same* taxpayer that is subject to *both* the Hall income tax and the franchise and excise tax. In the aforementioned scenario, the Hall income taxpayer and the franchise and excise taxpayer are not the same entity; therefore, the credit is not allowed to the franchise and excise taxpayer. Although a single-member LLC owned by an individual is disregarded as an entity separate from its owner for federal income tax purposes, Tennessee excise tax law requires that such single-member LLC be classified as a separate taxpaying entity for excise tax purposes.<sup>686</sup> Therefore, a single-member LLC and its individual owner are not considered to be the same taxpayer for the purpose of applying the Hall income tax credit.

## 3. Brownfield Tax Credit

Any taxpayer that has filed a business plan and is engaged in a qualified development project may offset up to 50% of their franchise and excise tax by this credit in a tier 1 or 2 enhancement

county and up to 75% in a tier 3 or 4 county.<sup>687</sup> Unused credits may be carried forward for 15 years.<sup>688</sup>

A qualified development project<sup>689</sup> is a project located on a brownfield property consisting of:

- A capital investment of at least \$25,000,000 in a tier 1 or 2 county, or \$5,000,000 in a tier 3 or 4 county; and
- An approved business plan

Brownfield property is:<sup>690</sup>

- Real property that is the subject of an investigation or remediation as a brownfield project under a voluntary agreement or consent order pursuant to Tenn. Code Ann. § 68-212-224.

The credit amount is 50% of the purchase price of brownfield property purchased in a tier 1 or tier 2 enhancement county for the tax period covered by the return for the purpose of a qualified development project consisting of a capital investment of at least \$25 million. Likewise, the credit amount is 75% of the purchase price for property in a tier 3 or 4 enhancement county with a capital investment of at least \$5 million. For a project in which brownfield property is received from a county, municipality, or industrial development board as defined in § 7-53-101 for a sale price of less than \$1, the amount of any credit is 50% (75% in a tier 3 or 4 county) of the most recent purchase price of the brownfield property that was paid by the county, municipality, or industrial development board.<sup>691</sup>

A capital investment may include real property, tangible personal property, and computer software, as valued under GAAP. The investment period during which the required capital investment must be made cannot exceed five years from the filing of the business plan.<sup>692</sup> The business plan is filed prior to the investment period; the 5-year investment period begins with the date the plan is filed. The plan should describe the capital investment to be made toward the qualified development project within the investment period and include a determination by the commissioners of Finance and Administration, Revenue, and Economic and Community Development where they find the project to be in the best interest of the state.<sup>693</sup> Qualifying plans will receive an approval letter from the Department of Revenue. A copy of the approval letter should be filed by the taxpayer with the Department in any year in which the taxpayer utilizes the credit.

In order to receive the credit, taxpayers must submit a claim for the credit, along with documentation as required by the commissioner showing that the capital investment was made toward the qualified development project during the investment period. The commissioner will review the claim for the credit and notify the taxpayer of the approved tax credit amount. The taxpayer may not take the credit until they have been notified as to the approved amount.<sup>694</sup> No credit will be allowed until the minimum capital investment requirement has been met.

#### **4. Broadband Internet Access Equipment [Repealed 7/1/2019]**

A taxpayer may take a credit against both franchise and excise taxes, equal to 6% of the purchase price of new, qualified broadband internet access equipment that is used in Tier 3 and Tier 4 enhancement counties and placed into service on or after April 24, 2017.<sup>695</sup>

Qualified equipment includes asynchronous transfer mode switches, digital subscriber line access multiplexers, routers, servers, multiplexers, fiber optics, and related equipment. The equipment should provide the county with broadband internet access services.<sup>696</sup>

The credit is limited to 50% of the taxpayer's combined franchise and excise tax liability, and any unused credit may be carried forward up to 15 years. Also, the credit is limited to an aggregate annual cap of \$5 million per calendar year. Taxpayers must submit the Broadband Internet Access Equipment Application for the credit by October 15 of the year following the calendar year in which the qualified broadband internet access equipment was placed into service. Based on this information, the Department will consider the aggregate cap and advise taxpayers of the amount of credit that they may take.

- ⚠ Effective July 1, 2019, Public Chapter 501 repealed this credit in its entirety. The credit was subject to appropriations and limitations.**
- ⚠ As a result of Public Chapter 501, the Department will no longer accept applications for the broadband internet access credit, and credits will no longer be allowed, regardless of the date on which equipment was purchased. Taxpayers who were allowed credits pursuant to the October 15, 2018, application may claim such credits on returns filed for tax periods ending after December 15, 2018. Any unused credit may be carried forward for no more than 15 years.**

## 5. Industrial Machinery

A qualified taxpayer may take a credit against its franchise and excise tax liability for purchases or leases of “industrial machinery” located in the state. The industrial machinery credit is limited to 50% of the combined franchise and excise tax liability.<sup>697</sup> Any credit that cannot be fully applied due to the 50% limitation may be carried forward up to 15 years.<sup>698</sup>

Up to 100% of a taxpayer’s combined franchise and excise tax liability may be offset for a taxpayer that has established its headquarters or a qualified new or expanded warehouse or distribution facility in this state. The Commissioners of Revenue and Economic and Community Development must deem the headquarters or warehouse or distribution facility to be in the “best interests of the state.”<sup>699</sup>

Taxpayers calculate the credit on Schedule T and maintain record of carryforward credits on Schedule V. The credit is generally 1% of the purchase price of the industrial machinery, but taxpayers can qualify for enhanced credit rates of 3%, 5%, 7%, or 10%, if they make certain levels of capital investments in this state.<sup>700</sup>

### Eligible Entities

The business types that may claim the industrial machinery credit include:

- Manufacturers engaged in fabrication or processing as their principal business. This is evaluated on a location-by-location basis.<sup>701</sup>
- Businesses that purchase “computers” (as defined by Tenn. Code Ann. § 39-14-601), and any peripheral devices, in conjunction with qualifying for the job tax credit.<sup>702</sup> These businesses will primarily be in the field of manufacturing, but also see the definition of a *qualified business enterprise* for the job tax credit.<sup>703</sup>
- New, renovated, or expanded warehouse or distribution facilities that are purchased or constructed through an investment in excess of \$10 million and for which a business plan has been approved.<sup>704</sup>
- Any business making a required capital investment greater than \$100 million.<sup>705</sup> These taxpayers are allowed an enhanced industrial machinery credit that is eligible for an increased credit rate. In addition, these taxpayers may claim the enhanced industrial machinery credit for computers and related peripheral devices purchased as part of the required capital investment, regardless of whether such taxpayers meet the

requirements to claim the job tax credit. These taxpayers must file an [Enhanced Industrial Machinery Credit Business Plan](#) with the Department.

### *Eligible Machinery*

Industrial machinery is defined in the Tennessee Sales Tax Code at Tenn. Code Ann. § 67-6-102(46)(A)-(M) and includes the following:

- Machinery, apparatus, and equipment with all associated parts, appurtenances, and accessories necessary to and primarily for fabrication or processing of tangible personal property for resale, and consumption off the premises by a manufacturer;<sup>706</sup>
- Hydraulic fluids, lubricating oils, and grease necessary for operations and maintenance;<sup>707</sup>
- Repair parts and any necessary repair or taxable installation labor;<sup>708</sup>
- Air or water pollution control equipment used by a manufacturer (fabrication or processing) that is required by law;<sup>709</sup>
- Mining machinery, apparatus, equipment, and materials with associated parts and accessories including repair parts and installation labor for coal mining, reclamation or for maintaining ingress and egress to coal mines;<sup>710</sup>
- Machinery used for remanufacturing industrial machinery;<sup>711</sup>
- Machinery used for press operations of a printer;<sup>712</sup>
- Equipment used to transport raw materials from storage to the manufacturing process and finished goods to storage;<sup>713</sup>
- Machinery used to package manufactured items and used by a manufacturer or an affiliated corporation that packages automotive aftermarket products;<sup>714</sup>
- Material handling equipment and racking systems used for storage, handling or movement in a “qualified new or expanded warehouse or distribution facility;”<sup>715</sup>
  - For example, a qualified facility invests over \$10 million, over three years, in the construction of a new building plus equipment, an expansion of an existing building plus new equipment, or the purchase of a previously occupied building plus new equipment. A written plan describing the investment must be filed with the Department.



- Computer hardware, software, and peripheral devices used in a qualified data center;<sup>716</sup>
- Equipment used by building supply manufacturers to build trusses, window units or door units;<sup>717</sup>
- Equipment used to make prescription eyewear, if the majority of eyewear is dispensed to patients outside of the state;<sup>718</sup> and
- Machinery, apparatus, and equipment with all associated parts, appurtenances, that is necessary to, and primarily for, the purpose of research and development.<sup>719</sup>

### *Ineligible Machinery*

Industrial machinery does *not* include:

- Equipment used for routine maintenance and the convenience of the workers.<sup>720</sup>
- Equipment used in the preparation of food for immediate retail sale.<sup>721</sup>
- Equipment used in the storage and distribution of digital products.<sup>722</sup>
- Warranties for qualified machinery.

### *Quality Control Equipment*

Quality control equipment qualifies as industrial machinery if it is both necessary for and used primarily for the fabrication or processing of the product for resale. *Processing* is a transformation or conversion of materials or things into a different state or form from that in which they originally existed.<sup>723</sup>

- Equipment used for quality control testing after the manufacturing process is complete does not qualify as industrial machinery.
- Equipment used in a random testing of products for a purpose other than what is necessary to the fabrication or processing of the product does not qualify.
- When product testing services are provided by someone other than a manufacturer, the equipment used would not qualify as industrial machinery.

### *Industrial Machinery and Industrial Supplies*

Industrial supplies are materials and supplies that come into direct contact with the manufactured product and are consumed within 25 consecutive calendar days. Industrial

supplies are exempt from sales and use tax but are not considered industrial machinery. Therefore, such items do not qualify for the franchise and excise tax industrial machinery credit.

### *Leased Industrial Machinery*

The industrial machinery credit is also available for leased industrial machinery located within Tennessee. Leases must be for new industrial machinery, and the taxpayer/lessee must be the original user. Lessees are treated as having purchased the machinery during the tax period in which the machinery is placed in service at an amount equal to its purchase price.<sup>724</sup>

If the lease term is less than 80% of the asset's useful life, the taxpayer is deemed to have made a partial purchase. The credit is computed on an amount determined by multiplying the actual purchase price of the machinery by a fraction, the numerator being the lease term and the denominator being the useful life of the leased machinery.<sup>725</sup>

#### **Partial Purchase Price Formula**

- **Actual Purchase Price x (Lease Term ÷ Useful Life of Machinery)**

### *Recapture Provision*

If industrial machinery for which a credit has been taken is disposed of before the end of its useful life or is moved outside of the state, a portion of the credit actually used to offset tax will be recaptured. "Useful life" is determined in accordance with the depreciation guidelines in effect for excise tax purposes (i.e., federal income tax depreciation provisions).<sup>726</sup> If the original credit was populated in the taxpayer's industrial machinery carryforward table but was never used to offset tax, then the carryforward table should be adjusted for the tax period in which the asset was disposed of or moved outside the state, prior to the end of its useful life.<sup>727</sup>

Credit recapture is reported on the bottom half of Schedule T. When auditing returns of taxpayers that have previously taken the industrial machinery credit, auditors may review depreciation schedules and similar schedules to identify whether industrial machinery was disposed of during the audit period and to consider whether the credit recapture applies.

#### **Credit Recapture Formula**

- **Industrial Machinery Credit Taken x (Asset's Remaining Useful Life at Time of Sale or Removal ÷ Asset's Total Useful Life)**

For example:

- On March 1, 2013, a taxpayer purchases an industrial machine for \$200,000 to be used at a plant in Tennessee. The taxpayer's plant later closed and on September 1, 2016, the asset was transferred out-of-state. The taxpayer advised that this was seven-year property for federal depreciation purposes.

$$\text{IMC} = \$200,000 \times 1\% = \mathbf{\$2,000}$$

$$\text{Recapture} = \$2,000 \times (3.5 \text{ years} / 7 \text{ years}) = \mathbf{\$1,000}$$

A business that goes through a restructuring that results in it filing a “final” franchise and excise tax return is subject to this provision. A taxpayer not surviving the reorganization will be subject to credit recapture, but the acquiring taxpayer may claim the industrial machinery credit on the tax-cost-basis of the assets acquired in the business restructuring. For an example and detailed explanation of these calculations, see [Letter Ruling 97-28](#).

The Department provides taxpayers with an [Industrial Machinery Credit Recapture Worksheet](#) to assist in the listing of assets disposed of or removed from the state for which an industrial machinery credit was previously established on Schedule T. This worksheet arrives at the total credit recapture amount, distinguishing between the portion that previously offset tax and the amount that populated in a carryforward table. Taxpayers should be able to provide this worksheet or a similar schedule to auditors as support for the credit recapture amount.

### *Enhanced Industrial Machinery Credit*

A taxpayer may qualify for an enhanced industrial machinery credit rate of 10%, 7%, 5%, or 3% on the cost of owned or leased industrial machinery and computers if the taxpayer makes a required capital investment of \$1 billion, \$500 million, \$250 million, or \$100 million, respectively.<sup>728</sup> A taxpayer who qualifies for any one of these enhanced credits may take the enhanced credit on the cost of computers and related peripheral devices,<sup>729</sup> regardless of whether it meets any of the requirements of, or qualifies for, the job tax credit.<sup>730</sup> To qualify for the enhanced credit, the taxpayer must file a [business plan](#) with the Department.

The required capital investment only qualifies the taxpayer for the enhanced 3%-10% credit rates, depending on the level of investment made. However, the industrial machinery credit itself is still based on the cost of owned or leased industrial machinery and computers located within the state.<sup>731</sup> In other words, the capital investment amount only determines the enhanced credit rate for which the taxpayer is eligible; the enhanced credit rate is then applied to the purchase price of the owned or leased industrial machinery purchased as part of the capital investment, *not* the entire capital investment.

The enhanced credit may be claimed on the tax return filed for the first year of the three-year investment period (this period may be extended at the discretion of the Commissioner of Economic and Community Development). However, if the taxpayer does not make the required capital investment by the end of the three-year investment period, the taxpayer must repay any enhanced credit received for which it failed to qualify, plus interest.<sup>732</sup>

### *Best Interests of the State Provisions*

The specific requirements to qualify for the industrial machinery and job tax credits may be modified in cases where there are certain “best interests of the state” provisions in the code. If the Commissioners of Economic and Community Development and Revenue agree that a potential taxpayer’s investment, which is beneficial to the state, would not occur without an incentive modification, they may evoke the “best interests of the state” provisions in the code.

*Industrial Machinery Credit Table – Summary of Credit Rates*

<b>Tax Rate</b>	<b>Eligible Businesses</b>	<b>Items Includable in Required Capital Investment</b>	<b>RCI Investment Threshold</b>	<b>Events Resulting in Credit Recapture</b>	<b>Investment Period</b>	<b>Business Plan Required</b>	<b>F&amp;E Liability Offset Limit</b>
1%	Manufacturers; QBEs claiming the JTC*	Industrial Machinery; Computers for JTC	None	Sale or Disposal; Removal from State	Current Tax Year	No	50%
1%	Warehouse, Distribution Facilities	Industrial Machinery; Computers for JTC	\$10 million	Sale or Disposal; Removal from State	3 years	Yes	50%
3%	Manufacturers; Warehouse, Distribution Facilities; and Others	Tangible Property and Real Estate	\$100 million	Sale or Disposal; Removal; RCI Not Met	3 years (2-year extension available <sup>♦</sup> )	Yes	50% (Up to 100% offset available <sup>**</sup> )
5%	Manufacturers; Warehouse, Distribution Facilities; and Others	Tangible Property and Real Estate	\$250 million	Sale or Disposal; Removal; RCI Not Met	3 years (2-year extension available <sup>♦</sup> )	Yes	50% (Up to 100% offset available <sup>**</sup> )
7%	Manufacturers; Warehouse, Distribution Facilities; and Others	Tangible Property and Real Estate	\$500 million	Sale or Disposal; Removal; RCI Not Met	3 years (2-year extension available <sup>♦</sup> )	Yes	50% (Up to 100% offset available <sup>**</sup> )
10%	Manufacturers; Warehouse, Distribution Facilities; and Others	Tangible Property and Real Estate	\$1 billion	Sale or Disposal; Removal; RCI Not Met	3 years (4-year extension available <sup>♦</sup> )	Yes	50% (Up to 100% offset available <sup>**</sup> )

\* Non-manufacturing QBEs may only claim the IM credit on computers and related peripheral devices purchased as part of the required capital investment made to qualify for the JTC.<sup>733</sup>

♦ The investment period may be extended at the discretion of the Commissioner of Economic and Community Development for “good cause shown.”<sup>734</sup>

\*\* This “best interests of the state” provision is only available to taxpayers who meet the requirements at Tenn. Code Ann. § 67-4-2009(3)(H).

### *I.R.C. § 338(h)(10) Election*

[Letter Ruling 14-06](#) addresses a situation where a buyer and seller jointly elected to treat a stock sale as a sale of assets for federal income tax purposes, under I.R.C. § 338(h)(10). This Ruling concluded that the buyer/taxpayer was not entitled to the industrial machinery credit for acquired manufacturing assets even though the buyer was deemed, for federal income tax purposes, to have acquired them as a result of the sale.

### *Verification of Industrial Machinery Credit*

The following documents may be reviewed by an auditor in verifying the industrial machinery credit:

- Taxpayer's sales tax IM exemption certificate for manufacturers.
- Business plan of warehouse/distribution facility with a \$10 million expansion.
- Business plan in regard to enhanced IM credits (3%, 5%, 7%, and 10% rate credits).
- Revenue and ECD Commissioners' written approvals of the additional (up to 100%) F&E liability credit offset available to taxpayers who have established their headquarters or a qualified new or expanded warehouse or distribution facility in this state, pursuant to Tenn. Code Ann. § 67-4-2009(3)(H).
- Depreciation schedules.

## **6. Qualified Production Credit**

Effective for tax years beginning on or after July 1, 2021, Public Chapter 70 authorizes a franchise and excise tax credit for qualified payroll expenses incurred by taxpayers engaging in qualified productions in Tennessee.

The credit amount is 40% of qualified payroll expenses. However, for qualified payroll expenses paid to individuals whose primary residence is in a tier 2, 3, or 4 enhancement county, the credit amount is 50% of qualified payroll expenses paid to such individuals. The credit taken on the return (including credit carryforwards) cannot exceed 50% of the combined franchise and excise tax liability. Any unused credit may be carried forward up to 15 years.

To qualify for the credit, the taxpayer must be engaged in a "qualified production" in this state and incur "qualified payroll expenses."

A "qualified production" means:

- The production of a film, pilot episode, series, esports event, or other episodic content;
- The creation of computer-generated imagery, video games, or interactive digital media; or
- Stand-alone audio or visual post-production scoring and editing; and
- Includes activities by a third party that are necessary to and performed on behalf of a person engaging in a qualified production in this state.

“Esports,” as included in the above definition of a qualified production, means leagues, competitive circuits, tournaments, or similar competitions where individuals or teams play video games, typically for spectators, either in-person or online, for the purpose of ranking, prizes, money, or entertainment.

“Qualified payroll expenses” means compensation paid in this state, as determined pursuant to Tenn. Code Ann. § 67-4-2111(f), for services performed by an employee or an independent contractor during the applicable tax period and that are necessary to and primarily for a qualified production in this state.

To apply for the credit, the taxpayer must first apply to the [Tennessee Film, Entertainment and Music Commission](#) (“Commission”), describing the taxpayer’s basis for the credit, including the nature of the production activities involved and number of employment positions the taxpayer estimates to be deemed qualified positions. If the Commission determines that the taxpayer is engaging in a qualified production in this state, the Commission will notify the taxpayer and the Department of Revenue of such determination. The taxpayer may then apply to the Department of Revenue for the credit. The taxpayer’s credit application will be subject to the approval of the Commissioner of Revenue and the Commissioner of Economic and Community Development. Once approved, the taxpayer will calculate the credit on [Schedule OP](#) and claim it on Form FAE170, Schedule D, Line 8.

### *[Request for Combined Filing](#)*

Subject to the approval of the Commissioner of Revenue and the Commissioner of Economic and Community Development, a taxpayer who files an application with the Department of Revenue to claim the qualified production credit may include in its application a request to file a combined franchise and excise tax return with one or more affiliated group members for the purpose of fully utilizing this credit. Each affiliated group member included in a combined return must close its taxable year on the same date.

If a taxpayer's request to file a combined return is granted, the taxpayer may submit an application to add or change affiliated group members to be included in the combined return prior to filing the first combined return on which the qualified production credit is to be claimed. The composition of affiliated group members included in a combined return for this purpose cannot be changed for a minimum of three years, beginning with the first tax year in which the credit is claimed on a combined return. If an affiliated group member included in a combined return exits the group during the taxable year due to a change in ownership, merger, or liquidation of the member, the exiting member must be excluded from the affiliated group and file a separate franchise and excise tax return for the taxable year and compute its net worth and net earnings on a separate entity basis.

## Financial Institution Tax Credits

There are certain franchise and excise tax credits that are available only to taxpayers that are financial institutions. For information on the tax credits available to financial institutions, please see Chapter 18 of this manual.

## Overpayment Credits

Overpayments are applied as follows. Overpayments on the taxpayer's account stay on the period in which they originated unless one of the following occur:

- The overpayment is refunded.
- The overpayment is automatically offset to another liability of the taxpayer.
- A Revenue employee moves the overpayment to another period and/or account (at the taxpayer's request).
- The taxpayer requests on its tax return that the overpayment be applied to the next year's tax.
- A taxpayer claiming an overpayment on Schedule E, Line 1 of the tax return does not cause the overpayment to be moved to that period. It only moves if needed to offset a tax liability.



## Chapter 16: Job Tax Credit

### Job Tax Credit Overview

The Job Tax Credit (“JTC”) is found at Tenn. Code Ann. § 67-4-2109(b). It was enacted in 1992 and has undergone numerous legislative changes over the years. The following discussion is based on the most current legislation.<sup>735</sup>

A qualified business enterprise that makes the required capital investment and creates a minimum number of new jobs, within an enhancement county, may obtain the standard JTC equal to \$4,500 for each qualified job created during the investment period. To receive the credit; the qualified business enterprise must file a business plan with the Department, which must be tentatively approved. A qualified business enterprise may also establish additional credits in subsequent years if certain requirements are met.<sup>736</sup>

For example, an additional annual JTC can be earned for:

- Creating new jobs in tier 2, 3, or 4 enhancement counties;
- Making a higher-level capital investment; or
- Creating jobs in an adventure tourism zone.

Taxpayers may not claim more than one additional annual credit per business plan/investment period.<sup>737</sup>

There are six types of JTC:

- Standard JTC;
- Additional Annual Credit – Tier 2, 3, or 4 Enhancement Counties;
- Additional Annual Credit – Higher Level Investments;
- Additional Annual Credit – Adventure Tourism Zone;
- Persons with Disabilities; and
- Community Resurgence Tax Credit.

## Terms Defined by Statute

Each of the underlined terms above has a specific and detailed statutory definition. Only taxpayers fully satisfying those requirements qualify for the standard credit. All requirements of the standard credit must be met before considering any additional annual credit.

### 1. Qualified Business Enterprise

A qualified business enterprise (“QBE”)<sup>738</sup> is an enterprise that meets at least one of the qualifications below:

- Has made the required capital investment necessary to permit the creation or expansion of manufacturing, warehousing *and* distribution, processing tangible personal property, research and development, computer services, call centers, headquarters facilities,<sup>739</sup> back office operations, convention or trade show facilities, or tourism related businesses (e.g., restaurants, lodging establishments, or other tourism related attractions);
  - An enterprise that has made a capital investment necessary to permit the creation or expansion of warehousing and not distribution or vice versa is not a QBE. However, those engaged in the creation or expansion of warehousing *and* distribution may be a QBE. See the section below for the requirements to be a warehousing and distribution QBE.
- Has made the required capital investment necessary to permit the creation or expansion of a repair service facility primarily engaged in providing repairs for aircraft owned by unrelated commercial, governmental, or foreign persons; or
- Promotes high-skill, high-wage jobs in high-technology areas, emerging occupations, or skilled manufacturing jobs in which the business has made the required capital investment necessary to permit an increase in the number of qualified jobs in that county and that receives an approval from the Commissioners of Revenue and Economic and Community Development (“ECD”) in a manner prescribed by the Department of Revenue.

A taxpayer may have locations or departments that meet this definition and others that do not. For example, a taxpayer may have a manufacturing facility and retail stores. The manufacturing facility would constitute a QBE and the manufacturing positions would potentially qualify for the credit, but the retail employees would not.

Typically, support staff such as office workers at a manufacturing facility would qualify for the credit since they are necessary to the operation of the QBE.<sup>740</sup>

### *Warehousing and Distribution*

In order to qualify as a warehousing and distribution QBE for job tax credit purposes, a taxpayer must meet *all* of the following criteria:

- The taxpayer must operate a *storage facility*, which means *real property* that is:
  - located in this state; and
  - primarily used to store goods that belong to the taxpayer's customers, where such goods are stored.
- The taxpayer's business operations must consist of:
  - operating a *storage facility* where the taxpayer provides a related service, such as product inspection, loading and unloading trailers, order fulfillment, packing and shipping, or inventory management;
  - employees who are working in the *storage facility*; and
  - transporting goods that are, or may be, stored at the taxpayer's *storage facility*, on behalf of its customers, by truck or other transport.

## **2. Required Capital Investment**

A required capital investment ("RCI") is an investment of \$500,000 in real property, tangible personal property, or computer software owned or leased in this state that is valued in accordance with GAAP, except for convention or trade show enterprises.

For businesses engaged in convention or trade show enterprises, the investment must be at least \$10,000,000. A capital investment is considered made on the date of payment or the date on which the business enterprise enters a legally binding commitment or contract for purchase or construction.<sup>741</sup>

- ⚠ New positions qualifying for the credit must have been created because of the required capital investment. Therefore, the investment must generally occur before the job creation.**

### 3. Enhancement County

“Enhancement county” is a county that meets one of the following criteria for any month during the 24-months immediately prior to the creation of any qualified job for which a JTC is sought. The figures are determined by using statistics from the Department of Labor and Workforce Development:

- The average number of dislocated workers in the county exceeds the average number of dislocated workers in Tennessee; or
- The per capita income of the county is less than TN’s average per capita income.<sup>742</sup>

#### *Designation of Tiers*

ECD designates all counties as either Tier 1, 2, 3, or 4 based on:

- Unemployment;
- Per capita income; and
- Poverty levels and high concentrations of employment in declining industries.

ECD uses statistical data prepared by “any agency of the state or federal government” and publishes the tier designations for all counties no later than July 1 of each year. Counties experiencing substantial characteristics of economic distress are designated as a Tier 2, 3, or 4 enhancement county.<sup>743</sup> ECD posts a color coded map titled “Tennessee Jobs Tax Credit Enhancement Counties” each year on July 1 that designates each Tennessee county as either Tier 1, 2, 3, or 4.

- ⚠ The map in effect as of the beginning date of the investment period, as shown on a QBE’s business plan, is the map used to determine the enhancement county tier that will be used for the entire investment period.**

The current Tennessee Jobs Tax Credit Enhancement Counties map, which is effective as of **July 1, 2022**, [can be accessed here](#). A list of [archive maps](#) can also be accessed on the Department's website for prior years.

#### 4. Qualified Job

The qualified job definition is comprised of two parts: the first part is applicable to most QBEs while the second part applies specifically to adventure tourism jobs.<sup>744</sup> Part I defines a qualified job as one that meets all of the following:<sup>745</sup>

- Permanent (not seasonal or part-time);
- Provides employment to a person in a QBE for at least 37.5 hours per week for at least 12 consecutive months;
- Offers minimum health care insurance, as described in the Tennessee Small Employer Group Health Coverage Reform Act.<sup>746</sup> (The law does not require a specific percentage of the insurance be paid by the employer, but there must be an employer plan in which the employee has the opportunity to enroll);
- Newly created in this state (did not exist in this state as a job/position of the taxpayer or of another business entity for at least 90 days<sup>747</sup> prior to being filled by the taxpayer);<sup>748</sup>
  - For example, XYZ, Inc. merges into ABC, Inc. on 9/1/2018 and terminates 20 machine operators. ABC, Inc. is the surviving entity and hires these operators on 9/10/2018. Because 90 days had not elapsed, ABC is not entitled to the JTC. However, if ABC, Inc. was a QBE and made the required capital investment and hired the operators on 2/15/2019, they could qualify for the JTC since over 90 days had elapsed.
  - Part-time positions in existence prior to the investment period are not considered qualified jobs *if they become full-time jobs during the investment period*. They are not "newly created in the state."
  - For example, a Tennessee manufacturer uses workers provided by an employment agency. After a trial period, the workers are hired by the manufacturer and made full-time employees that are offered health insurance. These positions are considered to have existed in the state when the

manufacturer first utilized them as leased labor; so, it is likely that they existed 90 days prior to the start of the investment period.

- It is filled (a position is deemed filled if it subsequently becomes vacant but is refilled within 90 days);<sup>749</sup> and
- If the position is created by a back office operations QBE, it must meet the definition of an industrial wage job<sup>750</sup> and pay at least the state's [average occupational wage](#).<sup>751</sup>
  - This wage requirement applies to all positions created by a back office operations QBE, regardless of the nature/function of the individual position.

**⚠ A “job” within the context of this credit means the “position.” Position descriptions are established when the job is created and are not impacted by the employee or employees that fill the position.**

### *Adventure Tourism District Job*

Part II of the qualified job definition addresses adventure tourism jobs located in an adventure tourism district.<sup>752</sup> Beginning July 1, 2017,<sup>753</sup> a qualified job also includes part-time and seasonal adventure tourism jobs created in an adventure tourism district.<sup>754</sup>

The majority of the duties of an adventure tourism job must involve outdoor recreational opportunities, such as:

- Equine and motorized trail riding
- White water rafting, kayaking, and canoeing
- Rappelling and zip lining
- Road biking
- Rock climbing
- Hang-gliding and paragliding
- Spelunking
- Shooting sports
- Mountain biking

- Rowing
- Other such activities

Unlike the previous qualified job requirements discussed, these jobs may be part-time. *Seasonal* adventure tourism jobs (regardless of whether they provide health insurance) are counted as one-half of one job in calculating the number of jobs created. Jobs that do not offer health insurance, are seasonal, or part-time cannot have existed in the state for 36 months prior to being filled. Permanent, full-time positions that offer health insurance cannot have existed in the state for at least 90 days prior to being filled.

Jobs that are adventure tourism jobs located in an adventure tourism district count as qualified jobs when:

- The employer provides employment for at least 12 consecutive months to a person for at least 37½ hours per week *with health care* (counts as one job);
- The employer provides employment for at least 12 consecutive months to a person for at least 37½ hours per week *without health care*, the position is an adventure tourism job located in an adventure tourism district, and the job did not exist in the state for 36 months prior to being filled (counts as one job);
- The employer provides *seasonal* employment for at least 26 consecutive weeks, with or without minimum health care, and the job did not exist in the state for 36 months prior to being filled (counts as ½ job);
  - Seasonal employment means performing services for a seasonal employer only during the seasonal employer’s active period(s) of a seasonal pursuit. It does not include performing services for a seasonal employer during the seasonal employer’s inactive period(s) of seasonal pursuit.<sup>755</sup>
- The employer provides part-time employment for at least 20 hours per week for 12 consecutive months, with or without minimum health care, and the job did not exist in the state for 36 months prior to being filled (counts as ½ job).

**⚠ Even though some new jobs count as ½ a job, the credit is computed on whole numbers. For example, 99½ jobs would receive the same credit as 99 jobs.**

### *Example - 12 Consecutive Months Requirement*

A position would have provided employment for 12 consecutive months if the position was:

- Initially filled on January 1 of Year 1 by J. Jones.
- J. Jones was terminated on March 1 of Year 1.
- T. Taylor filled this position on May 15, Year 1, but left on November 1, Year 1.
- C. Cash replaced T. Taylor and filled the position on January 10, Year 2.

Even though the position was filled only 229 days in Year 1, it is considered to have provided employment for 12 consecutive months because, after the position was initially filled, any subsequent vacancies were refilled within a period of not more than 90 days. This is an example of one position filled by three employees.

## **5. Investment Period**

The investment period is the period during which qualified jobs are created *as a result of the required capital investment*. Generally, the period may not exceed three years from the effective date of the JTC Business Plan.<sup>756</sup> Effective for tax years ending on or after July 1, 2016, taxpayers located in Tier 3 or 4 enhancement counties have five years in which to create the minimum required number of jobs.<sup>757</sup> This five-year period applies only to the creation of new jobs; the timeline for making the required capital investment is still limited to three years. Taxpayers indicate the investment period on their business plan and have the option to file two or more business plans. For example, the first business plan might cover an investment period of two years, and the second plan might cover an additional period of two years.

**⚠ The taxpayer chooses the starting date of the investment period on the Business Plan. This can be any date. However, if multiple business plans are filed, the dates of the respective investment periods may not overlap.**

### *Tier 3 and 4 Enhancement Counties: Timeline for Meeting Minimum Job Requirement*

As noted above, qualified business enterprises that are located in a Tier 3 or 4 enhancement county have five years (rather than three) in which to create the minimum number of qualified jobs necessary to receive the credit. While this special provision<sup>758</sup> gives Tier 3 and 4 QBEs two



additional years to meet the minimum job creation requirement, it does not extend the investment period, and credit will not be given for jobs created *after* the year in which the QBE meets the minimum job creation requirement if such requirement is met in the fourth or fifth year. For example:

- Taxpayer is a QBE located in a Tier 4 enhancement county and has submitted a Business Plan with a three-year investment period. The taxpayer must create at least 10 qualified jobs. As of the end of Year 3, the taxpayer has made the required capital investment and created 5 qualified jobs. In Year 4, the taxpayer creates an additional 3 qualified jobs. In Year 5, the taxpayer creates an additional 4 qualified jobs, thus meeting the minimum job creation requirement in Year 5. The taxpayer may claim the job tax credit on 12 jobs in Year 5.
  - Tier 3 and 4 QBEs that meet the minimum job creation requirement in the fourth or fifth year may claim the job tax credit on *all* qualified jobs created during the year in which the QBE meets the minimum job creation requirement but *not* in subsequent years, as illustrated in the next example.
- Taxpayer is a QBE located in a Tier 3 enhancement county and has submitted a Business Plan with a three-year investment period. The taxpayer must create at least 20 qualified jobs. As of the end of Year 3, the taxpayer has made the required capital investment and created 19 qualified jobs. In Year 4, the taxpayer creates an additional 5 qualified jobs, thus meeting the minimum job creation requirement in Year 4. The taxpayer may claim the job tax credit on 24 jobs in Year 4. In Year 5, the taxpayer creates an additional 6 qualified jobs; however, the taxpayer cannot receive credit for these 6 jobs because the three-year investment period has already concluded.
  - Qualified jobs must generally be created within the investment period, which cannot exceed three years. Tier 3 and 4 QBEs are allowed two additional years to meet the minimum job creation requirement. However, once a taxpayer has met this minimum requirement, credit for *further net increases* in qualified jobs may only be granted in *subsequent tax years within the investment period* in which further net increases occur.<sup>759</sup> In the above example, the investment period concluded at the end of Year 3; therefore, the net increase in qualified jobs that occurred in Year 5 does not count towards the credit (although, the taxpayer could potentially apply those qualified jobs towards a new investment period).

## Net Increase in Qualified Jobs during the Investment Period

A QBE may claim a credit after it first satisfies the minimum capital investment and job creation requirements and in subsequent tax years within the investment period in which further *net increases* occur above the level of employment established when the credit was last taken.<sup>760</sup>

“Net increase” refers to qualified jobs. The definition of a qualified job generally requires that the position provide employment for 12 consecutive months. So, the term “net increase” limits credits claimed after the initial year to those that exceed the number of qualified jobs that previously received the credit.

For example:

- A taxpayer receives the credit for creating 30 qualified jobs in Year 1 of the investment period.
- In Year 2, seven qualified jobs are created, but six of the Year 1 qualified jobs ended.
- The six Year 1 jobs were filled for 13 months before they ended, and they were not refilled.
- The six Year 1 jobs received the credit in Year 1 because they met the 12-month test and all of the other requirements of a qualified job.
- The seven new jobs created in Year 2 also met all of the requirements for the credit.
- However, the taxpayer may only claim credit for *one position* in Year 2 (7 jobs less the 6 jobs that ended).
- Credits are only allowed for *net increases* above the level of employment when the credit was last taken.
- Six of the seven Year 2 positions offset the loss of qualified positions created in Year 1, as seen in the table below.

Position	Creation Date	Position End Date	Qualified Job	2018 JTC established	2019 JTC established
1 - 6	1-1-2018	2-1-2019	6	6	-6
7 - 30	2-1-2018		24	<u>24</u>	
JTC earned in 2018				30	
1 - 7	1-1-2019		7		<u>7</u>
JTC earned in 2019					1

A qualified job that changes within the investment period and fails to meet all of the requirements of a qualified job should be treated as if the job ended, and the principles of *net increase* would apply. For example:

- A job is determined to be a qualified job in Year 2 of an investment period, but the weekly hours worked decrease to 35 in Year 3. The job would qualify for the \$4,500 credit in Year 2 if all other requirements are met, but any new qualified jobs for Year 3 would not count until the “deemed loss” of the Year 2 job was offset.

The netting process described above, for positions that either subsequently terminate or subsequently fail to meet the definition of a *qualified job*, applies only to qualified jobs that are subsequently created within *the same* investment period.<sup>761</sup> The netting process does not apply to qualified jobs that are subsequently created within *different* investment periods. For example:

- A taxpayer – a qualified business enterprise – moves its business operations to Tennessee, making a capital investment of \$750,000 and creating 50 qualified jobs in the state during an investment period that begins on January 1, 2019, and ends on December 31, 2021. The taxpayer qualifies for the JTC and claims the JTC for all 50 of the qualified jobs created during the 2019-2021 investment period.
- Subsequently, the taxpayer plans on expanding its business operations in the state and submits a JTC business plan that details this expansion project, which includes a

\$600,000 capital investment and estimates the creation of 40 new qualified jobs during an investment period that begins on January 1, 2022, and ends on December 31, 2024.

- In January 2022, four of the positions that the taxpayer created during the 2019-2021 investment period terminate and six of those positions cease to meet the definition of a *qualified job*. Although these 10 positions failed to maintain the requirements for a qualified job in 2022, because they were created during the 2019-2021 investment period, the taxpayer will not have to net these 10 positions against any new qualified jobs that it creates during the 2022-2024 investment period.

## Standard JTC

For a QBE located in a Tier 1 or 2 enhancement county to meet the requirements for the standard credit, they must do three things:

- File a business plan;
- Make a minimum \$500,000 capital investment; and
- Create 25 new job/positions as a result of the investment within three years<sup>762</sup> of the effective date of the business plan.<sup>763</sup>

See the chart below for the minimum number of jobs that must be created for the standard job tax credit and the years allowed in which to create them.

### 1. Table of Standard JTC - Jobs, Years & Tiers

County Designation	Minimum Investment*	Minimum Qualified Jobs <sup>764, 765</sup>	Years to Create Jobs	Credit Per Job**
Tier 1 or 2	\$500,000	25	3	\$4,500
Tier 3	\$500,000	20	5	\$4,500
Tier 4	\$500,000	10	5	\$4,500

\* \$10 million if convention or trade-show enterprise

\*\* The standard JTC increases from \$4,500 to \$5,000 per job if the QBE qualifies for the additional annual credit for higher-level investors and pays the average occupational wage.<sup>766</sup>

Jobs may be created in multiple counties involving multiple tiers over multiple years, but only one enhancement county map is generally used—the map in effect as of the date of the beginning of the investment period.

QBEs that have made a capital investment in the state of at least \$500,000 will qualify for the standard credit after creating 25 qualified jobs in a Tier 1 or 2 county, 20 jobs in a Tier 3 county, or 10 jobs in a Tier 4 county. If the sum of the jobs created in multiple tiered counties is 25 or more, all of the jobs created will qualify for the credit. Otherwise, only the jobs meeting the minimum job creation requirements of a specified tier will qualify, as shown in the following chart. Note, the last line of the chart shows that 24 jobs were created, but none qualified for the credit because the tier minimums were not met.

**Each row in the below chart is an *independent* example.**

<b>Number of Qualified Jobs Created by Enhancement County Designation</b>				
<u>Tier 1</u>	<u>Tier 2</u>	<u>Tier 3</u>	<u>Tier 4</u>	<u>Qualify for JTC</u>
25				25
	25			25
		20		20
			10	10
		5	11	11
		21	2	21
		20	10	30
20	2	1	2	25
20	2	1	1	0

## 2. Business Plan and Recommended Documentation

Taxpayers must file a [Job Tax Credit Business Plan](#) before claiming the JTC. The business plan must include all required information, including a description of the investment to be made, the number of jobs the investment will create, the expected dates the jobs will be filled, and the effective date of the plan.<sup>767</sup>

The “effective date” is the date on which the “investment period” is deemed to begin. The investment period is the period in which the taxpayer creates the qualified jobs resulting from its capital investment. Jobs created outside of the investment period do not qualify for the JTC and capital investments made outside the investment period do not count towards the minimum requirement. The taxpayer enters the investment period dates on the first page of the business plan. The beginning investment period date establishes the enhancement county tier map that is in effect for the entire investment period.

Taxpayers should mail the business plan to the Department. The Department will review the business plan and either tentatively approve it or deny it, if it is clear that the minimum legal requirements to claim the credit will not be met by the taxpayer. The Department will respond to the taxpayer in writing. A letter of tentative approval will state that it is based on the information provided. However, if the actual investment, number of new jobs, or any other material fact does not comply with the requirements of Tenn. Code Ann. § 67-4-2109(a) and (b), the JTC may not be claimed.

Attached to the JTC tentative approval letter is a listing of the [JTC: Recommended Documentation](#) that the taxpayer should maintain for verification purposes. An image of the Recommended Documentation sheet, shown on the following page, was first attached to tentative approval letters beginning in 2014.



## Tennessee Department of Revenue

### Job Tax Credit: Recommended Documentation

The following information and records should be maintained and available (preferably in an electronic format) to verify that all the requirements of the standard job tax credit have been met.

#### Capital Investment

List of items acquired during the investment period as part of the required capital investment (may include real property, tangible personal property, or computer software owned or leased in Tennessee) that details the purchase date, cost, description, location, and general ledger account charged.

#### New Job Position Documentation

Records for the 90\* day period immediately before the first day of the investment period as reported on the business plan detailing the following for positions in Tennessee:

- |   |   |
|---|---|
| 1. Unique position number               | 7. Position designation: permanent, full-time, or other   |
| 2. Position title                       | 8. Location of position, including county   |
| 3. Employee name                        | 9. Documents showing minimum health insurance offered (e.g., employee handbook insurance invoice, opt in/out form, payroll documents, etc.) |
| 4. Last four digits of employee's SSN   |   |
| 5. Hourly wage rate for each employee   |   |
| 6. Gross annual wages for each position |   |

*\*36-month period for permanent, part-time, and seasonal adventure tourism jobs located in an adventure tourism district*

Records of the items listed below during the investment period and the 12\*\* months following the end of the investment period:

- |                                   |  |
|-----------------------------------|--|
| 1. Items 1-8 listed above         | 4. Termination date                              |
| 2. Date position created / filled | 5. Indicate if health insurance has been offered |
| 3. Hire date                      | 6. Indicate if claimed job tax credit            |

*\*\*26 consecutive weeks for seasonal adventure tourism jobs in an adventure tourism district*

**Five template schedules are available on our website to assist you with maintaining and providing job and capital investment information.**

Payroll and depreciation records should be retained to provide support that all of the requirements for the jobs tax credit have been met. Payroll reports and purchase invoices generally are good sources of documentation.

#### **Schedule X is used for claiming the credit.**

Once the minimum requirements for the standard job tax credit have been met, the credit may be claimed by filing Schedule X with the franchise and excise tax return.

#### **Employees should be claimed by the business that controls and utilizes them.**

The job tax credit should be claimed by the entity that controls and utilizes the workers regardless of who files the related payroll reports. If another entity files the payroll reports, the same documentation must be provided to support the credit as well as documentation supporting the relationship between the entity and the payroll company.

Auditors may request the information listed on the Recommended Documentation sheet, including:

- Detailed employee/position lists, preferably in [the JTC - Schedules template format found on the Department's website](#).

**⚠ The template schedules linked on the [JTC page](#) of the Department's website for taxpayers to use are also used by auditors to document their audit work.**

- Employee/positions lists, in which the positions for which the credit was claimed are highlighted or otherwise identified.

**⚠ Audit testing of the credit will be suspended until the taxpayer has identified the specific positions that are being claimed for the credit.**

- Tennessee Wage and Premium Reports ("SUTA"). These reports generally provide support for positions that existed within the state. It is highly recommended that these reports be available during a JTC audit in an original or redacted form.

### *Amended Business Plan*

Taxpayers may file amended business plans. Taxpayers originally complete business plans based on the best information available at the time, but it is reasonable that a business plan may need to be amended. For example:

- A taxpayer files a business plan stating that the investment period is January 1, 2016, through December 31, 2018, but later realizes that jobs will be created and capital investments will also be made in 2019, which is outside the three-year investment period.
- The taxpayer may file one amended business plan (January 1, 2016, through December 31, 2017) and a second plan (January 1, 2018, through December 31, 2019), each with two-year investment periods.

The business plan is normally filed by the taxpayer, but the Department will accept business plans filed by the taxpayer's wholly-owned SMLLC (disregarded to parent). However, the credit will be claimed on the parent corporation's franchise and excise tax return and maintained on



the parent's account.

A QBE that is a qualified data center<sup>768</sup> must certify on the business plan that it has not been in violation of the Worker Adjustment and Retraining Notification Act, the Fair Labor Standards Act, or federal immigration laws within the last 12 months. A qualified data center's failure to provide this certification will disqualify the taxpayer from claiming the JTC. This applies for tax years ending on or after July 1, 2016.

### 3. When Credit May Be Claimed, Offset Limits, and Carryover

Taxpayers claim the credit by reporting it on Schedule X of the return. The standard credit is first claimed in the tax year in which all of the requirements for the credit have been met and in subsequent years within the investment period where there are net job increases because of the investment. A taxpayer may claim the standard credit once it has:

- Filed its business plan;
- Received a tentative JTC approval letter from the Department;
- Made the required capital investment; and
- Filled the minimum required number of new Tennessee jobs/positions within the three-year investment period (or five-year period if located in a tier 3 or 4 enhancement county).<sup>769</sup>

For example, a taxpayer located in a Tier 4 enhancement county meets the requirements of the first three bullets above in Year Three and creates 10 new positions in Year Five. The taxpayer would claim the credit in Year Five, since this is the first year in which all the requirements have been met.

The standard credit is \$4,500 per each new Tennessee job created.<sup>770</sup> It can offset up to 50% of the combined franchise and excise tax,<sup>771</sup> beginning with the first year in which the minimum statutory requirements are met. Any unused credit may be carried forward for up to 15 years.<sup>772</sup>

Qualified jobs that are not adventure tourism jobs must provide employment for at least 12 consecutive months.

**⚠ A taxpayer that has met all other requirements may claim the credit before the position has existed for 12 consecutive months. If the credit is claimed and the position ends short of 12 months, the taxpayer would file an amended return to report the decrease in the credit earned.**

## Additional Annual Job Tax Credits

In addition to the standard credit, three additional annual credits may be claimed under specific circumstances, *if the requirements of the standard credit have been met*. A taxpayer may not claim more than one additional annual credit and must indicate which one it will take on its business plan.<sup>773</sup>

### 1. Tier 2, Tier 3, or Tier 4 Enhancement Counties

Taxpayers qualifying for the standard job tax credit of \$4,500 may obtain an additional annual credit if the new jobs were created in an “enhancement county.” The Enhancement County JTC/Additional Annual Credit is a tax credit of \$4,500 per job created that is *in addition* to the standard JTC for companies that locate or expand in Tennessee counties designated as Tier 2, 3, or 4 enhancement counties. Taxpayers take the credit each year for three or five years, depending on the enhancement county in which the jobs are located. Taxpayers may only take this credit in tax years in which the job remains filled.<sup>774</sup>

#### Summary Table of Enhancement Counties

Enhancement County	Minimum Investment	Minimum Qualified Jobs <sup>775</sup>	Credit per Job	Duration of annual credit	Carryover
Tier 2	\$500,000	25	\$4,500	3 years	No
Tier 3	\$500,000	20	\$4,500	5 years	No
Tier 4	\$500,000	10	\$4,500	5 years	No

#### Business Plan – Enhancement County Credit

Taxpayers claiming this credit should check the box for “Additional Annual Job Tax Credit for Enhancement Counties” and enter the applicable county on the line provided.

### *Additional Time to Create Jobs/Positions – Enhancement County Credit*

A qualified business locating or expanding in a Tier 2 county may take three years to create the minimum required number of jobs. Businesses locating or expanding in a Tier 3 or 4 county may take up to five years to create the minimum required number of jobs.<sup>776</sup>

### *When Credit May Be Claimed, Offset Limits, and No Carryover – Enhancement County Credit*

The credit is claimed by filing Schedule X, Part 2. It may first be claimed in the tax year in which all of the requirements for the credit have been met and in subsequent years within the investment period where there are net job increases because of the investment. It may only be claimed in subsequent years when the newly created positions remain filled.

Taxpayers may choose to delay taking this credit, but they must begin to apply the credit no later than the first tax year following the end of the investment period.<sup>777</sup> This additional annual credit can *offset up to 100%* of the franchise and excise tax liability, but there is no carryover. Schedule X and the state's computer system will apply the credit before credits with carryover capabilities, such as the Industrial Machinery Credit and the Standard JTC.

## **2. Higher Level of Investment and Job Creation**

If the QBE involves a Higher Level of Investment and Job Creation (“HLIJC”), an additional annual credit is allowed, as shown in the chart below.<sup>778</sup> For example, if the investment exceeds \$1 billion and at least 500 “industrial wage jobs” are created, the \$5,000 additional annual credit is allowed for a period of 20 years, if the jobs remain filled during the year in which the credit is being taken. Also, the standard \$4,500 JTC available to all qualifying businesses will be increased from \$4,500 to \$5,000 per job if the QBE qualifies for the additional annual credit for higher-level investors.<sup>779</sup>

An “industrial wage job” is a qualified job with wages equal to or greater than Tennessee’s “average occupational wage” for the month of January of the year during which the job was created.<sup>780</sup> The “average occupational wage” is the average wage for all industries as reported by the Department of Labor and Workforce Development in the most recent annual quarterly census of employment and wages super sector data for the state, aggregate of all ownerships.<sup>781</sup> See the table: [average occupational wage](#).

*Summary Table – HLIJC Additional Annual Credit*

<b>Minimum Investment</b>	<b>Industrial Wage Jobs<sup>782</sup></b>	<b>Credit per Job</b>	<b>Duration of Annual Credit</b>
\$1 billion	500	\$5,000	20 years
\$500 million	500	\$5,000	12 years
\$250 million	250	\$5,000	6 years <sup>783</sup>
\$100 million	100	\$5,000	3 years
\$10 million*	100*	\$5,000	3 years

\* The lowest rung on the above chart requires a relatively modest investment, but there are additional requirements that a taxpayer making this level of investment must meet in order to qualify. Namely, the jobs must meet the definition of “headquarters staff employees” and pay at least 150% of the state’s “average occupational wage” for the month of January of the year in which the jobs are created. Note that as of July 1, 2015, “regional” headquarter facilities are no longer QBEs and are not allowed this credit.

“Headquarters staff employees” are executive, administrative, or professional workers performing headquarters-related functions and services. An executive employee is a full-time employee who is primarily engaged in the management of all or part of the enterprise. An administrative employee is a full-time employee who is not primarily involved in manual work and whose work is directly related to management policies or general headquarters operations. A professional employee is an employee whose primary duty is work requiring advanced knowledge (from a prolonged course of specialized study) in a field of science or learning.<sup>784</sup>

*Example – HLIJC*

A taxpayer invests \$100 million and creates 175 new jobs. Of these 175 jobs, 125 pay above the state’s average occupational wage and 50 pay less than this amount. Since the taxpayer has invested at least \$100 million and created at least 100 new industrial wage jobs, the additional annual credit rate for the 125 qualified jobs that meet the industrial wage requirement is \$5,000 annually for three years, provided the job remains filled. For purposes of the standard credit, all 175 new jobs, including those that pay below the average occupational wage, are eligible for the credit at a rate of \$5,000 per new job.<sup>785</sup> However, for purposes of the additional annual credit, only the jobs that pay above the average occupational wage are eligible for the credit.<sup>786</sup>

### *Business Plan – HLIJC*

Taxpayers claiming this credit should submit their Job Tax Credit Business Plan with the box checked for “Additional Annual Job Tax Credit for Higher Level Investments” and the applicable sub-box checked to indicate the level of investment expected to be made.

### *Investment Period – HLIJC*

The period in which to make the required capital investment for the HLIJC additional annual credit is three years from the effective date of the business plan. However, if the Commissioner of ECD determines that it is in the “best interest of the state,” the Commissioner may extend the three-year period up to two additional years, or four additional years if the investments exceed \$1 billion.<sup>787</sup>

### *When Credit May Be Claimed and Offset Limits – HLIJC*

The additional annual credit for all levels of investment is \$5,000 for each job that remains filled<sup>788</sup> during the year in which the credit is being taken. This annual credit may offset up to 100% of the franchise and excise tax liability for that year, but taxpayers cannot carry forward any unused additional annual credit beyond the year in which the credit originated, unless the Commissioners of ECD and Revenue approve the “best interest of the state” provisions before Jan. 1, 2011.<sup>789</sup>

The QBE may first apply the additional annual HLIJC credit in the tax year it which it met all of the statutory requirements, even if that is the first year of the investment period. The taxpayer may delay taking this credit. However, the taxpayer must begin to apply the credit no later than the first tax year following the end of the investment period.<sup>790</sup>

Please see [Letter Ruling 11-17](#) (Item 5) for an example of when the Department approved a taxpayer for a HLIJC credit, but it had not met the minimum requirements. Once the taxpayer had met the minimum requirements for the standard credit (\$500,000 investment and the minimum number of new jobs), the taxpayer was able to begin taking the standard credit at the full \$5,000 per job rate, per the special provision in the law.<sup>791</sup> However, the taxpayer had to wait until it had met the minimum job and investment requirements for the HLIJC before taking the additional annual credit.

### *2/3 Exclusion – Schedule G, Line 9 – Exempt Required Capital Investment*

Taxpayers may exclude two-thirds of the net book value of assets included in the required capital investment when qualifying for the HLIJC credit from the minimum measure of the franchise tax. The investment qualifies as “exempt” only in those years in which the HLIJC additional annual credit is actually allowed.<sup>792</sup>

Prior to June 17, 2009, Tennessee law did not limit the periods to which this exclusion could be applied. Taxpayers who began their investment period before this date may take the 2/3 exclusion for as long as the qualified assets are on their books.

After June 17, 2009, the periods to which this exclusion can be applied are limited to the years in which the additional annual credit is allowed.

### **3. Adventure Tourism Zone**

There is an additional annual credit for each new qualified job created in an area designated as an “adventure tourism zone (district).”<sup>793</sup> To qualify, taxpayers must first meet all the requirements of the standard job tax credit. The newly created jobs do not need to be adventure tourism jobs.<sup>794</sup> Tourism-related businesses may claim the standard job tax credit<sup>795</sup> because they may be QBEs. This includes restaurants, lodging establishments, or other tourism-related attractions. They may claim the standard job tax credit of \$4,500 per each new position, with an offset limit of 50% of their franchise and excise tax and a carry forward of 15 years. To qualify for the standard credit, the tourism related business must:

- File a business plan and receive tentative approval from the Department;
- Make an investment of at least \$500,000 in real or tangible property or computer software owned or used within the state within a three-year investment period; and
- Create the minimum required number of new qualified jobs. Effective July 1, 2017, a “qualified job” includes part-time and seasonal adventure tourism jobs created in an adventure tourism district.<sup>796</sup>

Taxpayers that have created a minimum number of positions in an adventure tourism zone and have met the requirements of the standard credit will qualify for the adventure tourism additional annual credit.

### *Minimum Job Creation within a District/Zone*

QBEs located in an adventure tourism district within a Tier 2, 3, or 4 enhancement county may qualify for the additional annual credit with less than 25 positions created. The credit is available if the business creates:

- At least 25 new jobs in a district within a Tier 1 enhancement county;
- At least 19 new jobs in a Tier 2 enhancement county;
- At least 13 new jobs in a Tier 3 enhancement county; or
- At least 10 new jobs in a Tier 4 enhancement county.<sup>797</sup>

For example, a taxpayer located in a Tier 3 enhancement county that filed a business plan, made a capital investment of \$500,000 and created 20 new qualified job positions would qualify for the standard job tax credit. If 13 of the new positions were located in an adventure tourism district, the taxpayer would also qualify for the additional annual job tax credit. Note that the 13 jobs do not need to be adventure tourism jobs. They only need to be located in an adventure tourism district.

Note that the job creation requirement in a Tier 3 enhancement county is 20 for the standard job tax credit and 13 for the additional annual adventure tourism credit. Taxpayers who are only creating 13-19 positions in a Tier 3 enhancement county adventure tourism zone will not qualify for either credit because the requirements of the standard credit must first be met.

### *Length and Amount of Additional Annual Credit*

This credit is for a period of three years for businesses located within a district in a Tier 1 or 2 enhancement county and five years for those located in a Tier 3 or 4 enhancement county.

The additional annual credit is \$4,500 for each qualified job, if the job remains filled by employees during the year for which the credit is being taken. Taxpayers may use this additional annual credit to offset up to 100% of the taxpayer's franchise and excise tax for that year. Taxpayers may not carry forward any unused additional annual credit. Taxpayers may choose to delay taking this credit, but they must begin to apply the credit no later than the first tax year following the end of the investment period.<sup>798</sup>

### *Creation of Adventure Tourism Districts*

The creation of “adventure tourism districts” is discussed at Tenn. Code Ann. § 11-11-204. Generally, a local governing body votes to create an adventure tourism district within the boundaries of such governing body by developing an adventure tourism district plan. Alternatively, one or more counties or one or more municipalities may enter into an intergovernmental agreement to designate jointly an adventure tourism district that contains areas within the boundaries of more than one local government. Adventure tourism professionals may petition local governing bodies to authorize the creation of an adventure tourism district. They will provide a specific business plan based on quantifiable data demonstrating that the creation of an adventure tourism district would enhance sustainable economic development in the area. Once a local governing body or bodies authorizes the creation of an adventure tourism district, the adventure tourism district plan must be submitted to the Departments of Tourism Development and Revenue for joint approval of the adventure tourism district.<sup>799</sup>

### **Persons with Disabilities**

A job tax credit of \$5,000 for each net new *full-time* employee and \$2,000 for each net new *part-time* employee is available to employers for the employment of persons with disabilities who are receiving state services directly related to the disabilities.<sup>800</sup> A full-time job is a permanent position providing employment for at least 37.5 hours per week and the person *is enrolled in* minimal health care benefits. A part-time job provides employment for at least 10 hours per week. A part-time employee is not required to be enrolled in health care benefits provided by the employer. An employee working 37.5 hours that is not enrolled in health care may claim the \$2,000 credit afforded part-time positions. A [Job Tax Credit for Hiring Persons with Disabilities Business Plan](#) must be filed before the last day of the year in which the employment begins.

Additional requirements include:

- A net increase occurs in the number of persons with disabilities employed by the taxpayer within the 90-day period immediately preceding employment.
- The taxpayer provides qualifying employment for at least 12 consecutive months for no less than the minimal hours per week.
- The credit applies initially in the tax year in which the taxpayer increases net new employment of such persons by one or more employees, and in subsequent fiscal



years in which additional net increases occur above the level of employment established when the credit was last taken.

- The disabled employee is being served by the Department of Mental Health and Substance Abuse Services, the Department of Intellectual and Developmental Disabilities, the Division of Rehabilitation Services of the Department of Human Services, the Council on Developmental Disabilities, or any other similar state employment incentive program.

Taxpayers claiming the job tax credit for hiring persons with disabilities are not required to make a capital investment or be a QBE in order to claim the credit.

## Community Resurgence JTC

A \$2,500 credit is available for all new or existing businesses located in a “high-poverty area” that have created at least 10 full-time positions within three years from the effective date of the business plan filed with the Department.<sup>801</sup> This credit does not require a capital investment and can be taken in addition to other job tax credits. It is a one-time credit with a 15-year carryforward, and it may offset up to 50% of the combined franchise and excise tax liability. Unlike other credits, it has an *aggregate annual limit* of \$12,500,000 for *all* taxpayers.

For the purpose of this credit, the terms “qualified business” and “qualified job” are uniquely defined.

- A qualified business is any business located in a census tract designated as a high poverty area. Note that the term qualified business enterprise is not used.
- A qualified job must be full-time and pay the state’s average occupational wage. This definition is unique to the community resurgence job tax credit. The qualified job definition found at Tenn. Code Ann. § 67-4-2109(a)(6) should not be used.<sup>802</sup> Note that the applicable definition does not mention adventure tourism jobs located in an adventure tourism district/zone and does not require the taxpayer to offer health insurance.

For this credit, taxpayers must be located in a “high-poverty area.” This means a census tract with a poverty level, all population, in excess of 30%, according to the [American Community Survey three-year estimates in 2013](#),<sup>803</sup> and determined every 10 years thereafter by ECD in consultation with the Comptroller of the Treasury. A taxpayer that has created ten qualifying

jobs in two census tracts will not qualify for the community resurgence job tax credit. The minimum of ten qualifying jobs must be created in a single census tract.

## Wage Rate Requirements

The table below summarizes the wage rate requirement, if any, for qualified jobs, depending on the type of job tax credit(s) being claimed by the taxpayer.

Type of JTC	Required Wage Rate
<b>Standard</b>	No requirement*
<b>Additional Annual:</b>	
<b>Tier 2, 3, or 4</b>	No requirement
<b>Higher Level of Investment</b>	100% industrial wage job
<b>HLIJC (\$10 million investment)</b>	150% average occupational wage
<b>Adventure Tourism</b>	No requirement
<b>Community Resurgence</b>	100% average occupational wage Tenn. Code Ann. § 67-4-2004(3)
<b>Back office operations</b> Tenn. Code Ann. § 67-4-2109(a)(6)(D)	100% industrial wage job
<b>Headquarter staff positions -</b> Tenn. Code Ann. § 67-4-2109(g) <b>(prior to repeal July 1, 2015)</b>	150% average occupational wage
<i>An industrial wage job pays the state's average occupational wage, so these terms are almost interchangeable.</i>	
* All positions that are created by a <b>back office operations</b> QBE are required to meet the 100% industrial wage job requirement.	

## Common Law Employer

The common law employer is the entity eligible for the job tax credit and the entity that has representation in the payroll factor on Schedule N. The guidance for determining which entity is the common law employer is the same for JTC and apportionment purposes. **Generally, the common law employer is the entity that utilizes and controls the workers.** The entity that issues an employee's Form W-2 may be a common paymaster, staff leasing company, or a professional employer organization that is not the common law employer. See Chapter 14 for more information on determining the common law employer.

TENN. COMP. R. & REGS. 1320-06-01-.30 (“Rule 30”) provides the authority to use “the usual common law rules” in determining the employer-employee relationship and in identifying the common law employer.<sup>804</sup> Under these rules, a person is generally considered an “employee” if the taxpayer includes the person as an employee for payroll taxes imposed by FICA. *However, there are circumstances under the common law where an employee for whom FICA is paid may not be considered an employee of that entity.* The following common law concepts may be considered when determining which entity is the employer for job tax credit and apportionment purposes. Auditors will consider the particular facts of each case and use their judgment in weighing the following:

- The *degree of control* exercised over the manner in which the work is performed. This is the most important factor in the analysis. This element is generally met if a laborer works exclusively for an entity that exercises significant managerial control over the worker and most aspects of the worker’s duties and responsibilities. If determining which entity is the common law employer remains unclear after considering the degree of control exercised, the following factors are considered, but they may not be equally weighted.
  - The right to hire and terminate the employee;
  - The right to reassign the employee to another client while the employee is performing services for the service recipient;
  - Bears the cost of employee benefits;
  - Issues the Form W-2 and files employment taxes in the entity’s name; and
  - Whether the work performed is part of the principal’s regular business.

The entity that controls and utilizes a worker is the common law employer and is the entity that the worker would generally identify as their true boss.

## Order of Use – One-time Credits and Credits with Carryovers

Taxpayers with various types of credits generally do not need to be concerned with the order in which they are used to offset tax on their franchise and excise tax returns. It is the Department’s intent to use credits in a manner that is most advantageous to the taxpayer. The state’s computer system and tax credit Schedules X and T apply credits without carryovers before those with carryovers. For example, the gross premiums tax credit, Tennessee income tax credit, and

additional annual job tax credit offset the tax first because any of these credit amounts not used in the year earned are lost.

## Tax Planning

### 1. Investment Period

A tax planning opportunity exists for taxpayers when choosing their investment period. The investment period may not exceed three years, but multiple business plans (each covering an investment period that is less than or equal to three years) may be established as long as the capital investment and job creation requirements are met for *each individual* business plan/investment period. For example, a QBE files a business plan with an investment period beginning January 1, Year 1 and ending December 31, Year 3. It makes the required capital investment of \$500,000 in both Years 1 and 3 and 50 qualified jobs are added in Years 1, 2, 3, and 4. Since the jobs added in Year 4 are outside the investment period, they will not qualify for the credit. However, if two business plans were filed (one for Years 1 and 2, and another for Years 3 and 4), then the qualified jobs added in all of these years could be claimed.

### 2. Credit Selection: Enhancement County or HLIJC Additional Annual Credit

Taxpayers may qualify for *both* the enhancement county additional annual credit *and* the HLIJC additional annual credit, but because the taxpayer may only claim one of these credits per investment period, they must choose which one to claim. Depending on the level of investment made and the number of jobs created, one of these credits may be more advantageous for the taxpayer to claim than the other.

For example, a QBE makes a capital investment of \$101,000,000 and creates 100 industrial wage jobs in a Tier 3 enhancement county. If the enhancement county additional annual credit is claimed, the taxpayer would earn a credit of \$4,500 for each of the 100 jobs for five years, totaling \$ 2,250,000 ( $\$4,500 \times 100 \text{ jobs} \times 5 \text{ years}$ ). However, if the HLIJC additional annual credit is claimed, the taxpayer would earn a total credit of \$1,500,000 ( $\$5,000 \text{ credit} \times 100 \text{ jobs} \times 3 \text{ years}$ ) and would qualify for the Schedule G exclusion of 2/3 of the net book value of assets that are part of the capital investment made to qualify for the HLIJC credit.<sup>805</sup>

## Survival of Credits in Reorganizations and Unitary Group Carryover Issues

### 1. Corporation Becomes SMLLC Disregarded to Parent

When a corporation that creates a JTC carryover converts to an LLC and then becomes a disregarded SMLLC that files with its parent, the carryover stays with the taxpayer that generated it and cannot be used by a different taxpayer. Since the LLC is no longer a taxpayer in its own right, the loss carryover is essentially lost unless the LLC becomes regarded at a later date, thus becoming a taxpayer again.<sup>806</sup>

### 2. Merger

Any available carryovers of a corporation that merges out of existence into another entity are lost. They may not be used by the surviving entity.

### 3. Taxpayer Sells its Disregarded SMLLC that Created the JTC

When a corporation (taxpayer) sells its disregarded SMLLC that created the JTC carryover, the JTC carryover stays with the taxpayer parent.<sup>807</sup> In a situation where the disregarded SMLLC creates new Tennessee jobs while filing with the parent, the resulting credit actually belongs to the parent, because the SMLLC is disregarded to the parent (the taxpayer) and treated like a division of the parent. Therefore, if the SMLLC is sold to a third party, any existing JTC carryover will remain with the taxpayer parent.

### 4. Unitary Group of Financial Institutions

A unitary group of financial institutions may take any qualified credit, including the JTC, that was generated by any group member that is in existence as a member of the group at the end of the group's tax year, provided that such credit has not previously been taken by the member itself before it joined the group or by another unitary group of financial institutions at the time the financial institution generating the credit was a member of that group.<sup>808</sup>

## Audit Documentation

Auditors must verify certain assertions made by the taxpayer concerning their qualification to receive the job tax credit. Verifications may be accomplished in a variety of ways. Auditors should determine the best method of verification based on the information available, the most efficient use of time, and the level of reliability of documentation. For example, an invoice

provides better evidence than an in-house depreciation schedule, a footnote to an audited financial statement provides better evidence than a verbal statement, a report filed with a state or federal agency provides better support than an in-house spreadsheet.

This section discusses suggested documentation that taxpayers should expect to be a part of most JTC audits. Actual documents retained as audit workpapers may vary because of the type of credit(s) claimed and issues unique to a given taxpayer. The discussion in this section is generally limited to the standard JTC credit entailing non-tourism jobs.<sup>809</sup>

Most taxpayer-provided documents in a JTC audit will be similar to those suggested on the [Job Tax Credit: Recommended Documentation](#) sheet (RD) that is mailed with tentative approval letters. It can also be found on the Department's website.<sup>810</sup> It informs taxpayers of the job/position and investment documentation that should be maintained (preferably in an electronic format) for availability for verification of the job tax credit. It suggests that unique position numbers be maintained and reported on the job/position lists provided to the Department in support of the credit claimed.

**⚠ Taxpayers that assign unique position numbers to all positions can show position increases more easily than those that rely solely on position titles and employee names.**

Beginning in 2018, the RD informs taxpayers that they *may use templates from the Department's website* to provide most of the recommended documentation.

The following schedule templates can be found on the Department's [website](#). These schedules encompass information suggested on the RD sheet:

- JTC Reconciliation
- Required Capital Investment
- Position List 90 Days Prior
- Position List(s) at Year End
- List 12 Months After End of Investment Period
- JTC Carryover

In cases where the taxpayer provides electronic data, but does not use the above templates, the auditor may import the taxpayer's data into these templates to perform audit work. The Department's retained audit workpapers will generally include these template schedules.

**⚠ Taxpayers are encouraged to use the templates on the Department's website, as it simplifies the audit process and reduces the possibility for mistakes.**

## 1. Retained Documents and Workpaper Organization

Many JTC audit workpapers begin as taxpayer-prepared schedules. Taxpayer-provided schedules are generally saved intact, and all audit work done is documented on copies of these schedules. The original and audit copies are cross referenced in the audit file.

In some cases, taxpayers may not allow auditors to retain certain data or documents, even in a redacted form. If this occurs, the auditor may prepare a detailed narrative that describes the records reviewed and the reason the documents were not retained and made part of the audit file. In all cases, the auditor should adequately document in their workpapers how audit conclusions were reached, either referencing the document copies found in the audit file or the alternative detailed narrative.

Retained documents will generally have comments, notes and tic marks that have been added by the auditor. There may be notations that name the document's source, describe the audit work done, and state the conclusions reached as a result of that work. Taxpayer-provided documents that were not used in the audit should be returned to the taxpayer and not retained in the audit file.

Whenever possible, the audit workpapers should include copies of documents that were relied on by the auditor in reaching conclusions about the credit(s) claimed by the taxpayer. This includes taxpayer-provided and auditor-prepared papers. Generally, JTC audit workpapers will have five or more sections. The following is an example of the sections and examples of corresponding documentation.

- Business Plan and General Information
  - Business plan
  - Tentative approval letter
- Qualified Business Enterprise (QBE)

- Document(s) used to verify QBE status.

**Examples include:**

- Page of federal income tax return that shows the NAICS code;
- Notes to financial statements; or
- Tennessee sales and use tax exemption certificate (e.g., industrial machinery)

- Required Capital Investment (RCI)

- Taxpayer-completed RCI template schedule or depreciation schedule.<sup>811</sup>
- Auditor copy of RCI template schedule or depreciation schedule that includes notations of audit work.
- Documents reviewed to verify accuracy of RCI list of purchases.

**Examples include:**

- Depreciation schedule;
- Invoices; or
- Lease agreement.

- Qualified Job/Position

- Taxpayer-completed Job/Position List schedule for at least 90 days prior to beginning of the investment period.
- Taxpayer-completed Job/Position List schedule for each year of investment period.
- Taxpayer-completed Job/Position List for 12 months after the end of the investment period.
- Auditor copies of each Job/Position List for each year of the investment period and for 12 months after the end of the investment period that include notations for audit work done to verify that jobs qualify for the credit.
- Documents reviewed to verify jobs listed met all attributes of a qualified job.

**Examples include:**



- Department of Labor and Workforce Development Premium and Wage Report;
  - Employee payroll file documents, payroll registers, or copies of Human Resources computer screenshots;
  - Employee benefits handbook for applicable year;
  - Health insurance invoice naming employee; or
  - Employee-signed form to opt out of insurance.
- JTC Reconciliation
    - Taxpayer-completed JTC Reconciliation schedule, listing the specific jobs by year for which the credit was claimed.
    - Auditor copy of JTC Reconciliation schedule with notations of audit work done, audit findings, and conclusions (including, if applicable, why any jobs were disallowed). Also, if applicable, additional audit work done in verifying additional annual credits for those positions verified for the standard credit.
  - JTC Carryover
    - Taxpayer-completed JTC Carryover schedule of credits previously established and available in the audit period.
    - Auditor copy of JTC Carryover schedule that reconciles audit and taxpayer numbers and explains any adjustments to the schedule.

**⚠ The JTC Reconciliation schedule, prepared by the taxpayer, lists the specific jobs/positions by year for which the credit was claimed. This is one of the first JTC schedules that auditors will want to review.**

## 2. Auditor's Authority to Request Additional Information

Qualification for the credit turns on whether or not the details encompassed in the definitions of "QBE," "required capital investment," "qualified job," and "investment period" have been met. Taxpayers should retain documents to substantiate these requirements.

The Commissioner of Revenue has the authority to conduct audits or require the filing of additional information necessary to substantiate or adjust the findings contained within the

business plan and to determine that the taxpayer has complied with all statutory requirements so as to be entitled to the credit.<sup>812</sup>

### 3. Audit Summary Report and Sample Language

The JTC section of the Audit Summary Report (“ASR”) is of great importance. It must fully describe the audit work done, documents reviewed, and the reasons for allowing or disallowing a credit. Every JTC audit is different, and the ASR should describe details unique to the audit.

In general, the ASR should:

- State the requirement (e.g., health insurance must be offered – give citation);
- State what information was reviewed to verify the requirement (e.g., payroll records) and source of the information - (e.g., taxpayer-provided, Labor/Workforce data);
- State what the auditor saw, what the auditor used to calculate from, and what source of information was used to reach the audit conclusion;
- State the conclusion (meets the requirement); and
- Include other information, such as an explanation as to why documents were not retained.

Each audit is unique and the language in the ASR will differ as a result, but auditors should complete the ASR while keeping in mind the five points listed above and provide details such as dates, document names, reference numbers, and detailed explanations of procedures performed. The following is an example of an ASR as it pertains to a job tax credit audit:

- Business Plan
  - *Tenn. Code Ann. § 67-4-2109(b)(1)(B) states a business plan should be filed. A Business Plan for the investment period 08/01/2016 – 12/31/2018 was received by the Department, tentatively approved, and issued control number 1234. Audit reviewed the Plan and found that the form was fully completed and free from obvious errors. The taxpayer stated on the plan that it is a manufacturer and that it intends to make a \$600,000 capital investment and create 20 new manufacturing jobs in Lyles, TN during the investment period.*

- Qualified Business Enterprise

- *Tenn. Code Ann. § 67-4-2109(b)(1)(A) states that only taxpayers that are QBEs may qualify for the credit and Tenn. Code Ann. § 67-4-2109(a)(5) includes manufacturing in the list of QBEs.* Audit reviewed the 2016-2018 federal corporate Forms 1120 and found that the North American Industry Classification System (NAICS) code of 337000 was reported on all returns. That code is used for furniture manufacturers. The Department's computer system shows that the taxpayer was issued an industrial machinery S&U exemption number of 12345. The taxpayer's financial statements for 2016-2018 were read, and Audit concluded that the taxpayer was engaged in only one type of business activity (manufacturing). Based on the above audit work, the auditor concludes that the taxpayer is a QBE-Manufacturer.

- Required Capital Investment

- *Tenn. Code Ann. § 67-4-2109(b)(1)(A) states that a required capital investment (RCI) must be made in order to qualify for the credit. Tenn. Code Ann. § 67-4-2109(a)(7) defines RCI as being an investment of at least \$500,000.* Audit received a list of the capital investments made during the investment period from the taxpayer that totaled \$510,000. Only three items were on the list. Audit verified the items listed as to ownership, date, description, amount, and location by tracing these attributes to invoices and to the 2017 depreciation schedule. The invoices (#123, 456, & 789) showed that manufacturing stamping machines were purchased on 1/3/2017 and shipped to Lyles, TN where the taxpayer's manufacturing facility is located. Based on Audit's review of the list, invoices and depreciation schedule, the auditor concludes that the minimum \$500,000 RCI was made during the investment period for the expansion of manufacturing activities in Lyles, TN.

- Tier

- *Tenn. Code Ann. § 67-4-2109(b)(1)(C) states that the minimum number of qualified jobs is dependent on the county location (Tier) of the business expansion that resulted in job creation.* Audit toured the plant in Lyles, TN during the audit. Audit reviewed the 2016-2018 federal tax returns (Form 1120) and the 2016-2018 detailed depreciation schedules. Audit found that the mailing address and physical location of the depreciable assets and

manufacturing plant was Lyles, TN. Audit reviewed the Economic and Community Development enhancement county map dated 7/26/2016, which covered the beginning of the investment period (8/1/2016) and concluded that the expansion that created new jobs was in a Tier 3 enhancement county. Lyles is in Hickman County. *Tenn. Code Ann. § 67-4-2109(b)(1)(C) requires a minimum of 20 qualified jobs be created in a Tier 3 enhancement county in order to qualify for the standard credit.*

- Qualified Job

- *Tenn. Code Ann. § 67-4-2109(a)(6) defines the attributes of a qualified job.* Generally, the job must be full-time (37.5 hours), be offered health insurance, have not existed in the state in the previous 90 days, and provide employment for 12 consecutive months.
- The taxpayer completed the JTC template schedules found on the Department's website. Audit obtained these schedules in an electronic format and saved them. Copies of the schedules were made for the purpose of documenting audit work done. The schedules included JTC Reconciliation, JTC List 90 Day Prior that covered the period 5/2/2016 - 7/31/2016, JTC Lists for the period 8/1/2016 - 12/31/2016, 2017, 2018, and JTC List 12 Months After for the period 1/1/2019-12/31/2019.
- Auditor obtained copies of the taxpayer's quarterly state unemployment reports (SUTA) for all quarters filed in 2016-2019, except for the first quarter filed in 2016. The taxpayer's name and FEIN on the SUTA reports were the same as those of the taxpayer as shown on the Business Plan. The wage totals reported on the templates mentioned above (90-day, Year End, and 12 Month) were tied to the SUTA reports without exception. Because the template lists tied to SUTA filings, Audit concluded that the electronic schedules (lists) provided by the taxpayer were complete for the dates indicated and for the taxpayer under audit.
- The templates (JTC Reconciliation, JTC List Year End 2017 and 2018) completed by the taxpayer reported that 12 jobs were created in 2017 and 3 jobs were created in 2018. These schedules identified the new JTC jobs by position number and employee name. Audit traced the employee names to the 2017 and 2018 SUTA quarterly returns for all quarters after their hire

dates, as reported on the template schedules (JTC List Year End 2017 or 2018). The employee wage amounts reported on the SUTA filings were similar for all quarters after the first quarter and were reconciled to the amounts reported on the templates. Audit concluded that the JTC-employees were in continuous employment after their initial hire dates and that wage data in the templates was consistent with the respective SUTA filings.

- 2016-2018 financial statements and footnotes prepared by an independent accountant were obtained from the taxpayer and read. There was no indication that an affiliated entity existed or that payroll costs were being reimbursed by another entity; so, Audit concluded that the taxpayer was the common law employer of the workers reported on the position lists.
- *Tenn. Code Ann. § 67-4-2109(a)(6)(B) requires that qualified positions must be new to the state.* Audit searched the financial statement footnotes for evidence of a sale, reorganization or other information that might indicate that the claimed jobs had existed in the state as positions of another business prior to being established by the taxpayer. Audit did not find anything that would suggest that there was a sale or reorganization and that the claimed positions existed in the state as positions of another entity prior to being filled by the taxpayer. Also, Audit reviewed the JTC List for the period ended December 31, 2016, to see if any of the 12 jobs claimed in 2017 as new positions were on that list, and none were found. Audit concluded that the positions for which JTC is claimed had not existed in the state as positions of the taxpayer or another business entity for the 90-day period prior to being filled by the taxpayer.
- *Tenn. Code Ann. § 67-4-2109(a)(6)(A)(i) states that a qualified job must work for at least 37.5 hours per week.* Audit added columns to the JTC Lists for the Years Ended December 31, 2017, and 2018, and calculated the number of hours worked per week by employees for which the credit is being claimed. In part, the calculation involved the division of gross pay by the pay rate to determine the number of hours worked. In all cases, the taxpayer's assertion that the positions were full-time was verified by the audit calculation.

- *Tenn. Code Ann. § 67-4-2109(a)(6)(A)(i) states that a qualified job must be a job that is offered (or receives) employer provided health care.* Audit obtained the employee handbooks (2017 and 2018) from the taxpayer and found on page 25 that all employees working over 30 hours per week are offered health insurance. In addition, Audit reviewed the final 2017 and 2018 payroll registers and found that the employees in positions for which the JTC is claimed had insurance deducted from their pay. Based on review of the employee handbooks and payroll registers, Audit concludes that the JTC positions were offered health insurance.
- *Tenn. Code Ann. § 67-4-2109(a)(4) states that a qualified job must be created as a result of the RCI.* The JTC positions highlighted on the JTC Lists for the Years Ended December 31, 2017, and 2018, were indicated as being located in Lyles, TN. All of these positions had position titles of “stamping machine operator.” Audit reviewed the JTC Lists for the period ended December 31, 2016, and found no stamping machine operators on that list. This job title was first used after the RCI was made on 1/3/2017. Audit reviewed the 2016 and 2017 depreciation schedules and found that all stamping machines were purchased after 1/1/2017. Audit concluded the positions claiming JTC were created as a result of the RCI.
- *Tenn. Code Ann. § 67-4-2109(a)(6)(A)(i) states that a qualified job must provide employment for at least 12 consecutive months.* Audit reviewed the taxpayer provided schedule JTC List 12 Months After for the period 1/1/2019-12/31/2019. All positions for which the credit is claimed in 2017 and 2018 were found on this 2019 schedule, and the data for each position was materially the same as reported in earlier years. All positions remained full-time status, were offered health insurance, and held the same position title and location. Audit concluded that because all 2017 and 2018 new JTC positions remained filled throughout the investment period, the “net” calculation per Tenn. Code Ann. § 67-4-2109(b)(1)(C) was not applicable.

## Audit Procedures

This section discusses general audit procedures that taxpayers should expect to be performed in most JTC audits. The earlier section on *Audit Documentation* discusses the importance of retaining documents that were relied on in the audit process. This section primarily discusses procedures for the standard JTC credit entailing non-tourism jobs.<sup>813</sup>

## 1. Preliminary Audit Research

The auditor should preliminarily review the JTC Business Plan and Schedules X because these items will be the primary focus of the audit. With this information, the auditor may customize audit procedures to test the requirements of the specific types of credits claimed and to allocate more time to potentially troublesome areas and less time to other areas.

In addition to reviewing Schedule X, auditors will often review Schedules G and N to gain a limited, preliminary knowledge about the level of capital investment and employment within the state. Schedules G and N may show that the value of tangible property and employment in the state increased, however additional audit work is needed to verify that the increase was *related to the expansion detailed in the JTC Business Plan*. For example, Schedule G may increase by \$601,000 from one tax year to the next, but this increase may not necessarily be related to the increase in qualified jobs as a result of the taxpayer's capital investment. Similarly, the payroll reported on Schedule N may increase, but the additional expense may not be for qualified jobs that increased as a result of the taxpayer's capital investment.

If possible, any "best interest of the state" provisions should be noted in the preliminary stages of the audit so that audit procedures may be modified, including obtaining the Department's record reflecting the Commissioners' authorizations.

## 2. Business Plan Review

Verify that the taxpayer filed a JTC Business Plan that was tentatively approved by the Department. These documents can be found in the Department's computer system. Consider whether the representations made in the Business Plan appear to be correct. Even though the Plan was *tentatively* approved, it is the responsibility of the auditor to verify whether this determination was correct. The auditor may:

- Note which "enterprise type" box the taxpayer checked on the Business Plan and make a preliminary conclusion as to its accuracy.
- Note the "effective date" of the Business Plan. This date is the "beginning of the investment period" and is referred to in many audit procedures.

**⚠ The enhancement county tier designation (1, 2, 3, or 4) is determined as of the *beginning of the investment period*. This designation will apply to the *entire investment period*, even if it changes during the investment period.**

- Note the taxpayer name on the Plan. Taxpayers are sometimes confused as to whether the taxpayer or an affiliate should be awarded the credit. Consider whether this might be an issue when planning the audit.

### 3. Identifying the Common Law Employer

Preliminary audit work includes verifying that the taxpayer under audit is the common law employer. A taxpayer may be the common law employer of workers that receive their Forms W-2 from an employment agency. In this case, the workers would not be included in the taxpayer's State Unemployment Tax Act (SUTA) report, but the labor expense would be reflected in the taxpayer's general ledger and trial balance. Auditors may review the taxpayer's records to identify these types of arrangements. If payments to an employment agency are noted, the related legal agreement should be requested and reviewed in determining the common law employer.

Furthermore, auditors may determine if the taxpayer has W-2 employees being controlled and utilized by others. The auditor's review of financial records may show that the taxpayer is being reimbursed for payroll costs. These reimbursements may indicate that the taxpayer is not the common law employer. Again, legal agreements should be reviewed in determining the common law employer that is entitled to claim the workers for purposes of the payroll factor and the job tax credit.

Many audit procedures assume that the taxpayer is the common law employer that issues the W-2s. However, if the taxpayer is the common law employer, but *not* issuing the W-2s, the auditor will need to modify JTC audit procedures related to the Tennessee Premium and Wage Report (SUTA).

### 4. Qualified Business Enterprise

Auditors must verify that the taxpayer is a QBE. This can be done in various ways. For example, verification may be made by noting the business activity code on the federal income tax return or noting the business activity disclosed in financial statement footnotes.

If the taxpayer has business locations or departments that do not meet the definition of a QBE, auditors may consider modifying audit procedures. Only the new jobs associated with departments or divisions that are QBEs should be considered for the JTC. For example, a taxpayer may have a national headquarters facility and retail stores. The headquarters facility



would constitute a QBE and headquarters staff employees would qualify for the credit, but retail employees would not.

## 5. Required Capital Investment

Audit work concerning the required capital investment should generally be done *after* verifying that the taxpayer is a QBE with a tentatively approved Business Plan and is the common law employer.

**The audit objective** concerning the required capital investment is to verify that the taxpayer has made the required capital investment within the investment period<sup>814</sup> necessary to permit the creation or expansion of manufacturing, warehousing and distribution, or other QBEs. The investment must be at least \$500,000<sup>815</sup> in real property, tangible personal property, or computer software owned or leased in this state, valued in accordance with GAAP. The new jobs count should not be tested *until* the minimum required capital investment is verified. Not every capital investment needs to be verified; only the first \$500,000 (\$10 million, if a convention or trade show enterprise).

- An explanation of how the investment caused business expansion, resulting in new jobs, should be made in the audit workpapers. Audit work to verify job increases should not be done *until* this explanation is documented.

**⚠ Only positions newly created as a result of the required capital investment are eligible for the JTC.**

- Calculation of the amount of the required capital investment includes the historical cost (or other GAAP required basis) of capital assets purchased plus values for equipment leased under a finance or operating lease, as valued in accordance with GAAP. The acquired property must be located within the state and may be real property, tangible property, or computer software.
  - Taxpayers are encouraged to complete the **List of Required Capital Investment** template available on the Department's [website](#).<sup>816</sup> This template includes all of the information detailed on the RD sheet. The taxpayer may choose to stop listing its capital asset purchases/leases for the investment period after the minimum required capital investment threshold is met. The list may include finance or operating leases. If monthly operating lease expenses are included in the required capital investment, the auditor

may need to obtain copies of the operating leases to verify their relationship to the expansion that resulted in job creation.

- To verify the accuracy of the required capital investment list, auditors may request GAAP depreciation schedules, sorted by location (state) and general ledger account. Consider tracing the schedule's cost totals to the trial balance or federal Schedule L balance sheet to confirm the schedule's accuracy and that the capital investment was made by the audited taxpayer and not by an affiliate.<sup>817</sup> Consider tracing up to \$500,000<sup>818</sup> of depreciable items, per the required capital investment list, to the depreciation schedule and agree all data fields (description, acquisition date, Tennessee location, cost amount).
- An additional step would be to trace some of the listed purchases to the original invoice. This may help to verify the accuracy of the description, acquisition date, Tennessee location, and amount reported on the required capital investment list. Also, information on the invoice may help to determine the asset's connection with the creation or expansion of the QBE.

### *Finance Leases*

Finance leases are included in the required capital investment **and valued at the same amount capitalized on the taxpayer's books**. This is true *even* if some of the lease payments are made *after* the end of the investment period. Conversely, lease payments made *during* the investment period for leases entered into *before* the investment period are not part of the required capital investment.

### *Operating Leases*

Operating leases are shown on the balance sheet,<sup>819</sup> except for leases with a term of 12 months or less and leases of property with a value of less than \$5,000. The balance sheet presentation alerts the auditor that operating leases exist, but the amounts shown are generally not the required capital investment amount.

**The actual lease payments posted to an income statement account during the investment period, for a lease that began during the investment period, are counted for the required capital investment, even if the lease extends beyond the investment period. For example:**

- On the first day of the three-year investment period, a taxpayer enters into a 60-month building lease that is properly treated as an operating lease under GAAP. The 36 payments that are made during the investment period are part of the required capital investment, and the 24 payments made after the end of the investment period are not part of the required capital investment.

If monthly operating lease expenses are included in the required capital investment list, the auditor may request copies of the lease documents to verify expense amounts and to determine the leased asset's relationship to the creation of new qualified jobs.

### *Items Not Counted Towards Required Capital Investment*

Auditors should **exclude** the following items from the required capital investment list:

- Capital investments not related to the QBE business expansion
  - Consider whether the required capital investment list includes capital investments for activities outside the scope of the QBE. (Ex: QBE had some divisions that did not do QBE activities.)
- Capital investments that did not result in the creation of new qualified jobs
  - Determine how the capital investment resulted in the creation of qualified jobs. Generally, job and asset location is one indicator. Also, exclude the investment if it benefited *existing* positions and was not the impetus for the creation of *new* positions.
- Capital investments made outside of the investment period
  - Note the start and end date of the investment period and identify any items in the required capital investment list that were made after the end date or before the start date.<sup>820</sup> Also, if any leases (either finance or operating) are included in the capital investment, ensure that only payment for leases entered into during the investment period are included in the list.<sup>821</sup>

## 6. Position Increase

This audit objective is to verify the increase in qualified jobs in the first year of the investment period and the “net increase” in qualified jobs in subsequent years within the investment period. See the earlier section on *Net Increase in Qualified Jobs during the Investment Period* for an explanation of how the net increase amount is determined. The taxpayer’s total number of positions in the state does not need to increase. However, the qualified positions *related to the required capital investment* do need to increase. “Net increase” means that previous years’ qualified jobs that end during the investment period must offset any subsequent years’ qualified jobs created, and the credit is only awarded when net increases occur above the level of employment established when the credit was last taken. Auditors must verify that jobs ending or no longer meeting the requirements of a qualified job are considered in arriving at a subsequent year’s *net increase* in qualified jobs.

### *Obtain schedules/lists from the taxpayer*

To verify the increase in qualified positions related to the required capital investment, several electronic position listings should be obtained from the taxpayer.<sup>822</sup>

- The Recommended Documentation sheet identifies the following lists:
  - Tennessee positions existing 90 days<sup>823</sup> before the investment period began;
  - Tennessee positions for each fiscal year in the investment period; and
  - Tennessee positions for the first year<sup>824</sup> following the investment period.

There will generally be a total of five lists. **Taxpayers should highlight or otherwise identify the positions for which the job tax credit is being claimed on these schedules.** There are templates for these lists/schedules on the Department’s [website](#) that taxpayers are encouraged to use. In addition, there is a template called *JTC Reconciliation*<sup>825</sup> in which the taxpayer may list the qualified jobs claimed each year. The audit copy of this schedule is used to show the jobs allowed or disallowed by Audit and the reason(s) why. Most of the audit work is done on other schedules and may then summarized on the JTC Reconciliation.

**⚠ Audit work done to verify position increases may be suspended until the taxpayer identifies the specific positions for which they are claiming the job tax credit.**

### *State Unemployment Tax Act (SUTA) reports*

Auditors may compare the JTC position lists provided by the taxpayer with the taxpayer's SUTA filings to gain assurance that the positions lists are complete and applicable to the taxpayer under audit. The employer's name and FEIN should be the same for the SUTA reports and JTC position lists. The annual wages reported on the JTC List Year End schedule and the quarterly wages reported on the SUTA filings may be reconciled.

The JTC position lists provided by the taxpayer gain legitimacy when they can be tied to SUTA filings. This audit procedure provides assurance that the lists are accurate and complete and that they reflect true Tennessee positions/employees of the taxpayer for the time period indicated. This audit step helps to show that the taxpayer-provided list contains positions that are the taxpayer's and not those of an affiliate, that the positions are not filled by contract laborers, and that the list has not omitted positions so as to claim them later on as new positions.

Employee names associated with the credit may be traced to SUTA filings to confirm that the employee was subject to Tennessee unemployment tax for the period covered by the filing. However, auditors should **not** rely too heavily on the limited information provided on SUTA reports, because they:

- Include part-time employees;
- Several employees listed could have filled one position;
- A large increase in total wages could be the result of large bonuses to a few people, rather than new full-time positions;
- The SUTA report filer may not be the common law employer; and
- Certain attributes of a qualified job are not found in the SUTA report (positions offered health insurance, positions result from RCI, and tier location of positions).

### *Gain an understanding of how the required capital investment created new jobs*

The JTC Business Plan describes the planned investment and job creation in a few sentences, but the audit workpapers may include a more detailed narrative. Auditors will need to understand how new qualified jobs are tied to the capital investment that created them and then customize

audit procedures accordingly. Each taxpayer and JTC audit will have a unique set of facts. Most new positions will have a common element, such as being associated with a new plant or a machine at a certain location. For example:

- If the investment is located at a unique address, the qualified jobs will generally be at that address.
- Once this association is noted, audit procedures may be customized to verify that only position increases at that location are allowed, unless additional information is received. For example:
  - A new accounting position may qualify for the credit even though it is not located near the required capital investment and is only indirectly related to the required capital investment. The new accounting position qualifies because it was created as a result of the required capital investment.

The auditor's template JTC List Year End schedule has a column "RCI" that the auditor may use to indicate that this attribute (job creation was a result of the required capital investment) was tested. Depreciation records, financial statements, and invoices may document the location of the required capital investment.

#### *Position is newly created in this state (90-day rule)*

The position must be newly created in this state during the investment period and after the RCI is made. It cannot have existed anywhere in this state as a job/position of the taxpayer or of another business entity for at least 90 days<sup>826</sup> prior to being filled by the taxpayer.<sup>827</sup> Both the RD list and [website](#) templates recommend that the taxpayer provide a list of positions that existed during the 90-day period *prior* to the beginning of the investment period. Positions for which the job tax credit is claimed generally should not be found on the template "JTC List 90 Days Prior."

For example:

- An investment period begins April 1.
- The JTC 90 Days Prior list is provided for January 1 – March 31<sup>st</sup>.

- A position created/filled on June 10 is listed as a position on JTC List 90 Days Prior as of March 15.
- Because the number of days between these dates is 87 (under 90) the position filled on June 10 does not qualify for the credit.

Auditors may review financial statement footnotes and consider whether the taxpayer was involved in an acquisition/merger, spinoff, or other restructuring. Based on their findings, auditors may develop audit procedures to demonstrate that the new positions claimed were (or were not) positions previously filled by the taxpayer or by another entity.

Positions of the taxpayer or an employment agency that existed during the 90-day period prior to the start of the investment period as temporary positions, part-time positions, or positions without benefits are not qualified jobs if they subsequently become full-time positions with benefits, because they previously existed as a position in the state during the 90-day period before the beginning of the investment period.<sup>828</sup>

### *Full-time position*

Qualified positions must generally be full-time positions (37.5 hours per week).<sup>829</sup> Audit verification may be done in a number of ways. Auditors may calculate the average hours per week by dividing gross wages by the wage rate to determine the total number of hours worked for the time period covered by the JTC position lists. Alternatively, auditors may review detailed payroll records and printouts to verify the number of hours worked.

It is not necessary for the employee to work 37.5 hours *every* week during the year, as long as the *average* number of hours worked/paid per week is at least 37.5 hours. However, workers that *consistently* work less than 37.5 hours per week *do not* qualify for the credit.

Taxpayers may erroneously claim that a position is full-time when the required number of hours falls short to meet the statutory definition<sup>830</sup> of “full-time.” For example, shift workers may work three 12-hour shifts per week, for a total of 36 hours. These employees would not be considered full-time employees, even if they are paid for 40 hours.

Full-time, salaried employees may not maintain a record of the hours they work. In this case, it may be assumed that they worked 37.5 hours, unless there is sufficient evidence to the contrary.

### *Permanent positions providing employment for 12 consecutive months*

A qualified job is one that provides 12 consecutive months of employment. During this time period, the attributes of 1) a full-time position (37.5 hours per week) and 2) that is offered/receives health insurance, must continue to be met. To verify that this requirement was met, an auditor may:

- Note the position creation date and the hire and termination dates of employees associated with a JTC position, as shown on the JTC lists provided by the taxpayer.
- Test the accuracy of the dates reported on the lists - **possible procedures**:
  - Review the payroll register or similar records that show payroll data for the JTC-associated employee(s) that includes details as to the number of hours worked and days of employment;
  - Trace JTC-associated employee(s) to quarterly SUTA reports and note the total wage amounts. Consider whether the wage amounts support that the employee(s) were full time employees for the entire quarter;
  - Review the employee payroll file and note key dates and wage rates. This information may substantiate representations made on the JTC lists.
    - For example, one may compute the number of hours worked/paid during a year for an employee. Divide the total wages per the JTC list or SUTA report by the wage rate to arrive at the number of hours worked. Note that 1,950 hours are worked annually if 37.5 hours are worked each week of a 52-week year. Modify this calculation to consider the position start date and the 12-month-out-date.
  - Determine the number of days that a position was vacant before being refilled. This must be 90 days or less to be a qualified job.

Taxpayers do not have to wait 12 months before claiming a job tax credit for a position that, with the exception of the 12-month requirement, otherwise meets all the other requirements of a qualified job. If it later turns out that the job does not last 12 months, the taxpayer should amend the return on which it took the credit and reduce the credit accordingly.



### *Position is offered or receives employer provided health insurance*

A qualified job is one in which the employee was offered or receives employer provided health insurance.<sup>831</sup> The taxpayer provided JTC lists should indicate whether health insurance was offered/received by each position for which the credit is claimed. To test this assertion, auditors may:

- Obtain the applicable employee handbook and note the employer's policy as to the offering of health insurance.
- Review detailed payroll registers and note any deductions for company-provided health insurance for JTC-associated employees.
- Obtain the employer's detailed health insurance invoice and trace JTC-associated employees to it.
- Obtain employee-signed documents indicating their choice to opt out of the company-provided health insurance.

Auditors may document audit work done with tic marks on the audit copies of JTC List Year End schedules.

### *JTC audits in which position numbers are not maintained/provided by the taxpayer*

Some taxpayers do not use position numbers. Their JTC lists will show employee names only. Because multiple employees may hold one position, the auditor's task of testing the net increase in qualified positions may be more difficult. A taxpayer's failure to provide position numbers does not invalidate the credit. However, the taxpayer must *still* demonstrate that it has met all of the requirements to claim the credit. Taxpayers will need to group together all employees that held a unique position, and the auditor will need to test each employee for employee-specific attributes such as working 37.5 hours per week.

## **7. JTC Credit Carryover**

Tax assessments may not be made in tax years that are no longer open under the statute of limitations, but adjustments *can* be made to the credit carryover tables for such tax years and the correct credit carryforward may be applied to tax years that *are* open under the statute of

limitations. Attached to [Schedule X](#) is a Job Tax Credit Carryover schedule that taxpayers should complete to keep track of their job tax credit carryovers. The auditor will review the taxpayer's JTC carryover schedule and may note in the ASR the agreement or any differences between the taxpayer and auditor-prepared carryover schedules.

## 8. Tier Minimums – Job Creation

Prior to July 1, 2016, the minimum number of qualified jobs that was required to be created was 25, regardless of their enhancement county location. Subsequent to July 1, 2016, the minimum number of jobs required to be created in a Tier 3 and Tier 4 enhancement county is 20 and 10, respectively.<sup>832</sup>

Auditors should:

- Verify the location(s) of the qualified jobs.
  - The RD asks taxpayers to provide the exact location of the position, including the county. The JTC lists/templates available on the Department's [website](#) request this information as well. Auditor verification of the location of new positions can be done in numerous ways. For example, the position's duties (e.g., running a certain machine) or its supervisor's location might help establish the position's location.
- Based on the physical location of the new positions, auditors should determine the enhancement county, or counties, as of the date of the beginning of the investment period. Enhancement county maps are issued every July 1, and tier designations may change between years. However, the map in effect at the beginning of the investment period, as stated in the business plan, is the map that should be used.
  - Certain new adventure tourism positions located in an adventure tourism district should be counted as one-half of one position when determining whether a tier minimum has been met (do not round position numbers up).

## 9. Additional Annual Credits

Audit procedures regarding any additional annual credits should be performed *after* the auditor has determined the positions that qualify for the standard credit. Additional annual credit audit procedures may be documented in the JTC Reconciliation worksheet. Columns may be added to this electronic schedule for each attribute tested. Tic marks can reference audit work done and audit findings.

## Chapter 17: Real Estate Investment Trusts

### What is a Real Estate Investment Trust?

Real Estate Investment Trusts (“REIT”) own or finance income-producing real estate and are similar to mutual funds. They are tied to almost all aspects of the economy and allow small investors to own a share in large-scale properties through the purchase of stock. REITs are used in connection with owning and financing commercial properties, such as hotels, hospitals, industrial facilities, storage centers, shopping centers, warehouses, apartment complexes, office buildings and timberlands.

The two main types of REITS are Equity REITs and Mortgage REITs.<sup>833</sup>

- An Equity REIT generates income from the rental of property and gains when the real estate is sold for a profit.
- A Mortgage REIT invests in mortgages or mortgage securities tied to properties and its primary source of gross receipts is derived from interest and fees.

REITs have a federal income tax advantage. Most corporations must pay taxes on their profits and then decide how much to reinvest in the company and how much, if any, to return to shareholders in the form of dividends. Therefore, any dividends paid to the shareholders are taxed at both the corporate and shareholder level. However, REITs are allowed to deduct dividends paid in arriving at their net income subject to tax. To the extent a REIT pays its profits out in dividends, it will not owe corporate income tax. The dividends paid deduction (DPD) allows REITS to avoid duplicate taxation. Assuming all of the REIT’s profit is paid out in dividends, only the shareholders receiving dividends are taxed.

REITS also have a Tennessee excise tax advantage. The starting point in computing net earnings subject to excise tax is the REIT’s federal taxable income before the net operating loss deduction and Section 857 deductions but *after* the deduction for dividends paid. If a REIT pays out all of its profit in dividends, it will not owe federal income or state excise tax.

Some REITs are traded on major stock exchanges. Others are private or public non-listed. The website <https://www.reit.com> is a good source of information and has a directory of public and private REITS.

## REIT Requirements

Federal tax law established REITs. REITs file Form 1120-REIT for federal income tax purposes. To qualify as a REIT, per IRC Section 856(c)(1), the entity:

- Must be a corporation, trust, or association.
- Would otherwise be taxed as a domestic corporation.
- Must not be a financial institution (referred to in section 582(c)(2)) or a “subchapter L insurance company.”
- Must adopt a calendar tax year.
- Must be managed by one or more trustees or directors.
- Must have beneficial ownership (a) evidenced by transferable shares, or by transferable certificates of beneficial interest; and (b) held by 100 or more persons. (The REIT does not have to meet this requirement until its 2nd tax year).
- Must derive 95% of its income from dividends, interest, and property income.
- Must derive 75% of its income from rent and mortgage interest.
- Must have 75% of its assets in real estate.
- Generally, the deduction for dividends paid (excluding net capital gain dividends, if any) must equal or exceed 90% of the REIT’s taxable income (excluding the deduction for dividends paid and any net capital gain).

Note that there is a requirement for REITs to pay out dividends. To qualify as a REIT, an entity must pay out at least 90% of its profits to investors as dividends. The dividends paid are deducted on Form 1120-REIT, Line 21b.

Also, note that a REIT’s sources of income are predominately passive investments in real estate. A REIT cannot offer a complete range of services, like housekeeping or janitorial services, to its tenants without jeopardizing its status as a REIT. However, these services can be offered by a taxable REIT subsidiary (“TRS”), as discussed in the next section.

## REIT Structure

REITs are often part of a large organizational structure. They rarely operate alone as a single entity. The types of entities that may be included in the organizational group include “qualified REIT subsidiaries” (“QRS”) and “taxable REIT subsidiaries” (“TRS”), in addition to lower tier LPs and LLCs.

### 1. Qualified REIT Subsidiary

A QRS is a corporation that is wholly-owned by a REIT but is not itself a REIT. Generally, it is a holding company that does not have operations of its own. It is disregarded for federal income tax purposes and files with its parent on Form 1120-REIT. It is *not* disregarded for franchise and excise tax purposes.

### 2. Taxable REIT Subsidiary

A TRS is a corporation wholly-owned by a REIT, but it is *not* disregarded for federal income tax purposes. The TRS and the REIT owner jointly make an election on federal Form 8875<sup>834</sup> to treat the subsidiary as a separate taxable entity. A TRS files its own Form 1120 (not Form 1120-REIT). They are operating companies that provide services to tenants or third parties such as housekeeping, landscaping, cleaning or concierge services.

### 3. Lower-tier LPs and LLCs

Lower-tier LPs and LLCs are often the entities that own the real property and conduct business operations. Numerous pass-through entities may be created so each entity holds a single piece of real estate. This is done for legal protection, loan restrictions, and to allow for different ownership groups. The pass-through entities may be entirely owned within the REIT group or may have some owners outside of the REIT group.

## REIT Types

Franchise and excise tax auditors may audit taxpayers within the REIT structure without initially realizing they are directly/indirectly owned by a REIT. When auditing a REIT or a REIT-owned entity, the auditor should first determine the type of REIT at issue.

There are three types of REITs under franchise and excise tax law that can result in different tax treatments:

- Public REIT;
- Private REIT; and
- Captive REIT.

### **1. Publicly-Traded REIT**

A “publicly traded REIT” is defined<sup>835</sup> as one that has made the REIT election with the IRS, files with the “securities and exchange commission” (SEC), and its shares are traded on a securities exchange that is either registered as a national securities exchange with the SEC or is a national securities exchange of a foreign country and regulated in a substantially similar manner by a foreign financial regulatory authority.

Some REITs may appear to meet this definition but fail to do so because they are traded on an over-the-counter (OTC) exchange or a private exchange.<sup>836</sup> Also, just because they file documents with the SEC does not mean they meet the definition; they could be filing in hopes of being listed in the future. An auditor may confirm if a REIT’s stock is publicly-traded on a national exchange by going to <https://www.reit.com/investor/explore> and then entering the name of the REIT. A page will name the exchange and where it is traded, if applicable. Generally, publicly traded REITs are traded on the NYSE.

### **2. Private REIT**

Private REITs are not traded on national stock exchanges and are exempt from SEC registration requirements. These types of REITs generally only sell to accredited investors under Regulation D (under the Securities Act of 1933) or to Institutional Investors.

### **3. Captive REIT**

A “captive REIT”<sup>837</sup> is an entity that made the REIT election and is at least 80% owned, directly or indirectly (determined in accordance with GAAP), by another entity and whose shares are not traded on a national stock exchange.

### **4. Captive REIT Affiliated Group**

A “captive REIT affiliated group”<sup>838</sup> (“CRAG”) is a captive REIT plus any entity in which the captive REIT, directly or indirectly, has more than 50% ownership interest. However, a CRAG does not exist if the captive REIT is owned, directly or indirectly, by a bank, a bank holding company, or a public REIT. Generally, a Captive REIT is closely held within, and by, an affiliated group, but note that the law excludes bank-related REITs from being classified as a CRAG.

Captive REITs historically used the DPD in order to mitigate taxation as a state-level tax planning strategy. A Captive REIT would own a partnership or LLC that had business operations. The lower-tier partnership or LLC would incur operating expenses, so they usually had little net income, and the Captive REITs had no taxable income due to the DPD.

However, beginning July 1, 2010, ***the DPD effectively is no longer available for a Captive REIT, unless it is owned, directly or indirectly, by a bank, a bank holding company, or a public REIT.*** While the Captive REIT group can deduct the DPD to compute its federal taxable income on Schedule J4, Line 2b, it must add it back on Schedule J, Line 14, thus negating the DPD deduction. Because of this, the Captive REIT group may incur an excise tax.<sup>839</sup>

## 5. Chart of REIT Types and F&E Implications

The first step in auditing a REIT or REIT-owned affiliate is to determine if the REIT is public, private, or captive. This is important for the reasons shown in the following chart.

Type	REIT Attribute		Owned Pass-Thru
Public REIT	Receive DPD	File FAE170	LPs, LLCs owned by a public REIT adjust Sch. J1 by amounts included on the K-1 they issue to the REIT
Private REIT	Receive DPD	File FAE170	LPs, LLCs owned by a non-public REIT do not adjust Sch. J1 for amounts the LP, LLC distributes to a non-public REIT via a K-1
Captive REIT (by definition, are non-public)	No DPD Sch. J4 allows the DPD, but it is added back on Sch. J; so, net is -0-	File FAE174 combined with the CRAG affiliates	LP, LLC, QRS, TRS > 50%-owned are combined on FAE174 return. The J1 line "distributed to a <u>public</u> REIT" would not apply.
Captive REIT owned by a bank <sup>840</sup>	Receives DPD. The add-back of DPD on Sch. J is not made.	Files like any other subsidiary of an FI on FAE174. This is <u>not</u> a CRAG. <sup>841</sup>	LPs, LLCs are included in FAE174 if they meet definition of FI at TCA 67-4-2004
Captive REIT owned by a public REIT	Receives DPD	This is <u>not</u> a (CRAG) because the owner is a <u>public</u> REIT. Files on FAE174 because it is a Captive REIT, but not combined with lower tiers.	LPs, LLCs are not included in the FAE174, since this is not a CRAG

## REIT Audit

The rules discussed in earlier chapters concerning disregarded entities, substantial nexus, separate entity reporting, and Schedule J add-backs and deductions generally apply to REITs, their subsidiaries, and lower-tier entities.<sup>842</sup> The following paragraphs will discuss only franchise and excise tax issues and audit tips that are unique to REITs and their affiliates, including the combined filing requirement for captive REIT affiliated groups and conclusions reached in



[Revenue Ruling 13-22](#), concerning an LP owned by a public REIT that is federally disregarded and files on the REIT's return.

It is possible to audit an LLC or LP and not be aware that it is directly or indirectly owned, to some extent, by a REIT. So, an initial step in any audit is to obtain an expanded organization chart that would show any REIT ownership. If there is a REIT in the organizational tree, the auditor must determine if it is a public, private, or captive REIT, as defined earlier.

## 1. REIT

All REITs are corporations.<sup>843</sup> REITs file on Form 1120-REIT and deduct the amount they pay in dividends in determining their federal and state taxable income. The DPD may only be taken by the corporation that has made the federal REIT election under I.R.C. § 856(c)(1). The deduction is not allowed for anyone other than the actual REIT that made the IRS election.

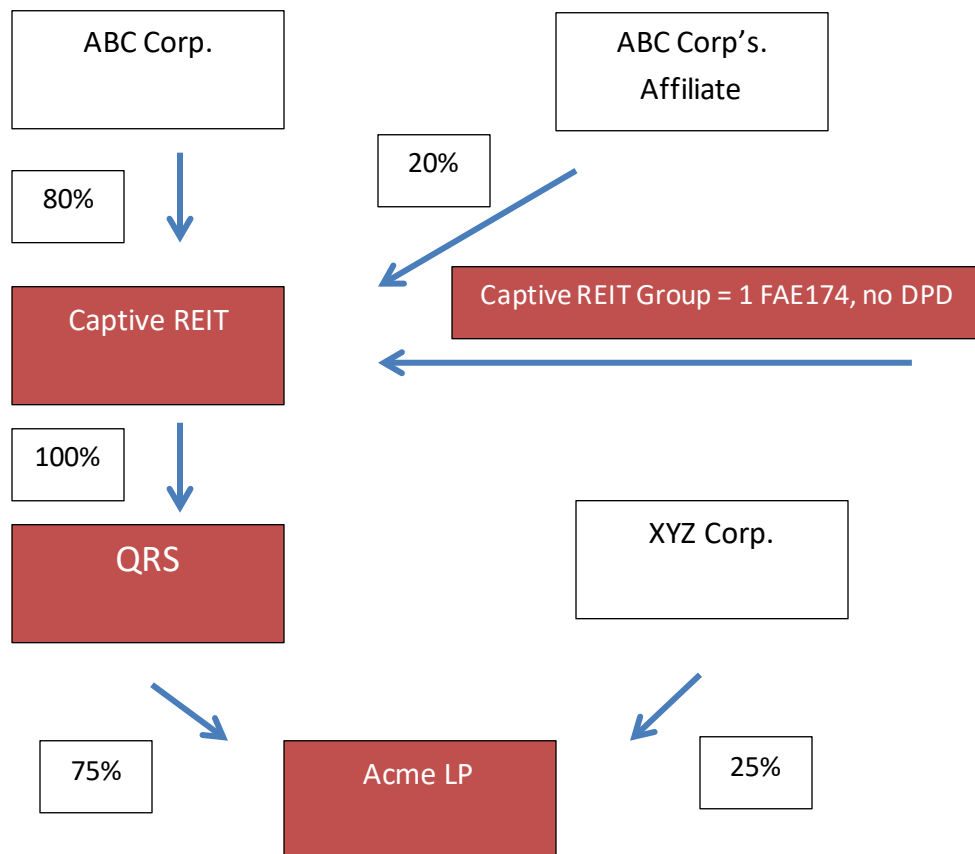
Often, the REIT itself is not subject to franchise and excise tax because its only connection with the state is its ownership interest in lower-tier entities that are “doing business” in the state. This ownership of limited liability affiliates would not create nexus for the REIT. However, even if the REIT has nexus in Tennessee, it will generally report little or no taxable income because of the DPD. Also, the franchise tax base generally would not reflect the book value of real estate because it is usually owned by lower-tier entities. In addition, the net worth amount would be diminished because of the required dividend payments (90% of income).

### *Audit Tips*

- Request an organization chart and determine if the 80% ownership test of a captive REIT has been met. See the next section if the REIT is a Captive REIT.
- Identify the REIT's direct and indirect affiliates. Consider if the lower-tier entities should be recommended for audit.
- If applicable, ask for a pro forma federal return that does not include any QRSS, since they are always required to be included in the federal Form 1120-REIT.
- Schedule J4, Line 2a is from Form 1120-REIT, page 1, Line 20 – “Taxable income before DPD and other deductions.” Schedule J4, Line 2b is from Form 1120-REIT, page 1, Line 21b – “Deduction for dividends paid.” REITs are unique in that they are allowed to deduct dividends paid.
- SMLLCs owned 100% by a REIT are disregarded since a REIT is a corporation.<sup>844</sup>

## 2. Captive REIT

A CRAG is an exception to the general franchise and excise tax rule concerning separate entity reporting. A CRAG files on a combined basis on Form FAE174.<sup>845</sup> Below is an organization chart of a captive REIT. Since the REIT is owned at least 80% by another entity, it is a captive REIT. The group includes the captive REIT and all entities in which the captive REIT has a direct/indirect ownership interest of more than 50%. The captive REIT, QRS, and Acme LP would report their activities on a single Form FAE174. Schedule J4 would reflect the combined net income of the group and would include the DPD. However, the DPD add-back on Schedule J will negate the deduction.



The CRAG's taxable net earnings are the combined net earnings/losses for all members of the affiliated group (all dividends, receipts, and expenses resulting from transactions between

members of the affiliated group are excluded), subject to the Schedule J add-backs/deductions,<sup>846</sup> even if some of the members would not be subject to the excise tax if they were not part of the affiliated group.<sup>847</sup>

The net earnings of the CRAG are apportioned to Tennessee based on the standard 3-factor formula<sup>848</sup> (dividends, receipts, and expenses between members of the group are excluded). The factors include values for group members that would not be subject to the tax, had they not been designated as CRAG members. The apportionment ratio is calculated on Form FAE174, Schedule N – Apportionment – Captive REITS.<sup>849</sup>

### *Audit Tips – Captive REIT and CRAG*

- Obtain an organization chart and determine if there is a captive REIT present.
  - IRS REIT election was made
  - 80% or more of REIT is owned by another entity that is not an FI or public REIT
  - REIT is *not* publicly traded
- Determine if the captive REIT is owned directly/indirectly by a bank, bank holding company or a public REIT. If this is the case, a CRAG does not exist. See chart above for filing requirement.
- Determine that the correct affiliates are combined on Form FAE174. (REIT has a direct/indirect ownership >50%).
- Verify that the group's combined net income, net of the DPD, is reported on Schedule J4 of Form FAE174.
- Verify that the DPD is added back on Form FAE174, Schedule J, negating the DPD deduction;<sup>850</sup> unless the captive REIT is owned by a bank or a public REIT.

### **3. Qualified REIT Subsidiary**

These corporations are wholly-owned by the REIT and are disregarded for federal income tax purposes, but not for franchise and excise tax purposes.

### Audit Tips – QRS

- Auditors should ask for a pro forma federal return reflecting just the QRS’s activities, since they are always disregarded to their parent’s Form 1120-REIT.
- A taxpayer may report the QRS’s separate entity activity on a pro forma Form 1120-REIT. However, the DPD should not be allowed for excise tax purposes. Just because a Form 1120-REIT was used as a pro forma does not mean the DPD should be allowed. A QRS is not a REIT, and therefore, is not allowed the DPD.<sup>851</sup>
- Form FAE170, Schedule J4 is the excise tax starting point, unless it is a CRAG affiliate.
- A QRS may be owned by a captive REIT and included in the CRAG’s combined return, Form FAE174. See previous diagram.

#### 4. Taxable REIT Subsidiary

These corporations file on Form 1120 and will not be included on a federal Form 1120-REIT.

### Audit Tips – TRS

- Audit procedures are the same as those done in any corporate audit.
- The DPD is not allowed, since it is not a REIT.
- A TRS may be owned by a captive REIT and included in the CRAG’s combined return, Form FAE174.

#### 5. LPs and LLCs

Lower-tier entities may be directly or indirectly owned by a REIT. The following discussion applies to LPs and LLCs that are owned by a REIT, but not a captive REIT.<sup>852</sup> There are adjustments on Form FAE170, Schedule J1 unique to REIT-owned pass-through entities.<sup>853</sup> These adjustments allow the entity to add any net loss or expense and deduct any net gain or income that is *distributed to a publicly-traded REIT*.

These unique addition and deduction lines are in addition to the regular add-backs and deductions common to all pass-through entities. However, unlike those adjustments, which

reverse income/loss and gains/losses *received* (via Schedule K-1) from owned pass-through entities that file franchise and excise tax returns, these additional adjustments are made when a taxpayer *distributes* (issues a Schedule K-1) to an entity that is owned directly or indirectly by a *publicly-traded* REIT. These adjustments are based on the percentage of ownership interest held in the entity by the public REIT.<sup>854</sup> The public REIT is not required to file a franchise and excise tax return for the LP/LLC to make these adjustments. An LP or LLC is basically *exempt* from excise tax if it directly/indirectly distributes all of its net earnings to a public REIT.

However, in situations where an LP/LLC is disregarded for federal income tax purposes to a REIT, it is not treated as a partnership and does not qualify for the additional add-back and deduction adjustments discussed above. See [Revenue Ruling 13-22](#). Note that it would still be required to file separate-entity franchise and excise tax returns.

#### *Audit Tips – LPs and LLCs*

- The auditor should request an expanded organization chart that shows who the taxpayer is owned by and who they own (directly and indirectly).
- If the LP/LLC is owned (directly/indirectly) by a REIT, determine if the REIT is a captive REIT. If it is a captive REIT, determine if the REIT is owned by a bank, bank holding company, or a public REIT. If the REIT is *not* owned by a bank or public REIT, stop and follow the audit guidance for a captive REIT affiliated group filing a combined return on Form FAE174.
- If there is REIT ownership, the auditor will need to determine if the REIT is publicly traded on a registered or national exchange, like the NYSE. The adjustments for distributions (Schedule K-1s issued) to a REIT only apply if the REIT is publicly traded.
- Review the LP's/LLC's Schedule K-1s issued and calculate the correct adjustment for amounts *distributed* to a public REIT.
  - If the REIT indirectly owns a portion of the taxpayer (LP/LLC), then the auditor will need all Schedule K-1s from intermediary pass-through entities. The percentage of ownership shown on these Schedule K-1s is needed to compute the amount actually distributed to the REIT (the LP's/LLC's Schedule K-1 distribution that is reflected on the REIT's Form 1120-REIT).

- If the pass-through entity is disregarded to the REIT for federal income tax purposes, review [Revenue Ruling 13-22](#) and do not make the “distributed to” adjustment on the pass-through entity’s separate-entity return.
- Determine that the taxpayer has not tried to claim a DPD by some creative means. Only the corporation that has made the REIT election is entitled to the DPD.

### *Revenue Ruling 14-07*

This [Ruling](#) discusses complex real estate investment structures consisting of multiple affiliated REITs, LLCs, and publicly traded partnerships (PTP). Appendixes A and B depict two organizational structures. Topics addressed include “captive REIT,” “public REIT,” “captive REIT affiliated group,” “combined reporting and loss of DPD” and more.

## **REIT Examples**

### **1. Publicly Traded REIT A**

Because of the DPD, REIT A has \$0 net income and may or may not be filing a franchise and excise tax return. The REIT wholly-owns a QRS, and the QRS holds a 50% ownership interest in an LP that owns a Tennessee warehouse. The LP’s other 50% ownership interest is held by unrelated outside investors. The LP has a net income of \$100,000. The LP can take a \$50,000 deduction on Schedule J1, Line 8 for income distributed to a public REIT. The LP issues a Schedule K-1 for 50% of its income to the QRS. The QRS is included in the REIT return. Therefore, the REIT has received 50% of the LP’s income. Also, if the QRS has a filing requirement, it would not have to report the LP’s income. Instead, it would take a deduction on Schedule J, Line 30 as income previously reported by the LP. For excise tax purposes, the income is recognized by the LP, which can report the income as a deduction for pass-through income distributed to a public REIT that directly or indirectly owns the LP. The LP will owe excise tax on 50% of its income, the amount of ownership percentage not held by the public REIT.

### **2. Publicly Traded REIT B**

This example uses the same facts as above, except the public REIT has two QRSs that each own 50% of the LP. The LP would take a full \$100,000 deduction on Schedule J1, Line 8, since its entire income of \$100,000 indirectly flows through to the REIT. Each QRS receives a deduction on Schedule J, Line 30 for income received from a pass-through entity subject to excise tax and

filing an excise tax return, assuming they are taxable entities. Because the LP is indirectly 100%-owned by a public REIT, it does not owe any excise tax on its income.

### **3. Non-Public REIT**

This example uses the same facts as the first example, except that the REIT is not publicly traded. Because of this, the LP does not receive a deduction on Schedule J 1 for the distribution to the REIT, through its QRS ownership. Therefore, the LP is liable for excise tax on its income. The QRS would not be subject to tax on the same income, since it could take a deduction on Schedule J, Line 30 as pass-through income received from the LP. If the REIT itself files an excise tax return, the DPD would leave it with no taxable income. The only entity that would be subject to excise tax is the LP, since it is owned by a non-public REIT.

## Chapter 18: Financial Institutions

### Overview of Financial Institution Taxation

Financial institutions (FI)<sup>855</sup> doing business<sup>856</sup> and having a substantial nexus<sup>857</sup> in Tennessee file a combined<sup>858</sup> franchise and excise tax return with unitary<sup>859</sup> businesses. This return is the [FAE174 Financial Institution and Captive Real Estate Investment Trust Tax Return](#).

The franchise and excise tax is computed on the combined net worth and net earnings of the unitary group.<sup>860</sup> Electing taxpayers may calculate their franchise tax net worth base on a consolidated basis<sup>861</sup> with affiliated group<sup>862</sup> members instead of a combined basis with unitary businesses.

Multistate<sup>863</sup> taxpayers filing Form FAE174 generally apportion net worth and net income based on a receipts factor.<sup>864</sup> The property and payroll factors are not considered unless consolidated net worth (CNW) is apportioned using Schedule 174NC.<sup>865</sup>

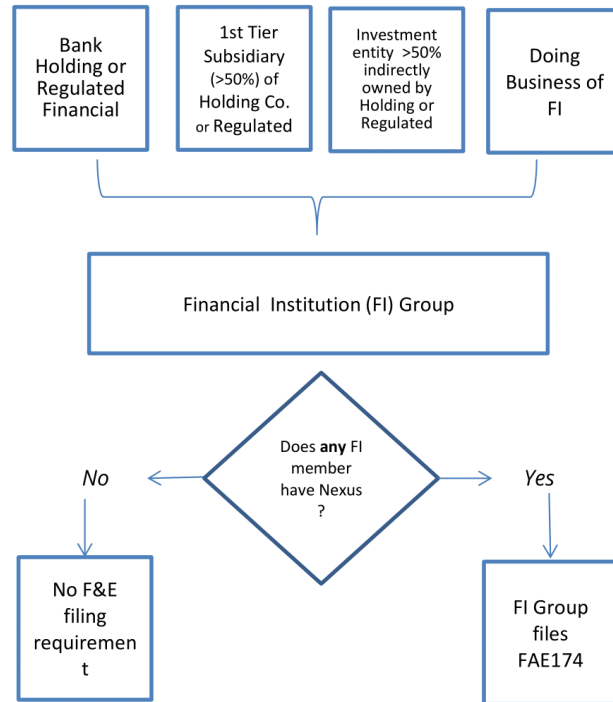
Preliminary audit steps should be done to determine:

- If the business is a financial institution;
- If the business has nexus with the state; and
- If there are any unitary businesses that should be included in the combined franchise and excise tax return.

See the decision chart on the following page, which identifies entities that should be included in an FI group.



**Decision Chart - Entity Inclusion in FAE174 Unitary Return**



## Financial Institution Defined

A financial institution<sup>866</sup> is a:

- Holding company;<sup>867</sup>
- Regulated financial corporation;<sup>868</sup>
- Subsidiary of a “bank” holding company or a regulated financial corporation;
- Investment entity<sup>869</sup> that is indirectly more than fifty percent (50%) owned by a “bank” holding company or a regulated financial corporation; or
- Any other person that is carrying on the “business of a financial institution.”<sup>870</sup>

**Insurance companies are not financial institutions.**

Note that the five-part definition of a “financial institution” contains numerous statutory terms that are defined under Tenn. Code Ann. § 67-4-2004. Each of these terms are discussed below.

### 1. Holding Company

The first type of financial institution listed above is a holding company, but only certain types of holding companies are considered financial institutions. The holding company must:

- Meet the definition of a bank holding company under 12 U.S.C. § 1841(a) of the Bank Holding Company Act of 1956 (“BHCA”); or
- be a corporation defined as a “savings and loan holding company,” “multiple savings and loan holding company,” or “diversified savings and loan holding company,” under 12 U.S.C. § 1467a(a)(1).

Generally, a bank holding company is formed or registered under the BHCA, which has control over a bank. A savings and loan holding company is one that directly or indirectly controls a savings association.

The federal code *exempts certain entities* from being a bank holding company.<sup>871</sup> It defines “bank” and lists exceptions to that definition.<sup>872</sup> An entity that might appear to be a bank holding

company may actually be a parent to a regulated financial corporation instead of a bank holding company. For example:

- An entity called XYZ Bank USA is not considered a bank under 12 U.S.C. § 1841(c)(2)(H) because it is an industrial loan company.
- XYZ's parent does not meet the state's definition of a holding company because, technically, it owns a regulated financial corporation and not a bank (even though "bank" is in the subsidiary's name).

Please see 12 U.S.C. § 1841(c)(2) for more examples of entities that should not be considered banks for the purpose of identifying bank holding companies. Discussed under this federal code section are foreign banks, insured institutions, trusts, credit unions, credit card operations, and industrial banks.

All bank holding companies are required to register with the Board of Governors of the Federal Reserve System and file certain reports. The 50 largest bank holding companies are listed at <https://www.ffiec.gov/npw/Institution/TopHoldings> and their report filings may be viewed at <https://www.ffiec.gov/npw/>. In addition, if there are more than 2,000 shareholders, the bank holding company must register with the Securities and Exchange Commission.

In summary, all banks are regulated financial corporations under Tennessee code, but not all regulated financial institutions are banks under 12 U.S.C. § 1841. A company that is a parent to an entity with "bank" or "trust" in its name does not automatically make it a holding company per Tenn. Code Ann. § 67-4-2004(21).

## 2. Regulated Financial Corporation

A second type of financial institution is a "regulated financial corporation," as defined under Tennessee law.<sup>873</sup> A regulated financial corporation is an FI if it is:

- An institution that has *accounts insured* under the Federal Deposit Insurance Act ("FDIC") per 12 U.S.C. § 1811; or
- A *member* of a federal home loan bank;<sup>874</sup> or
- Any other bank or thrift institution<sup>875</sup> organized under the laws of any jurisdiction.<sup>876</sup>

Regulated financial corporations include banks and thrift institutions *organized in a foreign country* that are engaged in the business of receiving deposits, any corporation organized under 12 U.S.C. §§ 611-6311,<sup>877</sup> Edge Act corporations, and any agency of a foreign depository, as defined in 12 U.S.C. § 3101. An Edge Act corporation is a subsidiary of a U.S. or foreign bank that *engages in foreign banking operations*; these subsidiaries are authorized under the 1919 Edge Act.

Note that many corporations are regulated by someone, but the franchise and excise tax definition of a “regulated financial corporation” is very specific. For example:

- Deferred presentment service entities and trust companies performing fiduciary duties are subject to Title 45 - Banks and Financial Institutions (Tenn. Code Ann. §§ 45-2-2001, 45-17-102) - but they are not regulated financial corporations under Tenn. Code Ann. § 67-4-2004(45).
- However, regulated financial corporations are financial institutions because their business is authorized by *Tennessee Code Annotated*, Title 45, and they are doing the “business of a financial institution.”<sup>878</sup>
- In other words, an entity that is not a regulated financial institution may still be considered a financial institution if it meets one of the other criteria.

### *Office of the Comptroller of the Currency*

National banks and federal savings associations are “financial institutions” for franchise and excise tax purposes because they are regulated financial corporations per Tenn. Code Ann. § 67-4-2004(45).

They are chartered and controlled by the Office of the Comptroller of the Currency (“OCC”). The OCC’s website has links to Lists of Financial Institutions and many helpful topics.<sup>879</sup> The OCC ensures that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations. The Comptroller of the OCC is also the director of the FDIC and NeighborWorks® America. In regulating national banks and federal thrifts, the OCC has the power to:

- Examine the national banks and federal thrifts;

- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure;
- Take supervisory actions against national banks and federal thrifts that do not comply with laws and regulations or that otherwise engage in unsound practices;
- Remove officers and directors, negotiate agreements to change banking practices, and issue cease and desist orders as well as civil money penalties; and
- Issue rules and regulations, legal interpretations, and corporate decisions governing investments, lending, and other practices.

### 3. **Subsidiary of a Holding Company or Regulated Financial Corporation**

Part 3 of the Tennessee FI definition states that a *subsidiary* of a “bank” holding company or regulated financial corporation is also considered a financial institution. The subsidiary must be a first-tier subsidiary. A *second-tier subsidiary* is not a financial institution and should **not** be included in a combined FAE174 return.<sup>880</sup>

The term “subsidiary” is not defined in the franchise and excise tax statutes. However, based on the basic tenets of statutory construction, the common use of the word “subsidiary” indicates that a subsidiary is a company that is owned greater than 50% by another company,<sup>881</sup> which is known as the “parent.” The subsidiary can be a company, corporation, or limited liability company. For purposes of the Tennessee FI definition, a subsidiary is not required to be a banking-type business. The only requirement is that it be a first-tier subsidiary of a “bank” holding company or regulated financial corporation.

### 4. **An Investment Entity that is Indirectly More Than 50% Owned by A Holding Company or Regulated Financial Corporation**

Part 4 of the Tennessee FI definition includes a person that receives more than 50% of its gross income from *investment securities*, from the business of a financial institution, and is indirectly more than 50% owned by a “bank” holding company or a regulated financial corporation.<sup>882</sup>

Investment securities include:

- Any note;
- United States treasury securities;

- Obligations of United States government agencies and corporations;
- Obligations of state and political subdivisions;
- Corporate debt securities;
- Participations in securities backed by mortgages held by the United States or state government agencies;
- Loan-backed securities;
- Bonds, debentures, evidence of indebtedness; and
- Other similar debt investments.

### 5. An Entity Carrying on the Business of a Financial Institution

The last part of the Tennessee FI definition states that any entity *carrying on the business of a financial institution* is a financial institution. Many taxpayers may be defined as FIs because of the following lengthy definition of the “business of a financial institution.”<sup>883</sup>

The business of an FI means:

- The business that a regulated financial corporation may be authorized to do under state or federal law *or the business that its subsidiary is authorized to do by the proper regulatory authorities;*
- The business that *any person*<sup>884</sup> organized under the authority of the United States or organized under the laws of any other taxing jurisdiction or country does or has *authority to do that is substantially similar* to the business that a corporation may be created to do under *Title 45*,<sup>885</sup> or any business that a corporation or its subsidiary is authorized to do by Title 45.
  - Title 45 - “Banks and Financial Institutions” - regulates banking institutions, savings and loan associations, credit unions, industrial loan and thrift companies, pawnbrokers, money transmitters, business and industrial development corporations (BIDCO), international banking, flex loan providers, mortgage lending, savings banks, title pledge lenders, deferred presentment services, and cash payment instrument services.
- Otherwise making, acquiring, selling or servicing loans or extensions of credit, including, but not limited to, the following:

- Secured or unsecured consumer *loans*;
- Installment *loans*;
- Mortgages or deeds of trust or other secured *loans* on real or tangible personal property;
- Credit card *loans*;
- Secured or unsecured commercial *loans* of any type;
- Letters of credit and acceptance of drafts (*a letter of credit is a written commitment by a bank on behalf of a buyer that guarantees payment*);
- The holding of participation loans in which more than one lender is a creditor to a common borrower;
- Loans arising in factoring;<sup>886</sup> and
- Any other transactions of a comparable economic effect;
- Leasing or acting as an agent, broker or adviser in connection with leasing real and personal property that is the economic equivalent of an extension of credit;<sup>887</sup> or
- Operating a credit card business.

If the “business of a financial institution,” as defined above, generates less than 50% of an entity’s gross income, the entity will not be considered a financial institution. For purposes of the 50% test, gross income does not include income from nonrecurring, extraordinary transactions.<sup>888</sup>

## Doing Business

The intent of the General Assembly is to subject taxpayers to the franchise and excise tax to the extent permitted by the United States Constitution and the Constitution of Tennessee. A financial institution, standing on its own, will have a franchise and excise tax filing requirement<sup>889</sup> if it is 1) “doing business within this state”<sup>890</sup> and 2) has substantial nexus.<sup>891</sup>

The code section that defines “doing business in Tennessee” specifically addresses financial institutions.<sup>892</sup> A financial institution is presumed to be “doing business in Tennessee” if the sum of its assets and the absolute value of its deposits attributable to sources within this state is \$5,000,000 or more. Tangible assets are attributed to the state in which they are located.

Income from intangible assets is attributed to the state in which the assets are located. Deposits are attributed to Tennessee if they are deposits made by this state or any of its agencies, instrumentalities or subdivisions or by any resident of this state, regardless of whether the deposits are accepted or maintained at locations in this state. Additionally, a financial institution is deemed to be doing business in this state if the institution:

- Maintains an office in this state;
- Has an employee, representative or independent contractor conducting business in this state;
- Regularly sells products or services of any kind or nature to customers in this state that receive the product or service in this state;
- Regularly solicits business from potential customers in this state;
- Regularly performs services outside this state that are consumed in this state;
- Regularly engages in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state;
- Owns or leases property located in this state; or
- Regularly solicits and receives deposits from customers in this state.<sup>893</sup>

A financial institution is **not** considered to be conducting the “business of a financial institution” in Tennessee if its only activity in the state is the ownership of an interest in one or more of the following types of property:

- An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company, as those terms are defined by the Internal Revenue Code of 1986;
- An interest in a loan-backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates;



- An interest in a loan, lease, note or other assets attributed to this state and in which the payment obligations were solicited and entered into by a person that is *independent and not acting on behalf of the owner*;
- An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed to this state and in which the payment obligations were solicited and entered into by a person that is *independent* and not acting on behalf of the owner;
- An interest in demand deposit clearing accounts, federal funds, certificates of deposit and other similar wholesale banking instruments issued by other financial institutions;
- An interest in a security; or
- An interest of a financial institution in any intangible, tangible, real or personal property acquired in satisfaction, whether in whole or in part, of any asset embodying a payment obligation that is in default, whether secured or unsecured, if the ownership of the interest would be exempt otherwise as provided in bullet points 1-5 above.<sup>894</sup>

In addition, activities within Tennessee related to the above interests that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from it, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property, are **not** considered to be conducting the business of a financial institution.<sup>895</sup> However, ownership of tangible property in the state may create nexus.<sup>896</sup>

The term "independent person who is not acting on behalf of the owner," which is mentioned in the third and fourth bullet points above, means:

- At the time of the acquisition of the assets, the owner of the asset does not directly or indirectly own 15% or more of the outstanding stock or, in the case of a partnership or limited liability company, 15% or more of the capital or profits interest, of the entity from which the owner originally acquired the asset. In determining indirect ownership, an owner is deemed to own all of the stock, capital interest or profits interest owned by another person if the owner directly owns 15% or more of the stock, capital interest or profits interest in that other person. Also, the owner is deemed to own all stock, capital interest and profits interest directly owned by any intermediary parties in the

transaction, to the extent a 15% or more chain of ownership of stock, capital interest or profits interest exists between the owner and any intermediary party;

- The entity from which the owner acquired the asset regularly sells, assigns or transfers interest in such assets to three or more persons during the full twelve-month period immediately preceding the month of acquisition; and
- The entity from which the owner acquired the asset does not sell, assign or transfer 90% or more of its exempt assets to the owner during the full twelve-month period immediately preceding the month of acquisition.<sup>897</sup>

## Unitary Group

Generally, entities must file their own separate entity returns based on their own single business activities. Financial institutions, however, are excepted from the separate entity filing requirements; FIs are required to file a combined return with unitary group members.<sup>898</sup> A “unitary business or group”<sup>899</sup> means:

- Business activities or operations of *financial institutions* that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution.
- The unitary concept applies only to financial institutions.

A unitary group filing Form FAE174 must include FIs with no Tennessee connections apart from being engaged in a unitary business with an FI that is subject to franchise and excise tax. Taxpayers should *first* identify entities that meet the definition of an FI and *then* determine the unitary group.<sup>900</sup>

Unitary group members are generally corporations. The definitions of “holding company” and “regulated financial corporation” both reference corporations. However, any entity doing the business of a financial institution would also be a member of an FI unitary group and could be a partnership or other type of entity. Thus, the combined FI return may include the activities of all types of entities. A real estate investment trust (“REIT”)<sup>901</sup> should be viewed like any other corporation. It may file as a part of a unitary group on Form FAE174 if it is a unitary financial institution. Also, as explained in the following section, captive REITs file on Form FAE174. A REIT that is *not* a captive REIT nor unitary with a financial institution must file on a separate entity basis on Form FAE170.

## 1. Captive Real Estate Investment Trust Affiliated Group

There is a second exception to the general rule that franchise and excise returns should be filed on a separate entity basis. Members of a “captive REIT affiliated group”<sup>902</sup> (“CRAG”) are required to file on a combined basis<sup>903</sup> on Form FAE174.

A *captive REIT*<sup>904</sup> is a non-public REIT that is owned at least 80% by another entity. The ownership may be direct or indirect and is determined by generally accepted accounting principles (“GAAP”). A captive REIT affiliated group files a combined return on Form FAE174 and includes the captive REIT and any entity in which the captive REIT, directly or indirectly, has more than 50% ownership interest. However, there is an additional exception to this filing requirement.

A CRAG does not exist if the captive REIT is owned, directly or indirectly, by a bank, a bank holding company, or a public REIT. The CRAG does not include the entity that has the 80%-or-more ownership in the non-public REIT.

There are several Tennessee code sections that address the taxation of REITs. For a complete discussion on this topic, see Chapter 17 of this manual.

## 2. Exempt Unitary Entities and Apportionment

Credit unions, insurance companies, and non-business trusts are exempt from franchise and excise tax.<sup>905</sup> All exempt entities<sup>906</sup> should be included in the FI group if they are unitary businesses.<sup>907</sup> However, the exempt entity’s net earnings should be excluded from the net earnings of the FI group, and the receipts should be excluded from both the numerator and denominator of the group’s apportionment formula.

An FI group computing its franchise tax net worth base on Schedule F should list exempt unitary businesses on the standard apportionment Schedule SF. However, the exempt businesses should not include their financial information. Listing the exempt unitary businesses on Schedule SF allows the taxpayer to provide the Department with a complete picture of the taxpayer’s organizational structure, but listing them should not affect the tax calculations of any entities subject to franchise and excise tax.

An FI group making the CNW election should list exempt affiliates on the election form. However, the exempt affiliates’ net worth should not be included in the consolidated net worth calculation on Schedule F2. See [Ruling 17-06](#).

### *Trust Preferred Securities Do Not Meet Exemption Criteria*

Entities whose purpose is to hold “trust preferred securities” generally are not exempt from franchise and excise tax under Tenn. Code Ann. § 67-4-2008(10).

This franchise and excise tax exemption applies to the asset-backed securitization of debt obligations, such as first or second mortgages, including home equity loans, trade receivables, whether an open account or evidenced by a note or installment or conditional sales contract, obligations substituted for trade receivables, credit card receivables, personal property leases treated as debt for purposes of the Internal Revenue Code of 1986, home equity loans, automobile loans, or similar debt obligations.

Trust preferred securities are hybrid securities that have debt characteristics that provide preferential treatment as debt for federal income tax purposes. However, they also have equity characteristics that allow bank holding companies to count the securities as capital for regulatory purposes. These types of securities are not “debt obligations” for the purpose of the exemption under Tenn. Code Ann. § 67-4-2008(10). See [Ruling 11-55](#).

### **3. Disclosure Requirement for Financial Institutions**

Financial institutions that receive dividends, directly or indirectly, from a captive REIT must disclose the dividends on the [Financial Institution F&E Captive REIT Disclosure Form](#). If the FI fails to make the disclosure, the dividends received deduction with respect to dividends received (directly or indirectly) from the captive REIT will be disallowed and the FI's net earnings will be adjusted accordingly. In addition, the taxpayer will be subject to a 50% penalty on the amount of any underpayment arising from this adjustment.

The penalty is equal to the greater of \$10,000 or 50% of any adjustment to the initially filed return. See Tenn. Code Ann. § 67-4-2006(e).

### **Combined Basis**

FI unitary groups complete Form FAE174 on a combined basis<sup>908</sup> for all members of the unitary group. All dividends, receipts and expenses resulting from transactions between members of the unitary group are excluded when computing combined net earnings or net loss,<sup>909</sup> but intercompany transactions are not excluded in computing the nonconsolidated franchise tax base.<sup>910</sup> The following chart shows that eliminations are made except for the franchise tax base computed on Schedule F. The excise tax law does not explicitly state that intercompany

eliminations should be made in computing the excise tax apportionment ratio on Schedule SE; however, it is a well-established Department policy that these eliminations should be made.

	<b>Eliminations are made to arrive at <u>Tax Base</u></b>	<b>Eliminations are made to arrive at the <u>Apportionment Ratio</u></b>	<b>Tenn. Code Ann. § 67-4-_____</b>
Franchise Tax, Schedule F Nonconsolidated Net Worth	No	Yes (Schedule SE)	2106(b), 2114(c)(1), 2118
Franchise Tax, Schedule F1 Captive REIT Net Worth	Yes	Yes (Schedule N)	2106(b), 2111(g)(2)
Franchise Tax, Schedule F2 Consolidated Net Worth	Yes	Yes (Schedules 174SC, 174NC)	2106(b), 2118(d)(3)(A)
Excise Tax, Schedule J	Yes	Yes (Schedule SE)	2006(a)(3), 2013(b)
Excise Tax, Schedule J, Captive REIT	Yes	Yes (Schedule N)	2006(9), 2013(d)

### 1. Joint Liability

The members of the FI unitary group designate one member that is subject to franchise and excise tax in this state to file the combined return. Each member subject to tax in this state is jointly and severally liable for the franchise and excise tax liability of the unitary business. However, this liability will not apply to any member that is a limited liability company, limited liability partnership, or limited partnership and meets certain criteria.<sup>911</sup> For example:

- The member was formed and operated for the primary purpose of acquiring, from one or more of its direct or indirect owners, notes, accounts receivable, installment sale contracts, or similar evidences of indebtedness; and
- The member has pledged substantially all (66.67%)<sup>912</sup> of its assets as security, directly or indirectly, for third party borrowings or securitized indebtedness acquired by third parties.<sup>913</sup>

## 2. FI Unitary Group versus GAAP Consolidated Group

Chapter 9 of this manual contains a section titled “Verifying Affiliated Group Members,” which discusses the GAAP rules concerning consolidation. Generally, entities under common control are included in consolidated financial statements. A review of that section may be helpful in understanding why certain entities are included or excluded from consolidated financial statements. Obtaining a basic understanding of the principles of consolidation may be helpful in identifying FI unitary group members.

## 3. Unitary Group - Federal Form 851

The federal Form 851 - Affiliations Schedule - provides helpful information in determining unitary members to be included on the FAE174 return. Form 851 identifies a corporate parent and its affiliated group. An affiliated group, for the purpose of this federal form, is one or more chains of includible corporations connected through stock ownership with a common parent corporation. The common parent must be an includible corporation and the following two requirements must be met.

- The common parent must own directly stock that represents at least 80% of the total voting power and at least 80% of the total value of the stock of at least one of the other includible corporations.
- Stock that represents at least 80% of the total voting power and at least 80% of the total value of the stock of each of the other corporations (except for the common parent) must be owned directly by *one or more of the other includible corporations*. For this purpose, the term “stock” generally doesn't include any stock that is nonvoting, nonconvertible, limited and preferred as to dividends, doesn't participate significantly in corporate growth, and has redemption and liquidation rights that don't exceed the issue price of the stock except for a reasonable redemption or liquidation premium.

Form 851 aids in determining FI group members because it shows the relationships between, and the principal business activity codes for, each corporation listed. The principal business activity codes are based on the North American Industry Classification System (“NAICS”). The activity resulting in the largest percentage of a company's total receipts is used in determining the code. The 520000 series codes are for finance and insurance receipts. Most FI unitary group members will generally be found in this series, but not all entities in this series will meet the state's definition of an FI. For example, a securities brokerage company has a NAICS code of 523120, but is not an FI.

The NAICS website provides a detailed description for specific codes and the names of top businesses found within specific codes.<sup>914</sup> Entities regulated under Title 45 of the *Tennessee Code Annotated* are considered to be doing the business of a financial institution. For example:

- 522110 – Commercial Banking
- 522120 – Savings Institutions
- 522130 – Credit Unions
- 522190 – Other Depository Credit Intermediation
- 522210 – Credit Card Issuing
- 522220 – Sales Financing
- 522291 – Consumer Lending
- 522292 – Real Estate Credit (including mortgage bankers and originators)
- 522293 – International Trade Financing
- 522294 – Secondary Market Financing
- 522298 – All Other Nondepository Credit Intermediation
- 522300 – Activities Related to Credit Intermediation (including loan brokers, check clearing, and money transmitting)
- 523110 – Investment Banking & Securities Dealing

Form 851 has its limitations. It might include corporations that should not be included in the FI group, and it excludes non-corporate entities and corporations filing on a variant of Form 1120 (e.g., Form 1120-REIT) that should be included in the FI group. For example:

- A financial institution unitary group may include partnerships and REITs<sup>915</sup> that would not be listed on federal Form 851.
- Not all corporations listed on federal Form 851 will meet the state’s definition of a unitary financial institution, like security brokerage companies.

## Franchise Tax Net Worth Tax Base

The franchise tax computation for a Form FAE174 filer is .0025 of the *greater* of the *combined net worth tax base* or the *combined real and tangible property tax base*. The net worth base calculation is completed on Schedule F unless the taxpayer is a captive REIT or has made a consolidated net worth election.

### 1. Schedule F – Non-Consolidated Net Worth

A standalone financial institution<sup>916</sup> and a *unitary group* filing on a combined basis<sup>917</sup> computes its net worth franchise tax base on Form FAE174, Schedule F. Combined net worth is the sum of each individual unitary group member's total assets less its total liabilities, as determined under GAAP.<sup>918</sup> The net worth base is computed individually for each unitary group member and then the net worth bases are combined. Each unitary member's net worth, indebtedness add-back,<sup>919</sup> and apportionment ratio is entered individually on Schedule F. The sum of the apportioned net worth amounts for all unitary group members is the net worth franchise tax base that is subject to the .0025 franchise tax rate.

#### *No Eliminations to the Non-Consolidated Net Worth Base*

The amount entered on Schedule F under the column Everywhere Total should **not** take into account intercompany eliminations. Intercompany transactions are eliminated when preparing consolidated financial statements under GAAP. However, the separate entity presentation on Schedule F is different from what is normally seen in a GAAP consolidated financial statement. Under GAAP, all the affiliates' assets, liabilities, and net worth values are summed and then eliminations are made to arrive at a single consolidated financial statement. Schedule F is different in that it retains separate entity net worth details. There is no support in the code for intercompany eliminations in this instance and they should not be made in arriving at the Schedule F net worth amount.

#### *Revenue Shifting*

Shifting revenue to a unitary group member with a lower apportionment ratio may create tax planning opportunities for taxpayers. This is possible because intercompany eliminations are *not* made in arriving at the non-consolidated net worth amount. If an auditor finds that unitary group members are artificially shifting revenues amongst one another in a manner that does not fairly represent the taxpayers' business activity in this state or their net worth, the auditor may request a variance if the auditor and their supervisor think it is appropriate.<sup>920</sup>



### *Equity Method Investments – Schedule F*

An FI unitary group member that has an ownership interest in another FI member will likely use the equity method of accounting under GAAP to account for its investment if the ownership interest is between 20% - 50%. The investment account on the balance sheet will reflect the initial cost of the investment and the subsequent changes in its value. For example:

- FI unitary group member #10 owns 40% of the common stock of FI unitary group member #21.
- The balance sheet of unitary member #10 has an account on its balance sheet titled “Investment in Unitary Member #21.” This account reflects the cost of unitary member #10’s 40% stake in unitary member #21 and it is adjusted annually to reflect unitary member #10’s 40% share of income and dividends from unitary member #21.
- Both the book value of unitary member #10’s investment account (in unitary member #21), which is included in unitary member #10’s net worth computation, and the actual net worth of unitary member #21 (per its GAAP books) are included on Schedule F.
- This effectively results in 140% of unitary member #21’s net worth being reported on Schedule F—100% of its reported net worth plus unitary member #10’s 40% share of its net worth, as reflected in the investment account.
- Taxpayers may avoid this outcome by making a consolidated net worth election and filing Schedule F2.

For more information regarding the GAAP equity method of accounting and the franchise tax consolidated net worth election, see Chapter 9 of this manual.

### *Apportionment – Schedule SF*

A franchise tax apportionment ratio is computed separately for each unitary member on Schedule SF. Each member’s net worth plus any applicable indebtedness is multiplied by a quotient of the member’s *total receipts* attributable to business in TN, divided by the member’s *total receipts* everywhere. This computation applies to all group members, even those that would not be subject to franchise and excise tax if not for being part of the unitary group. For example:

- A unitary member that is not doing business in Tennessee and does not have nexus with Tennessee would still report an apportionment denominator value on Schedule SF and a net worth value on Schedule F.

### *Certain Eliminations Required for Schedule SF Apportionment Ratio*

Dividends, receipts, and expenses resulting from transactions between members of a unitary group are excluded from the return *for purposes of apportionment* under Tenn. Code Ann. § 67-4-2118.<sup>921</sup> In other words, transactions between members are eliminated in arriving at the apportionment ratio that is reported on Schedule SF. Common intercompany transactions that are eliminated from the receipts factor include:

- Management fees
- Interest
- Dividends
  - Dividends are excluded from the numerator and denominator of a unitary member's apportionment ratio if they were:
    - Received from a unitary member included in the return;
    - Received from an 80%-or-more owned corporation that is not unitary; or
    - Non-business earnings.

### *Receipts Sourcing*

Tennessee law defines "receipts" and determines when receipts are attributable to this state for apportionment purposes. "Receipts" means all receipts valued at their *gross* amounts and derived from transactions and activities in the regular course of business.<sup>922</sup> Exceptions to this general rule are as follows:

- Dividends, receipts, and expenses resulting from *transactions between members of a unitary group* are excluded from the return for purposes of the apportionment of net worth (single entity, combined, and consolidated) under Tenn. Code Ann. § 67-4-2118.<sup>923</sup>
- Receipts from the disposition of assets such as securities<sup>924</sup> and money market transactions are included to the extent of the *net taxable gain*,<sup>925</sup> rather than the gross proceeds.

- The *net gain* (rather than gross proceeds) from the asset sale or disposition should be used if the use of gross proceeds would cause distortion in the apportionment ratio.<sup>926</sup>

In summary, the net worth apportionment denominators on Schedule SF will include all receipts for all members of the unitary group. The receipts will generally be valued at their gross amounts,<sup>927</sup> but *there are exceptions as noted above*.

The franchise and excise tax law identifies twelve receipt types, along with sourcing methods for each, that are to be considered in determining financial institution apportionment.<sup>928</sup> Although Schedule SF does not break out the twelve receipt types per entity, each individual entity included on Schedule SF must consider the twelve receipt types for apportionment purposes. For reference, Form FAE174, Schedules 174SC and SE, Lines 1-12, list these receipt types.

Receipt types 1-11 are often referred to as the “enumerated receipts.” Receipt type twelve is a “catch all” for receipts that do not fit into any of the other categories. Non-excluded receipts that do not fit into the first eleven enumerated receipts categories are sourced to Tennessee *in the same proportion that the aggregate of the eleven identified receipts are attributed to Tennessee*.<sup>929</sup> For example, *investment* interest and dividends fit into this last “catch all” category. Below is an example of how these non-enumerated receipts are factored into the apportionment calculation.

**Financial Institution Apportionment  
Proportionate Attribution of Other Receipts,  
per Tenn. Code Ann. §§ 67-4-2013(b)(3)(L) and 67-4-2118(c)(12)**

Receipt Type	TN	Everywhere	%
1 Interest	300,000	2,100,000	0.142857
2 Service Charges	15,000	74,900	0.200267
3 Trust Department	250,000	2,150,000	0.116279
4 Other Services	112,000	1,199,000	0.093411
5 Rental Income	2,099,000	13,180,000	0.159256
6 Investment Interest and Dividends		6,130,000	0
<b>Total</b>	<b>2,776,000</b>	<b>24,833,900</b>	<b>0.111783</b>
Remove receipts not specifically enumerated in statute		(6,130,000)	
<b>Determine ratio</b>	<b>2,776,000</b>	<b>18,703,900</b>	<b>0.148418</b>
Apply ratio to receipts not specifically enumerated in statute			<u>6,130,000</u>
Non-enumerated receipts sourced to Tennessee (909,804 / 6,130,000 = 0.148418)			909,804

The methodology used by taxpayers in reporting apportionment denominator values on Schedule SF often requires audit adjustments. Taxpayers often report the pro forma federal Form 1120, Line 11, amount as the denominator value, but audit adjustments will be needed if any of the following are present:

- There are receipts that are not enumerated in Tenn. Code Ann. § 67-4-2118(c)(1)-(11). These “other receipts” should not impact the apportionment ratio. The “other receipts” are correctly reported in the denominator, but the numerator value should be plugged (as illustrated above) so as to attribute to Tennessee the “other receipts” in the same

proportion as the ratio determined by receipts 1-11 in the aggregate. In other words, the ratio for “other receipts” should be the same as the overall ratio reported on Schedule SF for a given member. Common “other receipts” include investment dividends and income.

- The total income from Form 1120, Line 11, does not consider gross income amounts. For example, there may be a value on Form 1120, Lines 1-10, with a negative amount. Gross income can never be a negative amount. Therefore, an audit adjustment is needed to reflect the gross amount. If Rule 32 applies,<sup>930</sup> then the *net value* may be used, but the net value can never be less than zero. Federal Schedule D and Form 4797, from which many ordinary and capital gains and losses are traced to the first page of the federal return, will show the gross proceeds from asset sales or other dispositions.

### *Receipts Sourced to Tennessee – Schedule SF*

Receipts are attributed to Tennessee as follows:<sup>931</sup>

- Rents received from real or tangible personal property are sourced to Tennessee if the property is located in Tennessee;
- Interest income and other receipts from assets, loans, or installment sale contracts that are primarily secured by or deal with real or tangible personal property, are sourced to Tennessee if the property/security is located in Tennessee. If any part of the property/security is located both within and outside of Tennessee, *a portion* of the interest or other income is sourced to Tennessee based on the proportion of the “value” of the property in Tennessee as compared the “value” of the whole property;
  - “Value” means fair market value at the time the loan is made. If property is pledged as security after the initial loan is made, the ratio (Tennessee/Everywhere) may be adjusted.
- Interest income and other receipts from unsecured consumer loans are sourced to Tennessee if the loan is made to a Tennessee resident, regardless of whether the loan was made at a place of business, by a traveling loan officer, by mail, by telephone or by other electronic means;

- Interest income and other receipts from unsecured commercial loans and installment obligations are sourced to Tennessee if the proceeds of the loan are to be *applied in* Tennessee;
  - If it cannot be determined where the funds are to be applied, the receipts are to be sourced to the state where the business “applied for” the loan.
    - “Applied for” means initial inquiry, customer assistance in preparing the loan application, or submission of a completed loan application, whichever occurs first. “Loan” does not include demand deposit accounts, federal funds, certificates of deposit, and other similar wholesale banking instruments issued by other financial institutions.
- All receipts and fee income from the issuance of letters of credit, acceptance of drafts, and other devices for assuring or guaranteeing a loan or credit are sourced *in the same manner as* interest income/receipts from the loan. (See bullet points 2, 3, and 4 above.);
- Interest income, merchant discount, other receipts, including service charges from financial institution credit card and travel and entertainment credit card receivables and credit card holders, and fees, are sourced to the state where the card charges and fees are regularly billed;
- Receipts from the sale of an asset, tangible or intangible, are attributed in the same manner that the income from the asset would be attributed under this section;
- Receipts equal to the net gain or income from the sale of a security made by a dealer in the security (26 U.S.C. § 475) are sourced to Tennessee if the dealer’s customer is located in Tennessee and the receipt is not sourced under bullet point seven above. A customer is in Tennessee if the customer is an individual, trust, or estate that is a resident of Tennessee and, for all other customers, if the customer’s *commercial domicile* is in Tennessee. Unless the dealer has actual knowledge of the residence or commercial domicile of a customer during a taxable year, the customer is deemed to be a Tennessee customer if the billing address of the customer, as shown in the records of the dealer, is in Tennessee;<sup>932</sup>

- Receipts from the performance of fiduciary and other services are sourced to Tennessee if the service is delivered to a Tennessee location under market-based sourcing.<sup>933</sup>
- Receipts from the issuance of traveler's checks, money orders or United States savings bonds are sourced to the state where such items were purchased;
- Receipts from a participating financial institution's portion of participation loans are sourced as otherwise provided above. A participation loan is any loan in which more than one lender is a creditor to a common borrower; and
- Any other receipts of gross income not specifically covered in (1)-(11) above should be sourced to Tennessee in the same proportion that aggregate receipts are attributed to Tennessee under (1)-(11).
  - This is accomplished by computing the apportionment ratio without considering any numerator or denominator values for this twelfth category of receipts. The ratio based on receipt types 1-11 above is then applied to this category of receipts to source the other receipts to Tennessee. See the Receipts Sourcing section in this chapter for an example of this calculation.

## 2. Schedule F2 – Consolidated Net Worth

Individual financial institutions, captive REITs, captive REIT affiliated groups, and financial institution unitary groups filing Form FAE174 may make an election to compute their franchise tax net worth base on a consolidated basis as part of a larger affiliated group that has made a consolidated net worth (“CNW”) election. The CNW election is binding for a minimum of five years<sup>934</sup> and must be agreed to by all affiliated group<sup>935</sup> members. In addition, to be eligible to make the CNW election, all members of the CNW affiliated group must close their books on the same date.<sup>936</sup> The CNW affiliated group's consolidated net worth calculation on Schedule F2 might include affiliated entities that would not otherwise be included in the combined return of a captive REIT affiliated group or financial institution unitary group on Form FAE174. A CNW affiliated group member that is not otherwise a member of a captive REIT<sup>937</sup> affiliated group or a financial institution<sup>938</sup> unitary group would be included in the CNW calculation but not the excise tax calculation on the combined FAE174 return.<sup>939</sup>

Consolidated net worth is the difference between the total assets less the total liabilities of the *affiliated group*. The financial data used to calculate the CNW amount comes from a GAAP basis,

pro forma consolidated balance sheet that includes all members of the CNW affiliated group. The pro forma consolidated balance sheet is to be prepared in accordance with GAAP, where transactions and holdings between members of the CNW affiliated group and holdings in non-domestic persons have been eliminated.<sup>940, 941</sup>

It is important to note that Schedule F - *Non-Consolidated Net Worth* - and Schedule F2 - *Consolidated Net Worth* - each involves different “groups” of entities. Each group has its own unique definition in the franchise and excise tax statutes<sup>942</sup> (e.g., unitary, affiliate) and care should be taken so as to apply the correct definition to a given situation. For example:

- A *unitary group* may make a CNW election to compute net worth on a consolidated basis with a larger *affiliated group*. The members of the *unitary group* that are included in the FAE174 return are *financial institutions*, as defined in the franchise and excise tax code.<sup>943</sup>
- The group members of the CNW *affiliated group* are all *domestic persons*<sup>944</sup> in which there is a greater than 50% ownership interest amongst one another.<sup>945</sup>
- It is possible that the CNW *affiliated group* includes entities that would not otherwise be included in the excise tax portion of the *unitary group's* FAE174 return. One example of this situation might be a construction company that is 51% owned by a person that is carrying on the “business of a financial institution.” Because the construction company is 51% owned by an FI, it meets the definition of an *affiliated group member* and would be included in the FI CNW affiliated group; however, because the construction company is not itself an FI, it would *not* be included in the excise tax portion of the FI combined return on Form FAE174. If the construction company is subject to franchise and excise tax on a separate entity basis, it will file a separate Form FAE170 to report its portion of the group’s CNW amount and to report its net earnings or loss subject to excise tax.

#### *Receipts Are Sourced to Tennessee on Schedules 174NC, 174SC, 170NC, 170SC*

The CNW apportionment ratio is computed on either Schedule 174SC or 174NC for a *unitary group* filing Form FAE174. If a non-FI affiliated group contains a member that *is* an FI, the FI member must conform to the standard three-factor apportionment formula that is used by the entire affiliated group.<sup>946</sup> The inverse is also true. If an FI affiliated group contains a member that *is not* an FI, the non-FI member must utilize a receipts-only apportionment formula.<sup>947</sup> Members of the *affiliated group* that do not meet the definition of “unitary” (like in the construction company example above) would file a separate franchise and excise tax return on Form FAE170 and would compute their CNW apportionment ratio on either Schedule 170NC or 170SC. All



affiliates that are bound by a CNW election will be members of either: 1) an affiliated group, or 2) an FI affiliated group. For example:

- All affiliates will file the NC-type schedule, or all affiliates will file the SC-type schedule.
- If the definition of “financial institution affiliated group”<sup>948</sup> is met, then the SC-type schedule is used.

The term “financial institution affiliated group,” in its simplest terms, means that the majority (more than 50%) of the affiliated group’s gross receipts come from conducting the “business of a financial institution.”<sup>949</sup> In this case, the CNW amount is apportioned using a single receipts factor instead of a three-factor formula (property, payroll, and receipts). The term “financial institution affiliated group” should *not* be used outside the context of CNW apportionment.

For more information on how to make the determination of whether a CNW affiliated group is an “affiliated group” or an “FI affiliated group,” and to determine which CNW apportionment schedule is correct for a given taxpayer, see Chapter 9 of this manual.

### 3. Schedule F1 – Captive REIT Net Worth

A captive REIT affiliated group (“CRAG”) computes its franchise tax on a combined basis<sup>950</sup> on Form FAE174, Schedule F1 - Captive Real Estate Investment Trust Net Worth. Net worth for a CRAG is the difference between the total assets less the total liabilities of the CRAG, as shown by a GAAP basis, pro forma consolidated balance sheet that includes all members of the CRAG. The pro forma balance sheet is prepared in accordance with GAAP, where transactions and holdings between members of the CRAG and holdings in non-domestic persons have been eliminated.<sup>951</sup>

#### *Three Factor Apportionment – Captive REITs*

##### **Property Factor:**

- The numerator is the average value of the CRAG's real and tangible personal property, excluding exempt inventory<sup>952</sup> owned or rented and used in this state during the tax period.
- The denominator is the average value of the CRAG's real and tangible personal property owned or rented and used during the tax period, excluding exempt inventory determined on a per member basis.

- Owned property is valued at its original cost.
- Property rented by the CRAG is valued at eight times the net annual rental rate.
- The property factor is determined based on a pro forma consolidated balance sheet prepared in accordance with GAAP, where transactions and holdings between members of the CRAG and holdings in non-domestic persons have been eliminated.<sup>953</sup>
- The property factor also includes the ownership share of real or tangible property owned or rented by any general partnership not filing a franchise and excise tax return.<sup>954</sup> Please refer to Chapter 14 of this manual for additional discussions of all the apportionment factors.

**Payroll Factor:**

- The numerator is the total amount paid in Tennessee by the CRAG for compensation.
- The denominator is the total compensation of the CRAG paid everywhere during the tax period.

The payroll factor is determined based on a pro forma consolidated income statement prepared in accordance with GAAP, where transactions and holdings between members of the CRAG and holdings in non-domestic persons have been eliminated.<sup>955</sup>

**Receipts factor:**

- The numerator is the CRAG's total receipts in Tennessee.
- The denominator is the CRAG's total receipts during the tax period.<sup>956</sup>

The receipts factor is determined based on a pro forma consolidated income statement prepared in accordance with GAAP, where transactions and holdings between members of the CRAG and holdings in non-domestic persons have been eliminated.<sup>957</sup>

If a member of a CRAG is a common carrier that apportions its income using the special apportionment provisions under Tenn. Code Ann. § 67-4-2013(a), see Tenn. Code Ann. §§ 67-4-

2111(b)(3), (e)(3), and (g)(3) for instructions as to how the property, payroll, and receipts factors are to be computed for a common carrier that is a member of a CRAG.

## Franchise Tax Real and Tangible Property Tax Base

The franchise tax base for real and tangible property is reported on Form FAE174, Schedule G. This schedule is identical to the Form FAE170 schedule, except the values reported on Form FAE174 are the *sum of the unitary group member's* GAAP book values of real and tangible property owned or used within the state. Another difference is that Form FAE170 filers may use tax basis books and records to prepare Schedule G if the taxpayer does not maintain GAAP basis books and records; however, the exception to using GAAP basis books and records is ***not*** available to FAE174 filers.<sup>958</sup>

It is possible that one unitary member owns property that is leased by another unitary member. In this case, *both* the owned property and the rents paid for use of the property are reported on Schedule G of the combined return and no intercompany eliminations are made.<sup>959</sup>

## Unitary Members with Short Periods

A *federal* consolidated return must cover the common parent's entire consolidated tax return year and each subsidiary's transactions *for the portion of the year for which it is a member*. If a subsidiary corporation becomes, or ceases to be a member, during a consolidated tax return year, it does so at the *end of the day* on which its status as a member changes.<sup>960</sup> For federal income tax purposes, each subsidiary must adopt the common parent's annual accounting period, but there may be a short period due to acquisitions, reorganizations, dispositions, or similar events. Form FAE174 covers the same reporting period as the federal income tax return of the federal consolidated group parent.<sup>961</sup>

Unitary group members entering or exiting the FI unitary group during the tax year may prorate their portion of the group's franchise tax.<sup>962</sup> If a consolidated net worth election is in effect, any affiliated group member exiting the affiliated group before year end is excluded from the consolidated net worth calculation on Schedule F2 and must complete Schedule F. In this case, both Schedules F and F2 will be completed on Form FAE174 for the tax year.<sup>963</sup> For example:

- New, Inc. is the parent of a federal consolidated group with a June 30 fiscal year end.
- On March 31, 2018, New, Inc. acquired Sub-TN, an entity that is doing business in and has nexus with Tennessee; as a result, the New, Inc. unitary group becomes subject to franchise and excise tax.

- Sub-TN's pre-acquisition activities for January through March 2018, will be included in the calendar year consolidated federal income tax return of Old, Inc. for the 2018 tax year.
- New, Inc. is subject to franchise and excise tax as of April 1, 2018, and it will file a franchise and excise tax return (Form FAE174) covering the tax period that coincides with its federal income tax return period of July 1, 2017, through June 30, 2018. This return will include Sub-TN's activity from April 1, 2018, through June 30, 2018.
- Excise tax is never prorated, but the franchise tax related to Sub-TN may be prorated on both Old, Inc. and New, Inc.'s Form FAE174 filings.
- Old, Inc. should include Sub-TN's pre-liquidation values<sup>964</sup> in the net worth calculation reported on Schedule F of Old, Inc.'s 2018 calendar year FAE174 return, and Sub-TN's franchise tax should be prorated for the short period of January 1, 2018, through March 31, 2018.
- New Inc. has not made a consolidated net worth election, so it will complete Schedule F on its Form FAE174, and Sub-TN's franchise tax should be prorated for the short period of April 1, 2018, through June 30, 2018.
- If New, Inc. had made a CNW election, Sub-TN's tax attributes would have been included in the CNW amount and CNW apportionment ratio, but there would be no proration adjustment for its short period.

## Excise Tax

Tenn. Code Ann. § 67-4-2006 defines "net earnings" and "net loss" for corporations, S corporations, partnerships and FIs.<sup>965</sup> Like corporations, the FI calculation begins with federal taxable income or loss before the federal net operating loss deduction and special deductions. All of the Tennessee excise tax statutory add-backs and deductions under Tenn. Code Ann. § 67-4-2006(b)-(c) also apply to FIs.

FIs that form a unitary business compute their excise tax on a combined basis, excluding all dividends, receipts, and expenses resulting from transactions between members of the unitary group. The excise tax return includes members of the unitary group that would not otherwise be subject to excise tax, if considered apart from the unitary group.<sup>966</sup>

## 1. Captive REIT Affiliated Group

The excise tax computation for CRAGs begins on Form FAE174, Schedule J4, even though the CRAG may include non-corporate entities.<sup>967</sup> One very important distinction between CRAGs and public REITs is that the dividends paid deduction available to public REITs is **not** permitted for CRAGs.<sup>968</sup> A CRAG will include the dividends paid deduction from federal Form 1120-REIT, Line 21(b) on Form FAE174, Schedule J4, Line 2(b). However, because CRAGs are not allowed to take this deduction for Tennessee excise tax purposes, the deduction is added back on Form FAE174, Schedule J, Line 14.

## 2. Excise Tax Apportionment – Schedule SE

The excise tax apportionment formula for FIs (standalone FI or FI unitary group) is based solely on a receipts factor.<sup>969</sup> Unitary groups report combined Tennessee and everywhere receipts by enumerated receipt type on the excise tax apportionment Schedule SE. The code enumerates eleven specific receipt types; there is a twelfth “catch all” receipt type for any receipts that do not fit into the other categories. Receipts in this last category are attributed to Tennessee in the same proportion that the other, aggregated enumerated receipts are attributed to the state.<sup>970</sup>

Receipts from all transactions and activities in the regular course of the taxpayer’s business are included in the apportionment factor at their *gross value*.<sup>971</sup> However, receipts from the disposition of securities and money market transactions are included to the extent of the *net taxable gain*.<sup>972</sup> The apportionment computation should include receipts from unitary members that would not otherwise have an excise tax filing requirement if they were considered apart from the unitary group.<sup>973</sup>

The excise tax law does not specifically state that taxpayers must exclude transactions between unitary members from the excise tax apportionment ratio, but it is a long-standing position held by the Department that such intercompany eliminations should be made. This treatment is consistent with other provisions in the franchise and excise tax laws. For instance, dividends, receipts, and expenses resulting from transactions between unitary members are excluded<sup>974</sup> in determining the combined net earnings subject to the excise tax. Also, in relation to the franchise tax apportionment ratio,<sup>975</sup> the franchise tax law states that dividends, receipts, and expenses between unitary members should be excluded. Furthermore, the excise tax apportionment ratio for captive REITs also excludes dividends, receipts, and expenses between CRAG members.<sup>976</sup> A common audit adjustment is the removal of intercompany receipts from the excise tax apportionment formula.

Receipts are attributed to Tennessee as follows:

- Rents received from real or tangible personal property are sourced to Tennessee if the property is located in Tennessee;
- Interest income and other receipts from assets, loans, or installment sale contracts that are primarily secured by or deal with real or tangible personal property, are sourced to Tennessee if the property/security is located in Tennessee. If any part of the property/security is located both within and outside of Tennessee, *a portion* of the interest or other income is sourced to Tennessee based on the proportion of the “value” of the property in Tennessee as compared the “value” of the whole property;
  - “Value” means fair market value at the time the loan is made. If property is pledged as security after the initial loan is made, the ratio (Tennessee/Everywhere) may be adjusted.
- Interest income and other receipts from unsecured consumer loans are sourced to Tennessee if the loan is made to a Tennessee resident, regardless of whether the loan was made at a place of business, by a traveling loan officer, by mail, by telephone or by other electronic means;
- Interest income and other receipts from unsecured commercial loans and installment obligations are sourced to Tennessee if the proceeds of the loan are to be *applied in* Tennessee;
  - If it cannot be determined where the funds are to be applied, the receipts are to be sourced to the state where the business “applied for” the loan.
    - “Applied for” means initial inquiry, customer assistance in preparing the loan application, or submission of a completed loan application, whichever occurs first. “Loan” does not include demand deposit accounts, federal funds, certificates of deposit, and other similar wholesale banking instruments issued by other financial institutions.
- All receipts and fee income from the issuance of letters of credit, acceptance of drafts, and other devices for assuring or guaranteeing a loan or credit are sourced *in the same manner as* interest income/receipts from the loan. (*See bullet points 2, 3, and 4 above.*);

- Interest income, merchant discount, other receipts, including service charges from financial institution credit card and travel and entertainment credit card receivables and credit card holders, and fees, are sourced to the state where the card charges and fees are regularly billed;
- Receipts from the sale of an asset, tangible or intangible, are attributed in the same manner that the income from the asset would be attributed under this section;
- Receipts equal to the net gain or income from the sale of a security made by a dealer in the security (26 U.S.C. § 475) are sourced to Tennessee if the dealer's customer is located in Tennessee and the receipt is not sourced under bullet point seven above. A customer is in Tennessee if the customer is an individual, trust, or estate that is a resident of Tennessee and, for all other customers, if the customer's *commercial domicile* is in Tennessee. Unless the dealer has actual knowledge of the residence or commercial domicile of a customer during a taxable year, the customer is deemed to be a Tennessee customer if the billing address of the customer, as shown in the records of the dealer, is in Tennessee;<sup>977</sup>
- Receipts from the performance of fiduciary and other services are sourced to Tennessee if the service is delivered to a Tennessee location under market-based sourcing;<sup>978</sup>
- Receipts from the issuance of traveler's checks, money orders or United States savings bonds are sourced to the state where such items were purchased;
- Receipts from a participating financial institution's portion of participation loans are sourced as otherwise provided above. A participation loan is any loan in which more than one lender is a creditor to a common borrower; and
- Any other receipts of gross income not specifically covered in (1)-(11) above should be sourced to Tennessee in the same proportion that aggregate receipts are attributed to Tennessee under (1)-(11).
  - This is accomplished by computing the apportionment ratio without considering any numerator or denominator values for this twelfth category of receipts. The ratio based on receipt types 1-11 above is then applied to this category of receipts to source the other receipts to Tennessee. See the Receipts Sourcing section in this chapter for an example of this calculation.

### *Captive REIT Affiliated Group Apportionment – Schedule N*

CRAGs apportion their excise tax base using the three-factor apportionment formula on Form FAE174, Schedule N.<sup>979</sup> This schedule is identical to the one on Form FAE170, which is derived from Tenn. Code Ann. § 67-4-2012. However, dividends, receipts, and expenses resulting from transactions between members of the CRAG are excluded from the apportionment calculation on Form FAE174.<sup>980</sup>

### **3. Loss Carryovers**

The fifteen-year period in which a taxpayer may utilize loss carryovers applies to FIs filing Form FAE174 just as it applies to Form FAE170 filers. An FI unitary group may take a loss carryforward that was generated by any group member that is *in existence as a member of the group at the end of the group's tax year*; provided, that such loss carryover has not previously been taken by the member itself before it joined the group or by another FI unitary group.<sup>981</sup>

[Revenue Ruling 07-14](#) involves an FI unitary group that includes a parent and lower tier unitary affiliates. The ruling considers the survival of loss carryforwards generated by affiliates that dissolved, merged, converted to an SMLLC, or underwent an F reorganization. This ruling involves a single FI unitary group.

- **Dissolution of affiliate.** In the event an affiliate (FI member) makes a liquidating distribution of its assets to the FI parent and subsequently dissolves, the unitary group *cannot* use the NOL carryforward generated by the affiliate. Tenn. Code Ann. § 67-4-2006(c)(4) states that the unitary group may take any NOL carryforward “that was generated by any group member *that is in existence as a member of the group at the end of the group's tax year.*” Because the affiliate dissolved and is not in existence as a member of the group at the end of the group's tax year, the NOL carryforward generated by the affiliate is not available for use by the unitary group.
- **Merger into parent.** In the event an affiliate (FI member) merges out of existence and into the FI parent, the unitary group cannot use the NOL carryforward generated by the affiliate, because the affiliate group member *was not in existence as a member of the group at the end of the group's tax year.*
- **Conversion to SMLLC.** In the event the affiliate (FI member) converts from a corporation to an SMLLC, the SMLLC will be disregarded to the parent. Such conversion is tantamount to a merger of the subsidiary out of existence and into the parent. Again,



any NOL carryforward generated by the affiliate does not survive because the affiliate group member *was not in existence as a member of the group at the end of the group's tax year.*

- **F reorganization.** An affiliate that undergoes an F reorganization will not prevent the unitary FI group from continuing to use the NOL it generated. It is important to understand the limited nature of what an F reorganization involves. Under 26 U.S.C. § 368(a)(1)(F), it is "a mere change in identity, form, or place of organization of *one corporation*, however effected." Importantly, an F reorganization cannot involve the merger or consolidation of *two* separate operating companies.

### Example

Bank A, Inc., *a standalone bank*, goes through a reorganization that results in it becoming a subsidiary of A-Z Banks, Inc. Historically, Bank A, Inc. filed its own Form FAE174. After the reorganization, it will be included in A-Z Banks, Inc.'s Form FAE174.

Can A-Z Banks, Inc. use Bank A, Inc.'s loss carryover that was generated before the reorganization?

Yes, because Bank A, Inc. existed as a member of the unitary group at the end of the group's tax year and the loss carryover has not previously been utilized.

## Credits Available to Financial Institutions

In addition to the credits covered in Chapter 15 of this manual, there are additional franchise and excise tax credits available to financial institutions. These credits involve loans, grants, or contributions in relation to affordable housing, community development financial institutions, or the Tennessee small business or rural opportunity funds.

### 1. Affordable Housing (Community Investment Credit)

Financial institutions may take a credit against their combined franchise and excise tax liability when they make qualified loans, qualified long-term investments, grants, contributions, or qualified low-rate loans to an eligible housing entity for an eligible activity.<sup>982</sup> This community investment tax credit is claimed on the franchise and excise tax Form FAE174, Schedule D.

### *Administration & Claiming the Credit*

This program is administered by the Tennessee Housing Development Agency (“THDA”) in cooperation with the Tennessee Department of Revenue (the “Department”). THDA certifies the housing entity and activity as eligible for the tax credits, and the Department awards the tax credits to the financial institutions to be claimed on their franchise and excise tax returns.

Before claiming this credit, taxpayers must submit the [Affordable Housing Certificate of Contribution for Tax Credit](#) to the THDA. Certain parts of this form are to be completed by the contributor (financial institution), eligible organization, THDA, and the Department.

The taxpayer claims the actual credit awarded by the Department on Form FAE174, Schedule D, Line 3 – Community Investment Credit.

### *Eligible Entities*

Eligible housing entities<sup>983</sup> include:

- Tennessee nonprofit organizations and corporations with Internal Revenue Code § 501(c)(3) status, including entities created and controlled by such corporation, or wholly-owned subsidiaries of such corporation, that engage in eligible activities on behalf of such corporation;
- The Tennessee Housing Development Agency;
- A public housing authority, including an entity created and controlled by such authority, or a wholly-owned subsidiary of such authority, that engages in eligible activity on behalf of such authority; or
- A development district.

### *Eligible Activities*

Eligible activities<sup>984</sup> include activities that:

- Create or preserve affordable housing for low-income Tennesseans;
- Help low-income Tennesseans obtain safe and affordable housing;
- Build the capacity of an eligible nonprofit to provide housing opportunities to low-income Tennesseans; and

- Any other activities approved by the Executive Director of the Tennessee Housing Development Agency and the Commissioner of Revenue.

“Low-income” means any individual or family at or below 80% of the applicable area median family income as determined by family size.<sup>985</sup>

### *Credit Types and Amounts*

There are four types of affordable housing community investment tax credits. The particular credit type and amount depends on whether the taxpayer chooses a one-time or annual credit and the type of investment made by the taxpayer in an eligible entity.

The **one-time credits**,<sup>986</sup> which are based on the total investment amount in an eligible entity for any eligible activity, are as follows:

- **5%** of a qualified loan or qualified long-term investment
- **10%** of a grant, contribution, or qualified low-rate loan

Any one-time credits that are unused may be carried forward for 15 years after the tax year in which the credit originated.<sup>987</sup>

The **annual credits**,<sup>988</sup> which are based on the annual unpaid principal balance of the investment, are as follows:

- **3%, annually**, of the unpaid principal balance of a qualified loan made to an eligible housing entity for any eligible activity as of December 31 of each year for the life of the loan or 15 years, whichever is earlier.
- **5%, annually**, of the unpaid principal balance of a qualified low-rate loan made to an eligible housing entity for any eligible activity as of December 31 of each year for the life of the loan or 15 years, whichever is earlier.

Any annual credit that exceeds the taxpayer’s tax liability for a given tax year **may not** be carried forward to subsequent tax years.<sup>989</sup>

### **DEFINITIONS**

For purposes of this credit, the investment-related terms underlined above are defined as follows:

- **Qualified loan** means a loan that is at least 2% below the prime rate, as published by the Wall Street Journal at the time the loan is approved, that does not qualify as a qualified low-rate loan.<sup>990</sup>
- **Qualified long-term investment** means an equity investment made for a period of more than 5 years to an eligible housing entity.<sup>991</sup>
- **Qualified low-rate loan** means a loan that is at least 4% below the prime rate, as published by the Wall Street Journal at the time the loan is approved.<sup>992</sup>

### Example – Credit Computations

A financial institution makes a \$200,000 qualified loan to an eligible housing entity for an eligible activity. Based on this loan, the financial institution can choose to take either a *one-time* credit of \$10,000 (5% rate), any unused portion of which can be carried forward for up to 15 years, **or** an *annual* credit that is equal to 3% of the unpaid principal balance of the loan at the end of each year. **Any unused annual credits cannot be carried forward.** If the loan were payable to the financial institution over a five-year period, the 3% *annual* credits would be calculated as follows:

<u>Tax Year</u>	<u>Loan Principal Balance</u>	<u>Credit (at 3%)</u>
1	\$200,000	\$6,000
2	\$160,000	\$4,800
3	\$120,000	\$3,600
4	\$80,000	\$2,400
5	\$40,000	\$1,200
6	\$0	\$0

If the financial institution were to make a \$200,000 qualified low-rate loan to an eligible housing entity for an eligible activity, this would generate a *one-time* credit of \$20,000 (10% rate) **or** *annual* credits at the 5% rate, calculated as follows (assuming same payments terms as above):

<u>Tax Year</u>	<u>Loan Principal Balance</u>	<u>Credit (at 5%)</u>
1	\$200,000	\$10,000
2	\$160,000	\$8,000
3	\$120,000	\$6,000
4	\$80,000	\$4,000
5	\$40,000	\$2,000
6	\$0	\$0

### *Syndicated Lending*

[Letter Ruling #19-05](#) discusses the application of community investment tax credits to a syndicated lending arrangement. A syndicated loan is an arrangement where a borrower enters into a single credit agreement with two or more originating lenders. All of the lenders participate jointly in the origination and lending process, and each lender has a direct relationship with the borrower and receives its own promissory note from the borrower.<sup>993</sup>

When two or more financial institutions make a loan to an eligible housing entity for an eligible activity, pursuant to a syndicated lending arrangement in which they are the originating lenders, the financial institutions may claim either the one-time credit or annual credit (with the applicable percentage based on the loan type). However, all lenders must utilize the same credit computation method (e.g., one-time credit at 5%).

If the lenders choose the one-time credit, the credit amount each lender may claim on its tax return is based on the loan amount reflected in the individual lender's promissory note. If the lenders choose the annual credit, the credit amount is based on the balance owed to each lender, pursuant to each lender's promissory note, as of December 31 each year.

### *Loan Participation*

[Letter Ruling #19-05](#) discusses the application of community investment tax credits to a loan participation arrangement. A participation loan is an arrangement that involves the transfer of ownership of a loan (or portion of a loan) between two or more lenders. An "originating lender" originates the loan and then transfers ownership interests in the loan to one or more "participating lenders" while retaining an interest in the loan. The participating lenders do not become parties to the credit agreement and do not have any direct contractual relationship with the borrower.<sup>994</sup>

Under a loan participation arrangement, the determination of which lenders are eligible to claim the community investment tax credit depends on the type of credit claimed by the originating lender. If the originating lender chooses the one-time credit, only the originating lender will be eligible to claim the one-time credit; participating lenders that join into the arrangement later are not eligible to claim the one-time credit (or annual credit). The participating lenders are not eligible to claim the one-time credit because they are not part of the loan at its origination, and thus, are not deemed to have generated the loan and the resulting one-time credit and credit carryforwards.<sup>995</sup> However, if the originating lender chooses the annual credit, participating lenders that join into the arrangement later will also be eligible to claim the annual credit.

If the originating lender chooses the one-time credit, the credit amount the lender may claim on its tax return is based on the total loan amount reflected in the lender's promissory note. If the originating lender chooses the annual credit, the credit amount for the originating lender and all participating lenders is based on the balance owed to each lender, pursuant to each lender's percentage of ownership in the loan, as of December 31 each year.

When participating lenders join into a participation loan for which the originating lender chose the annual credit, the period for claiming the credit is measured by reference to the date on which the loan originated (and not the date on which the participating lender received its ownership interest in the loan). For example:

- A participation loan is originated in 2019, and the originating lender chooses the annual credit. The originating lender sells a portion of the loan to a participating lender in 2021. The participating lender may only claim the annual credit through 2033 or the life of the loan, whichever is earlier.

### *Records Retention*

Pursuant to claiming this credit, certain records must be maintained by the financial institution and the eligible housing entity.<sup>996</sup>

- The regulated financial institution must maintain a certification from the Tennessee Housing Development Agency establishing entitlement to the credit.
- The eligible housing entity receiving the funds must maintain such records as required by the Tennessee Housing Development Agency, to ensure that affordable housing opportunities are being provided.

The Department of Revenue is authorized to share with the Tennessee Housing Development Agency information necessary to effectuate the administration of this credit. The Tennessee Housing Development Agency is bound by restrictions on the disclosure of such information, which is otherwise applicable to the Department of Revenue.<sup>997</sup>

## 2. Community Development Financial Institutions (Community Investment Credit)

Financial institutions may take a credit against their combined franchise and excise tax liability when they make qualified loans, qualified long-term investments, grants, contributions, or qualified low-rate loans to a *community development financial institution* (CDFI) that is certified by the United States Department of the Treasury's Community Development Financial Institutions Fund.<sup>998</sup> This community investment tax credit is claimed on the franchise and excise tax Form FAE174, Schedule D.

### *Claiming the Credit*

Before claiming this credit, taxpayers should mail the completed [Community Development Financial Institution Certificate of Contribution for Tax Credit](#) to the Tennessee Department of Revenue. To be approved, the form must have three signatures: the contributor (financial institution), the eligible organization, and the Department of Revenue.

The actual credit is claimed on Form FAE174, Schedule D, Line 3 – Community Investment Credit.

### *Credit Types and Amounts*

There are four types of CDFI community investment tax credits. The particular credit type and amount depends on whether the taxpayer chooses a one-time or annual credit and the type of investment made by the taxpayer in a certified CDFI.

The **one-time credits**,<sup>999</sup> which are based on the total investment amount in a certified CDFI, are as follows:

- **5%** of a qualified loan or qualified long-term investment
- **10%** of a grant, contribution, or qualified low-rate loan

Any one-time credits that are unused may be carried forward for 15 years after the tax year in which the credit originated.<sup>1000</sup>

The **annual credits**,<sup>1001</sup> which are based on the annual unpaid principal balance of the investment, are as follows:

- **3%, annually**, of the unpaid principal balance of a qualified loan made to a certified CDFI as of December 31 of each year for the life of the loan or 15 years, whichever is earlier.

- **5%, annually**, of the unpaid principal balance of a qualified low-rate loan made to a certified CDFI as of December 31 of each year for the life of the loan or 15 years, whichever is earlier.

Any annual credit that exceeds the taxpayer's tax liability for a given tax year **may not** be carried forward to subsequent tax years.<sup>1002</sup>

### **DEFINITIONS**

For purposes of this credit, the investment-related terms underlined above are defined as follows:

- **Qualified loan** means a loan that is at least 2% below the prime rate, as published by the Wall Street Journal at the time the loan is approved, that does not qualify as a qualified low-rate loan.<sup>1003</sup>
- **Qualified long-term investment** means an equity investment made for a period of more than 5 years.<sup>1004</sup>
- **Qualified low-rate loan** means a loan that is at least 4% below the prime rate, as published by the Wall Street Journal at the time the loan is approved.<sup>1005</sup>

Generally, a community development financial institution **may not** charge a rate of interest that exceeds 24% annually.<sup>1006</sup>

### **3. Rural Opportunity Fund & Small Business Opportunity Fund Credits**

This credit is equal to 10% of a financial institution's contribution to the Tennessee Rural Opportunity Fund ("ROF") or the Tennessee Small Business Opportunity Fund ("SBOF"). The credit is allowed annually for 10 years, beginning with the tax year in which the contribution is made. Unused credits are **not** permitted to be carried forward.<sup>1007</sup>

For the purpose of this credit, loaning funds to either the ROF or the SBOF constitutes a contribution to these funds. However, if at the close of the tenth year of the period during which the credit is allowed, the taxpayer or its assignee received repayment, or retains any right to payment, of all or any portion of the amount contributed or any interest accrued on the amount contributed, the credit plus interest will be *recaptured* in the first tax year following the ten-year period during which the credit is allowed.<sup>1008</sup>

To claim this credit, the taxpayer must complete the [Rural Opportunity Fund and Small Business Opportunity Fund Certificate of Contribution for Tax Credit](#) form and mail it to Pathway Lending



at the address indicated on the form instructions. Southeast Community Capital Corporation (d/b/a Pathway Lending) is the community development financial institution (CDFI) that manages the ROF and SBOF funds.

#### 4. Job Tax Credit

Generally, qualified business enterprises (“QBE”) that qualify for the job tax credit are in the business of manufacturing, warehousing and distribution, processing tangible personal property, a headquarters facility, or back office operations.<sup>1009</sup> Financial institutions that are headquarters facilities would be QBEs and may qualify for the credit. Also, financial institutions could qualify for the job tax credit because they are first-tier subsidiaries of a bank holding company or regulated financial corporation and they have made a capital investment that results in the expansion of QBE activities, such as manufacturing, research and development, computer services, call centers, or tourist services.

See Chapter 16 of this manual for a full discussion of the job tax credit.

#### Credit Carryover

A unitary group of financial institutions may take any qualified credit that was generated by any group member that is in existence as a member of the group at the end of the group's tax year, provided that such credit has not previously been taken by the member itself before it joined the group or by another unitary group of financial institutions at the time the financial institution generating the credit was a member of that group.<sup>1010</sup>

For example:

- A standalone bank merges into a newly-formed subsidiary of a larger bank that has many unitary members. Any unused job tax credit earned by the standalone bank may be used by the larger bank's unitary group after the merger.
- Bank B, of the ABC unitary group, is acquired by Bank D and joins the DEF unitary group of financial institutions. Any unused job tax credit earned by Bank B while it was a part of the ABC unitary group may be used by the DEF unitary group.

#### Audit Procedures

Most audit procedures apply to both FI and non-FI audits. The following is a nonexclusive list of audit procedures specific to FI audits.

## 1. Gather Data

Obtain data and supporting workpapers from the taxpayer and the Department's computer system for each audit period. Such data should include:

- Tax filings
  - Form FAE174 with all supporting schedules, statements, workpapers and elections
  - Federal income tax returns with all supporting schedules, statements and workpapers
- GAAP financial statements; preferably audited and with accompanying footnotes
  - Review 10-K filings for relevant data.<sup>1011</sup>
  - GAAP depreciation schedules that tie to the taxpayer's general ledger and show the book values of property owned in Tennessee, including finance leases
  - GAAP basis operating lease details, including any amounts charged to expense accounts
- Organization charts; preferably dated and including ownership percentages and NAICS codes
  - These should be reviewed in conjunction with federal Form 851
  - Entities included in the FI combined return should be identified
- Taxpayer-prepared workpapers that support the franchise and excise tax return
  - Franchise tax net worth - show balance sheet data for each member
    - Schedule F filers should provide each member's indebtedness calculation worksheets to support the inclusion (or exclusion) of indebtedness from

the net worth franchise tax base

- Schedule F1 and F2 filers should show the details of the eliminations of transactions and holdings between members of the affiliated group and holdings in non-domestic persons
- Franchise tax apportionment – show, by member, the computation of the franchise tax apportionment ratio
  - Schedule F filers should show the details of each member’s apportionment ratio calculation reported on Schedule SF
  - Schedule F1 (captive REIT) filers should show the details of each member’s apportionment data included in the apportionment calculation on Schedule N
  - Schedule F2 (CNW) filers:
    - Provide all CNW election documents (original election and subsequent amendments)
    - Show calculations in determining that affiliated group members are “domestic persons,” per Tenn. Code Ann. § 67-4-2004(15)
    - Show each member’s receipts from both FI and non-FI activities (net of dividends and receipts from transactions between members), to determine whether the affiliated group is an FI affiliated group (Schedule 174SC) or a non-FI affiliated group (Schedule 174NC)
- Tennessee tangible property owned and rented – show, by member, the book value (cost less accumulated depreciation) of real and tangible personal property and rental expense by classification
- Excise tax net earnings – show, by member, the tax basis income statement detail

- Excise tax base modifications – show, by member, any Tennessee modifications (addbacks or deductions) to federal taxable income
- Excise tax apportionment – show, by member, the computation of the excise tax apportionment ratio
- Detailed apportionment schedules – show for each member all the enumerated (and type twelve, “catch all”) receipts, broken out by state and receipt type
- Detail of intercompany receipts elimination – show, by entity and general ledger account, the intercompany receipts that were eliminated from the franchise and excise tax apportionment ratio computation
- Support for community investment tax credits (affordable housing and CDFI)
  - Obtain the taxpayer’s tentative approval letter with Department control number
  - Verify that the Certificate of Contribution for Tax Credit received from the THDA is complete with all signatures on the second page
  - Note any security agreements signed by the lender and the borrower
- Support for contributions made to the Tennessee Rural Opportunity Fund and/or the Tennessee Small Business Opportunity Fund
  - Unsecured subordinated promissory note showing money was lent by the taxpayer to the fund
  - The promissory note should state that it is intended to qualify as a qualified investment to be used for community development purposes
  - The promissory note usually will have a heading on page one of the note stating the name of the fund to which the contribution is made

## **2. Determine the Unitary Group and CNW Affiliated Group**

- FI unitary group

- Using the organization chart, financial statement details, federal tax returns, and other relevant documents obtained, identify the universe of entities related to the taxpayer and then determine the entities that should be included in the FAE174 return.
  - An entity’s PBA code may help identify its primary business.
  - Auditors should consider using tic marks or highlights to explain why they included or excluded an entity from the unitary group.
- Identify the parent that is responsible for filing and paying the tax.
- Test entities included in the return to verify that they meet the definition of a financial institution.
- Evaluate the entities and conclude whether they are unitary with each other.
- FI CNW affiliated group (if applicable)
  - From the universe of entities related to the taxpayer, as identified from the organization chart and related documents, identify the related entities that are includable in the taxpayer’s CNW affiliated group. See Chapter 9 of this manual for more information regarding CNW affiliated group composition.
  - The CNW affiliated group may include entities that would not be included in the FI unitary group. CNW affiliates may include those that do not meet the definition of an FI. Also, they may include those not unitary with the FI group.
  - The CNW affiliated group may exclude affiliates found in the FI group. For example, affiliates that are non-domestic<sup>1012</sup> persons would be included in the FI unitary group but would be excluded from the CNW affiliated group.
  - Determine if the majority of the CNW affiliated group’s receipts were derived from conducting the business of an FI<sup>1013</sup> for apportionment purposes.

### 3. Filing Period

- Enter the return's filing period on applicable audit workpapers.
- For each unitary member, include its tax period beginning and end dates on applicable schedules for annualization and proration purposes.

### 4. Verify Data

#### *Verify the denominator value of the apportionment ratio on Schedule SE*

- Reconcile the denominator to the federal return. Make notes of any reconciling items.
- Determine that intercompany transactions have been eliminated from the receipts factor.
- Determine that "other business receipts" reported on Schedule SE, Line 12, do not impact the excise tax apportionment ratio.
  - Recall that "other business receipts" includable on Line 12 are to be attributed to Tennessee in the same proportion as the aggregate gross receipts included on Schedule SE, Lines 1-11; in other words, the Tennessee numerator of Line 12 must be "plugged" so as to maintain the same apportionment ratio as determined by the ratio of the sum of Tennessee receipts to the sum of everywhere receipts on Lines 1-11.
- Determine that receipts are reported at gross values, unless Rule 32 applies.<sup>1014</sup>

#### *Verify the denominator values of the apportionment ratios on Schedule SF*

- Follow the same procedures indicated above for Schedule SE, except the values are maintained for each member.

#### *Verify apportionment ratio numerator values*

- Document in the audit workpapers the work done to verify the apportionment ratio numerator. Describe documents reviewed and audit findings.

- Pull a sample using a judgmental sampling method so that at least one transaction is understood sufficiently to agree with the taxpayer's sourcing.

*Verify credits claimed for community investments (affordable housing and CDFI) and Tennessee opportunity fund contributions (TN ROF and SBOF)*

- Obtain Department-issued tax credit control letters and evidence of related loan balances.

## Examples of Common Audit Findings

- A brokerage company is erroneously included in the combined return; it is not a subsidiary of a bank holding company or a regulated financial corporation or the direct subsidiary of a bank holding company or regulated financial corporation.
  - A brokerage company does not meet the definition of “business of a financial institution.”<sup>1015</sup> A brokerage company's main duty is to act as a middleman that connects buyers and sellers to facilitate investment transactions.
- The apportionment ratio does not reflect *gross* receipts and Rule 32 does not apply.<sup>1016</sup>
- Dividends, receipts, and expenses resulting from transactions between members of the unitary group are not excluded when computing combined net earnings or net loss.
- Intercompany transactions are excluded in computing the non-consolidated franchise tax base (Schedule F).
- The apportionment ratio does not attribute “other business receipts” (e.g., Schedule SE, Line 12) to Tennessee in the same proportion that the other enumerated receipts are attributed to Tennessee.
- A unitary member that left the unitary group (due to a sale, merger, etc.) is erroneously included on Schedule F2 - Consolidated Net Worth - instead of filing Schedule F and computing its net worth on a separate entity basis.

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- <sup>1</sup> *Bank of Commerce & Trust Co. v. Senter*, 149 Tenn. 569, 260 S.W. 144 (1924).
- <sup>2</sup> *Corn v. Fort*, 170 Tenn. 377, 95 S.W.2d 620 (1936).
- <sup>3</sup> *Mid-Valley Pipeline Co. v. King*, 221 Tenn. 724, 431 S.W.2d 277, 1968.
- <sup>4</sup> 1999 Tennessee Laws Pub. Ch. 406, Tenn. Code Ann. §§ 67-4-2007, 67-4-2105.
- <sup>5</sup> Tn.gov/Revenue
- <sup>6</sup> Tenn. Code Ann. §§ 67-4-2007(b), 67-4-2105(a).
- <sup>7</sup> Tenn. Code Ann. §§ 67-4-2005, 67-4-2104.
- <sup>8</sup> Tenn. Code Ann. §§ 67-4-2002, 67-4-2102.
- <sup>9</sup> Form FAE174, if a financial institution or captive real estate investment trust.
- <sup>10</sup> Tenn. Code Ann. §§ 67-4-2007(e)(1), 67-4-2106(c).
- <sup>11</sup> Tenn. Code Ann. § 67-4-2004(19).
- <sup>12</sup> Tenn. Code Ann. § 67-4-2004(34); activities outside scope of exempt status may be taxed.
- <sup>13</sup> Tenn. Code Ann. §§ 67-4-2007(d), 67-4-2106(c).
- <sup>14</sup> Tenn. Code Ann. §§ 67-4-2007(b), 67-4-2105(c).
- <sup>15</sup> Tenn. Code Ann. §§ 67-4-2104, 67-4-2105(a).
- <sup>16</sup> Tenn. Code Ann. § 67-4-2119.
- <sup>17</sup> Tenn. Code Ann. § 67-4-2007.
- <sup>18</sup> Tenn. Code Ann. § 67-4-2006(a).
- <sup>19</sup> Tenn. Code Ann. § 67-4-2006(b).
- <sup>20</sup> Tenn. Code Ann. § 67-4-2007.
- <sup>21</sup> 2002 Tennessee Laws Pub. Ch. 856.
- <sup>22</sup> See Chapter 14 for the tax rate when an election has been made under Tenn. Code Ann. § 67-4-2023 involving certified distribution sales.
- <sup>23</sup> Tenn. Code Ann. § 67-4-2008.
- <sup>24</sup> [Letter Ruling # 11-63](#)
- <sup>25</sup> IRS Publication 598 – *Tax on Unrelated Business Income of Exempt Organizations*.
- <sup>26</sup> [Letter Ruling # 17-07](#)
- <sup>27</sup> [Important Notice # 04-11](#)
- <sup>28</sup> See [Letter Ruling # 11-55](#). Entities formed for the purpose of securitizing trust preferred securities are not exempt.
- <sup>29</sup> Tenn. Code Ann. § 4-28-102. See <https://www.tn.gov/ecd/small-business/tninvestco/about-tninvestco.html> for fund names.
- <sup>30</sup> See [Important Notice #09-05](#); the seven-month extension period is effective for tax years beginning on or after January 1, 2021 (for tax years beginning prior to this date, the extension period is six months).
- <sup>31</sup> [Important Notice # 04-28](#)
- <sup>32</sup> See [Revenue Ruling # 08-20](#)
- <sup>33</sup> Tenn. Code Ann. §§ 67-4-2004(35), 67-4-2008(b), (c), and (d).
- <sup>34</sup> Tenn. Code Ann. §§ 67-4-2004(36) and 67-4-2008(a)(9).
- <sup>35</sup> Tenn. Code Ann. § 67-4-2008(a)(9)(D).



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<sup>36</sup> This is true, assuming that all of the OME's individual members or partners have made the election under Tenn. Code Ann. § 67-4-2008(b)-(d) and filed the appropriate documentation with the Tennessee Secretary of State, in accordance with Tenn. Code Ann. § 67-4-2008(a)(9).

<sup>37</sup> In this manual, wherever reference is made to a "partial exemption" or a "partially exempt" entity, with respect to the franchise and excise tax obligated member entity ("OME") exemption, these terms refer to an OME where all of the members or partners (direct owners) have made the election to become obligated members that are fully liable for the debts, obligations, and liabilities of the OME, in accordance with Tenn. Code Ann. § 67-4-2008(b)-(d), but some of the obligated members (or owners of the obligated members) are a type of entity that provides limited liability protection (e.g., an OME that is partly owned by an LP, LLC, or a corporation).

<sup>38</sup> Tenn. Code Ann. § 67-4-2008(a)(9)(D).

<sup>39</sup> See Tenn. Code Ann. §§ 67-4-2008(a)(9) and 67-4-2008(b)-(d).

<sup>40</sup> See Tenn. Code Ann. § 67-4-2008(a)(10)(B).

<sup>41</sup> Tenn. Code Ann. § 67-4-2008(11)(B).

<sup>42</sup> Tenn. Code Ann. § 67-4-2008(a)(11)(B)(iii).

<sup>43</sup> Tenn. Code Ann. § 67-4-2008(a)(11)(B)(iv).

<sup>44</sup> Tenn. Code Ann. § 67-4-2004(38).

<sup>45</sup> Tenn. Code Ann. § 67-4-2004(37).

<sup>46</sup> Tenn. Code Ann. § 61-1-306.

<sup>47</sup> Tenn. Code Ann. § 61-1-1005.

<sup>48</sup> Tenn. Code Ann. § 48-249-309(b).

<sup>49</sup> [Important Notice # 13-15](#)

<sup>50</sup> Note that the type of federal return filed by a "business trust" is not determinative of whether such trust is subject to franchise and excise taxes as a taxable business trust; rather, the status of a trust as a "business trust" for franchise and excise tax purposes is dependent upon the kind of activities in which it engages.

<sup>51</sup> *Id.*

<sup>52</sup> Treas. Reg. §301.7701-4(b).

<sup>53</sup> Tenn. Code Ann. § 67-4-2003(c).

<sup>54</sup> Tenn. Code Ann. §§ 67-4-2007(b) and 2105(c).

<sup>55</sup> Tenn. Code Ann. §§ 67-4-2007(d) and 2106(c).

<sup>56</sup> Treas. Reg. §301.7701-3.

<sup>57</sup> [Important Notice # 13-16](#)

<sup>58</sup> Tenn. Code Ann. § 58-2-204(c)(5).

<sup>59</sup> Tenn. Code Ann. § 67-4-2004(38).

<sup>60</sup> Tenn. Code Ann. § 67-4-2105(a).

<sup>61</sup> Tenn. Code Ann. § 67-4-2007(a).

<sup>62</sup> Tenn. Code Ann. § 67-4-2004(14).

<sup>63</sup> Tenn. Code Ann. § 67-4-2004(14)(E)(i)-(iv).

<sup>64</sup> Tenn. Code Ann. § 67-4-2004(49).

<sup>65</sup> Tenn. Code Ann. § 67-4-2012.

<sup>66</sup> Tenn. Code Ann. § 67-4-2012.

<sup>67</sup> Tenn. Code Ann. § 67-4-2012.

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<sup>68</sup> [Revenue Ruling 17-08](#)

<sup>69</sup> <https://www.irs.gov/individuals/international-taxpayers/effectively-connected-income-eci>

<sup>70</sup> Tenn. Code Ann. § 67-4-2004(49)(B).

<sup>71</sup> Tenn. Code Ann. § 67-4-2004(52).

<sup>72</sup> Tenn. Code Ann. § 67-4-2004(17).

<sup>73</sup> Tenn. Code Ann. § 67-4-2004(21).

<sup>74</sup> Tenn. Code Ann. § 67-4-2004(45).

<sup>75</sup> Tenn. Code Ann. § 67-4-2004(30).

<sup>76</sup> Tenn. Code Ann. § 67-4-2004(5).

<sup>77</sup> Tenn. Code Ann. § 67-4-2004(14)(B).

<sup>78</sup> *Complete Auto Transit, Inc. v Brady*, 430 U.S. 274 (1977).

<sup>79</sup> *South Dakota v. Wayfair, Inc.*, 585 U.S. \_\_\_ (2018).

<sup>80</sup> Tenn. Code Ann. §§ 67-4-2010, 67-4-2110.

<sup>81</sup> Tenn. Code Ann. §§ 67-4-2012, 67-4-2111.

<sup>82</sup> 15 USC § 381, enacted in 1959.

<sup>83</sup> *Wisconsin v. William Wrigley, Jr. Co.*, 505 U.S. 214 (1992) provides an interpretation of the phrase “solicitation of orders.” Also, solicitation is defined as “[t]he act or an instance of requesting or seeking to obtain something; a request or petition.” Black’s Law Dictionary (7th ed. 2000).

<sup>84</sup> Attorney General Opinion # 04-159.

<sup>85</sup> [http://www.mtc.gov/uploadedFiles/Multistate Tax Commission/Uniformity/Uniformity Project s/A - Z/StatementofInfoPublicLaw86-272.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Project_s/A_-_Z/StatementofInfoPublicLaw86-272.pdf)

<sup>86</sup> Black’s Law Dictionary (8th ed. 2004).

<sup>87</sup> Tenn. Code Ann. §§ 67-4-2007(d), (e)(1), and 67-4-2106(c).

<sup>88</sup> Tenn. Code Ann. § 67-4-2007(e)(1).

<sup>89</sup> Tenn. Code Ann. § 67-4-2103(d).

<sup>90</sup> Tenn. Code Ann. §§ 67-4-2007(d) and 67-4-2106(c).

<sup>91</sup> See IRS Treas. Reg. § 301.7701 for more detailed information regarding federal tax classification.

<sup>92</sup> TENN. COMP. R. & REGS. 1320-06-01-.40.

<sup>93</sup> TENN. COMP. R. & REGS. 1320-06-01-.41.

<sup>94</sup> There is no need to prepare a Form 1065 for the LLC that distributes all its proceeds on Schedule K-1 to two entities that file within the same consolidated Form 1120. While the result is the same either way for federal income tax purposes, it is much simpler for the LLC to be disregarded and included in the consolidated federal return that includes the two corporations that own the LLC.

<sup>95</sup> Tenn. Code Ann. §§ 67-4-2007, 67-4-2103.

<sup>96</sup> Tenn. Code Ann. §§ 67-4-2007, 67-4-2103.

<sup>97</sup> Tenn. Code Ann. §§ 67-4-2007, 67-4-2103.

<sup>98</sup> Tenn. Code Ann. § 67-4-2116.

<sup>99</sup> Tenn. Code Ann. §§ 67-4-2003, 67-4-2103.

<sup>100</sup> Tenn. Code Ann. § 67-1-115.

<sup>101</sup> Tenn. Code Ann. § 67-4-2015(a).

<sup>102</sup> Tenn. Code Ann. § 67-4-2115(a).

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<sup>103</sup> The box titled “Date Tennessee operations began” must be completed on all initially filed Forms FAE170 and FAE174.

<sup>104</sup> Tenn. Code Ann. § 67-4-2015(a).

<sup>105</sup> Filing due dates occurring on a weekend or a legal holiday, for IRS purposes, may be extended to the next workday by the Commissioner of Revenue.

<sup>106</sup> Tenn. Code Ann. § 67-4-2015(k).

<sup>107</sup> TENN. COMP. R. & REGS. 1320-06-01-.02.

<sup>108</sup> The seven-month extension period is effective for tax years beginning on or after January 1, 2021. For tax years beginning prior to this date, the extension period is six months.

<sup>109</sup> Annualized Tax = (Tax Liability Reported on Return x 365.25) ÷ Number of Days in Short Tax Period.

<sup>110</sup> Tenn. Code Ann. § 67-4-2015(h)(1)(A).

<sup>111</sup> The taxpayer should check the box on page one of the return that indicates the taxpayer has filed for a federal extension (if applicable).

<sup>112</sup> Tenn. Code Ann. § 67-4-2015(h)(1)(C).

<sup>113</sup> For tax years beginning on or after January 1, 2021, the extension period is seven months from the original return due date. For tax years beginning prior to January 1, 2021, the extension period is six months.

<sup>114</sup> Tenn. Code Ann. § 67-1-113(b).

<sup>115</sup> Tenn. Code Ann. § 67-4-2015(a).

<sup>116</sup> Tenn. Code Ann. § 67-4-2115(a).

<sup>117</sup> TENN. COMP. R. & REGS. 1320-06-01-.28(2)(c).

<sup>118</sup> All balance sheet accounts will have zero balances.

<sup>119</sup> Tenn. Code Ann. § 67-4-2004(16).

<sup>120</sup> Tenn. Code Ann. § 67-4-2115(a)-(b).

<sup>121</sup> A pre-liquidation balance sheet prepared in accordance with GAAP should be available as support for the net worth and property numbers reported on the final return. An alternative method of accounting may be accepted if the taxpayer does not maintain books and records in accordance with GAAP.

<sup>122</sup> Tenn. Code Ann. § 67-4-2115(b).

<sup>123</sup> The instructions to the Franchise Tax Worksheet for Accounts in Final Return Status were revised in 2019 and the “at least half of the month” wording was removed.

<sup>124</sup> Tenn. Code Ann. § 67-4-2115(b).

<sup>125</sup> Tenn. Code Ann. § 67-4-2115(b).

<sup>126</sup> Tenn. Code Ann. §§ 67-4-2007(c), 67-4-2105(c).

<sup>127</sup> Tenn. Code Ann. § 67-4-2117.

<sup>128</sup> Tenn. Code Ann. § 67-4-2115(b).

<sup>129</sup> Tenn. Code Ann. § 67-4-2009(6)(A).

<sup>130</sup> See [Important Notice #13-16](#)

<sup>131</sup> IRC §708(b)(1)(B).

<sup>132</sup> Tenn. Code Ann. § 48-249-909.

<sup>133</sup> Tenn. Code Ann. §§ 67-4-2105(c), 67-4-2007(c).

<sup>134</sup> IRC §368(a)(1)(A)-(G).

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<sup>135</sup> See [Important Notice #16-04](#)

<sup>136</sup> The *annualized income installment method* for computing quarterly estimated tax payments is permitted for tax years beginning on or after January 1, 2017.

<sup>137</sup> Tenn. Code Ann. § 67-1-115.

<sup>138</sup> Tenn. Code Ann. § 67-1-703(b).

<sup>139</sup> For tax years beginning before January 1, 2016, the penalty rate was 5% per month, with a maximum of 25%. Tenn. Code Ann. § 67-4-2015(d).

<sup>140</sup> Tenn. Code Ann. § 67-4-2015.

<sup>141</sup> Tenn. Code Ann. § 67-1-803(d)(3).

<sup>142</sup> Tenn. Code Ann. § 67-1-804(b)(1).

<sup>143</sup> Tenn. Code Ann. §§ 67-1-804(b)(2), 67-4-2006(e).

<sup>144</sup> Tenn. Code Ann. § 67-4-2007(f).

<sup>145</sup> Tenn. Code Ann. § 67-1-804(b)(3).

<sup>146</sup> Tenn. Code Ann. § 67-1-804(c)(2).

<sup>147</sup> Tenn. Code Ann. §§ 67-1-804(d), 67-1-1400 *et seq.*

<sup>148</sup> Tenn. Code Ann. § 67-1-803(c)-(d).

<sup>149</sup> Tenn. Code Ann. § 67-1-803.

<sup>150</sup> Tenn. Code Ann. § 67-1-803(c)(1)(A)-(E).

<sup>151</sup> Tenn. Code Ann. § 67-1-803(d)(1)(A)-(I).

<sup>152</sup> Tenn. Code Ann. § 67-1-107.

<sup>153</sup> Tenn. Code Ann. § 67-1-803.

<sup>154</sup> Tenn. Code Ann. § 67-1-801(a)(1)(B).

<sup>155</sup> Tenn. Code Ann. § 67-1-801(a)(2).

<sup>156</sup> Tenn. Code Ann. §§ 67-4-2016, 67-4-2116.

<sup>157</sup> Tenn. Code Ann. § 67-1-1501(b).

<sup>158</sup> Tenn. Code Ann. § 67-1-1802(a)(1)(A).

<sup>159</sup> Tenn. Code Ann. § 67-1-1802(b)(1).

<sup>160</sup> Tenn. Code Ann. § 67-1-1501(b)(5).

<sup>161</sup> Tenn. Code Ann. §§ 67-4-2003(b), 67-4-2103(b).

<sup>162</sup> Tenn. Code Ann. § 67-1-113.

<sup>163</sup> Tenn. Code Ann. § 67-1-1438.

<sup>164</sup> Foreign expropriation capital losses cannot be carried back but are carried forward up to 10 years. Also, a net capital loss of a regulated investment company (RIC) incurred in tax years beginning before December 23, 2010, is carried forward up to 8 years. There is no limit on the number of tax years a RIC is allowed to carry forward a net capital loss incurred in tax years beginning after December 22, 2010.

<sup>165</sup> An LLC electing classification as an S-corporation generally is not required to file Form 8832 to elect classification as a corporation before filing Form 2553. By filing Form 2553, an LLC is deemed to have elected classification as a corporation in addition to the S-corporation classification. S-corporation shareholders cannot include non-resident aliens, partnerships, or corporations.

<sup>166</sup> This QSub election results in a deemed liquidation of the subsidiary into the parent. Following the deemed liquidation, the QSub is not treated as a separate corporation and all of the

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subsidiary's assets, liabilities, and items of income, deduction, and credit are treated as those of the parent.

<sup>167</sup> Under Chapter 3 of the Internal Revenue Code.

<sup>168</sup> A Canadian or Mexican corporation described in IRC § 1504(d), maintained solely for complying with the laws of Canada or Mexico for title and operation of property, may elect to be treated as a domestic corporation and thereby file as part of an affiliated group.

<sup>169</sup> [Important Notice #17-16](#)

<sup>170</sup> See Tenn. Code Ann. § 67-4-2006(b).

<sup>171</sup> Visit <https://www.tn.gov/revenue/tax-resources/legal-resources/tax-rates-and-interest-rate.html> to see the current interest rate in effect.

<sup>172</sup> Tenn. Code Ann. § 67-1-1501(b)(3).

<sup>173</sup> Tenn. Code Ann. § 67-1-1501(b)(3).

<sup>174</sup> Tenn. Code Ann. § 67-1-1802(a)(3).

<sup>175</sup> Tax basis records may be used for franchise tax purposes when GAAP records are not maintained. Tenn. Code Ann. §§ 67-4-2106(b), 67-4-2108(a)(3).

<sup>176</sup> Federal Form 870-Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment is filed by taxpayers wishing to consent to the federal assessment of the deficiencies shown in the form in order to limit any interest charge and expedite the adjustment to their account.

<sup>177</sup> Tenn. Code Ann. § 67-4-2010(a).

<sup>178</sup> Tenn. Code Ann. § 67-4-2011(b).

<sup>179</sup> Tenn. Code Ann. § 67-4-2011(c).

<sup>180</sup> Tenn. Code Ann. § 67-4-2004(10).

<sup>181</sup> Tenn. Code Ann. § 67-4-2011(d).

<sup>182</sup> Tenn. Code Ann. § 67-4-2011(e).

<sup>183</sup> Tenn. Code Ann. § 67-4-2004(4).

<sup>184</sup> The definition of business earnings was broadened in 1993 with Public Chapter 282 to include the functional test. Prior to this amendment, only the transactional test was used to determine business earnings. Note that many cases decided prior to the 1993 law change are no longer applicable. Examples of these "old law" court cases include *General Care Corp. v. Olsen*, 705 S.W.2d 642 (Tenn. 1986) (liquidation of all assets), *Union Carbide Corp. v. Huddleston*, 854 S.W.2d 87 (Tenn. 1993) (partial liquidation of assets), *Federated Stores Realty, Inc. v. Huddleston*, 852 S.W.2d 206 (Tenn. 1993) (partial liquidation of assets), and *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994) (sale of partnership interest). In fact, the Court stated in *Associated Partnership I*, which was decided after the law change, that its decision would have been different if it had been decided under the amended law.

<sup>185</sup> Tenn. Code Ann. § 67-4-2004(33).

<sup>186</sup> TENN. COMP. R. & REGS. 1320-06-01-.23(3).

<sup>187</sup> Tenn. Code Ann. § 67-4-2010(b).

<sup>188</sup> The "unitary" definition found at Tenn. Code Ann. § 67-4-2004(52) applies only to financial institutions.

<sup>189</sup> *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460 (Tenn. Ct. App. 1996).

<sup>190</sup> *Id.*

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<sup>191</sup> *L.M. Berry & Co. v. Huddleston*, No. 01A01-9809-CH-00487, 1999 WL 976528 (Tenn. Ct. App. Oct. 28, 1999).

<sup>192</sup> *Siegel-Robert, Inc. v. Johnson*, No. M2008-02228-COA-R3-CV, 2009 WL 3486625 (Tenn. Ct. App. Oct. 28, 2009).

<sup>193</sup> *Newell Window Furnishing, Inc. v. Johnson*, 311 S.W.3d 441 (Tenn. Ct. App. 2008).

<sup>194</sup> *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59 (2011).

<sup>195</sup> *H.J. Heinz Co., LP v. Chumley*, No. M2010-00202-COA-R3-CV, 2011 WL 2569755 (Tenn. Ct. App. June 28, 2011).

<sup>196</sup> Tenn. Code Ann. § 67-4-2105(a).

<sup>197</sup> Tenn. Code Ann. § 67-4-2004(38).

<sup>198</sup> Tenn. Op. Atty. Gen. 04-159 (Nov. 8, 2004).

<sup>199</sup> Tenn. Code Ann. § 67-4-2119.

<sup>200</sup> Tenn. Code Ann. § 67-4-2117.

<sup>201</sup> Tenn. Code Ann. § 67-4-2106(a).

<sup>202</sup> Tenn. Code Ann. §§ 67-4-2108(a), 2108(a)(6)(G), and 2109(b)(2)(B).

<sup>203</sup> Tenn. Code Ann. § 67-4-2121.

<sup>204</sup> Tenn. Code Ann. §§ 67-4-2106(b) and 2108(a)(3).

<sup>205</sup> ASC 205-30: Liquidation Basis of Accounting.

<sup>206</sup> Tenn. Code Ann. § 67-4-2106(b).

<sup>207</sup> ASC 505-10-45-3.

<sup>208</sup> ASC 505-10-45-4.

<sup>209</sup> Tenn. Code Ann. § 67-4-2107(b).

<sup>210</sup> TENN. COMP. R. & REGS. 1320-06-01-.15.

<sup>211</sup> Schedules N (standard apportionment), O (common carriers), P (air carriers), R (air express carriers), or S (manufacturers electing to use single sales factor).

<sup>212</sup> Tenn. Code Ann. § 67-4-2111(a).

<sup>213</sup> As defined by Tenn. Code Ann. § 67-4-2004(2)(A) to mean, greater than 50% direct or indirect ownership interests among domestic persons, regardless of whether such persons do business in Tennessee.

<sup>214</sup> Tenn. Code Ann. § 67-4-2103(i).

<sup>215</sup> Tenn. Code Ann. § 67-4-2004(16).

<sup>216</sup> Tenn. Code Ann. § 67-4-2115(b).

<sup>217</sup> A corporate taxpayer that converts to a disregarded LLC is not removed from an affiliated group as long as the conversion does not result in the taxpayer having a short period that ends on a date that differs from the affiliated group's.

<sup>218</sup> Tenn. Code Ann. § 67-4-2004(15) defines domestic person as any person with more than 20% of the average of its property, payroll and receipts factors, as each factor is computed for a separate entity under § 67-4-2111, in the United States. Thus, non-domestic persons are those that do not meet this definition. However, when a member of an affiliated group invests in a foreign disregarded SMLLC that qualifies as a disregarded entity for franchise and excise tax purposes, the net worth of that foreign disregarded SMLLC *will* be included in the consolidated net worth computation (see [Letter Ruling # 14-03](#)).

<sup>219</sup> Tenn. Code Ann. § 67-4-2106(b).

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<sup>220</sup> Tenn. Code Ann. § 67-4-2004(15).

<sup>221</sup> Tenn. Code Ann. § 67-4-2004(2)(A).

<sup>222</sup> Tenn. Code Ann. § 67-4-2004(38).

<sup>223</sup> An exception to this would be if the parent was a natural person—that is, an individual. The ownership interests between affiliated group members cannot be through natural persons. For example, a natural person that has a greater-than-50% ownership interest in two otherwise unaffiliated entities would not make those two entities affiliated group members.

<sup>224</sup> For tax years beginning prior to July 1, 2016, the sales (gross receipts) factor would be double-weighted instead of triple-weighted, and the total ratios (property, payroll, and sales) divided by four instead of five.

<sup>225</sup> <https://www.irs.gov/individuals/international-taxpayers/effectively-connected-income-eci>

<sup>226</sup> <https://www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income>

<sup>227</sup> Tenn. Code Ann. § 67-4-2106(b).

<sup>228</sup> *Id.*

<sup>229</sup> A “non-domestic person” is an entity that does not meet the definition of a “domestic person” at Tenn. Code Ann. § 67-4-2004(15).

<sup>230</sup> *See* Tenn. Code Ann. § 67-4-2004(2).

<sup>231</sup> Tenn. Code Ann. § 67-4-2111.

<sup>232</sup> Although the consolidated net worth apportionment formula is based on GAAP books and records, Tenn. Code Ann. § 67-4-2111(b)(2)(B) still requires that property owned by the taxpayer be valued at its original (GAAP basis) cost (i.e., original cost without deducting accumulated depreciation).

<sup>233</sup> As defined by Tenn. Code Ann. § 67-4-2111(l)(2).

<sup>234</sup> Tenn. Code Ann. § 67-4-2118.

<sup>235</sup> Common carriers have special apportionment provisions that are based on mileage and gross receipts for franchise and excise tax purposes, codified at Tenn. Code Ann. §§ 67-4-2111 and 67-4-2013, respectively. Regardless of whether the common carrier is part of a financial institution affiliated group or a non-financial institution affiliated group, it will use the provisions codified at Tenn. Code Ann. § 67-4-2111 to determine its apportionment factors for consolidated net worth.

<sup>236</sup> Uniform Division of Income for Tax Purposes Act – Article IV of the Multistate Tax Commission’s *Multistate Tax Compact*. Tennessee’s standard apportionment methodology for franchise and excise tax purposes is based on the UDITPA model.

<sup>237</sup> Tenn. Code Ann. § 67-4-2103(f).

<sup>238</sup> Tenn. Code Ann. § 67-4-2004(18).

<sup>239</sup> Tenn. Code Ann. § 67-4-2004(5)(A).

<sup>240</sup> Tenn. Code Ann. §§ 67-4-2004(17) and 67-4-2004(5)(A)(i)-(ii).

<sup>241</sup> With respect to Tennessee, *affiliate* as defined by Tenn. Code Ann. § 67-4-2004(1)(A).

<sup>242</sup> Tenn. Code Ann. § 67-4-2004(15).

<sup>243</sup> Tenn. Code Ann. § 67-4-2103(d).

<sup>244</sup> ASC 810-10-45-15.

<sup>245</sup> ASC 810-10-45-16.

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<sup>246</sup> Tenn. Code Ann. § 67-4-2004(15).

<sup>247</sup> *Id.*

<sup>248</sup> The ability of the investor to exercise significant influence over the investee can be indicated in several ways, including the investor's representation on the investee's board of directors and the investor's participation in the investee's policy-making processes.

<sup>249</sup> GAAP does permit two fair value adjustments to the cost method: 1) impairment losses (adjustments for *impairment* when it is determined that the fair value of the investment has fallen below the investor's carrying amount of the investment), and 2) observable price changes in orderly transactions for identical/similar investments issued by the same investee.

<sup>250</sup> The common parent corporation must directly own at least 80% of both the voting power and total value of all outstanding stock of an includable subsidiary corporation.

<sup>251</sup> With respect to foreign corporations, they are includable only if they meet the definition of a domestic person under Tenn. Code Ann. § 67-4-2004(15).

<sup>252</sup> Tenn. Code Ann. § 67-4-2103(d).

<sup>253</sup> Tenn. Code Ann. § 67-4-2103(e).

<sup>254</sup> Letter Rulings # [17-06](#) and [17-13](#)

<sup>255</sup> Tenn. Code Ann. § 67-4-2004(5)(A).

<sup>256</sup> The book value of real and tangible property owned or used within the state is determined by generally accepted accounting principles (GAAP) accounting records, when available.

<sup>257</sup> Tenn. Code Ann. § 67-4-2108(a)(1).

<sup>258</sup> *Id.*

<sup>259</sup> Tenn. Code Ann. § 67-4-2108.

<sup>260</sup> Tenn. Code Ann. § 67-4-2108(a)(3).

<sup>261</sup> [Important Notice #04-30](#)

<sup>262</sup> [https://assessment.cot.tn.gov/RE\\_Assessment/](https://assessment.cot.tn.gov/RE_Assessment/)

<sup>263</sup> Under GAAP, the taxpayer might also employ use of the specialized accounting rules for *nonmonetary transactions* codified at ASC 845.

<sup>264</sup> *GAAP Guide – Restatement and Analysis of Current FASB Standards* (2014).

<sup>265</sup> Tenn. Code Ann. § 67-4-2108(a)(3).

<sup>266</sup> Tenn. Code Ann. § 67-4-2115(b); TENN. COMP. R. & REGS. 1320-06-01-.29.

<sup>267</sup> Tenn. Code Ann. § 67-4-2108(a)(4); TENN. COMP. R. & REGS. 1320-06-01-.27(3).

<sup>268</sup> TENN. COMP. R. & REGS. 1320-06-01-.18(3).

<sup>269</sup> Tenn. Code Ann. § 67-4-2108(a)(1).

<sup>270</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(B)-(C).

<sup>271</sup> Tenn. Code Ann. § 67-4-2108(a)(2); TENN. COMP. R. & REGS. 1320-06-01-.18(4).

<sup>272</sup> *Crown Enterprises, Inc. v. Woods*, 557 S.W.2d 491, 493 (Tenn. 1977).

<sup>273</sup> Tenn. Code Ann. § 67-4-2108(5).

<sup>274</sup> Tenn. Code Ann. §§ 67-4-2108(a)(5)(C), 67-4-2004(9).

<sup>275</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(B).

<sup>276</sup> Tenn. Code Ann. §§ 67-4-2108(a)(6)(G), 67-4-2108(a)(1).

<sup>277</sup> A single unit of property consists of all components that are functionally interdependent, such that one component cannot be placed in service without the other components.

<sup>278</sup> Tenn. Code Ann. § 67-4-2108(a).



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<sup>279</sup> Tenn. Code Ann. § 67-4-2108(a)(3).

<sup>280</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(D); TENN. COMP. R. & REGS. 1320-06-01-.18(1).

<sup>281</sup> The net annual rental amount is the gross annual rent paid, less the gross rent received for sub-rental.

<sup>282</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(D); TENN. COMP. R. & REGS. 1320-06-01-.18(1).

<sup>283</sup> TENN. COMP. R. & REGS. 1320-06-01-.18(1).

<sup>284</sup> [Revenue Ruling 01-06](#)

<sup>285</sup> *Id.*

<sup>286</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(D). For apportionment factor, see TENN. COMP. R. & REGS. 1320-06-01-.28(2)(c)(2).

<sup>287</sup> Tenn. Code Ann. § 67-4-2115.

<sup>288</sup> The final sentence of Rule 28(2)(c)(2) does not function to exclude any expense from the computation, but only limits the “in lieu of” inclusion amount. See [Letter Ruling 06-08](#)

<sup>289</sup> GAAP Standard ASC 842; IRS Publication 535.

<sup>290</sup> The new lease accounting standard was introduced by FASB Accounting Standards Update No. 2017-13, and it became effective for public business entities for fiscal years beginning after December 15, 2018.

<sup>291</sup> Leases with a term of 12 months or less and leases of property with a value of less than \$5,000 are not required to be reported on the balance sheet.

<sup>292</sup> The new lease accounting standard was introduced by FASB Accounting Standards Update No. 2017-13, and it became effective for public business entities for fiscal years beginning after December 15, 2018.

<sup>293</sup> The net annual rental amount is the gross annual rent paid less the gross rent received for sub-rental.

<sup>294</sup> For partnerships, see Schedule M-3 (Form 1065) Part III, Line 28.

<sup>295</sup> Tenn. Code Ann. § 67-4-2108(b).

<sup>296</sup> Federal Form 1065 instructions.

<sup>297</sup> Tenn. Code Ann. § 67-4-2108(a)(3).

<sup>298</sup> *Id.*

<sup>299</sup> *Id.*

<sup>300</sup> TENN. COMP. R. & REGS. 1320-06-01-.18(2).

<sup>301</sup> Net earnings that are attributable to any activities unrelated to and outside the scope of the activities that give a nonprofit its exempt status are subject to the excise tax.

<sup>302</sup> Tenn. Code Ann. §§ 67-4-2006 and 67-4-2007(a).

<sup>303</sup> Tenn. Code Ann. §§ 67-4-2006(a)(1)-(9).

<sup>304</sup> LLCs that have made an election on federal Form 8832 to be taxed as a corporation would file on Form 1120 and should complete Schedule J4.

<sup>305</sup> Amounts reported on federal Schedule K, Line 11 (code F) for Section 743(b) adjustments are not included in the additional income items reported on excise Schedule J1, Line 2. Note the use of code F changed with the 2019 Form 1065 instructions.

<sup>306</sup> Tenn. Code Ann. § 67-4-2006(a)(5)(A).

<sup>307</sup> “Public REIT” means an entity that has an election in effect under § 856(c)(1) of the Internal Revenue Code that files with the securities and exchange commission and whose shares are

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traded on a securities exchange that is either registered as a national securities exchange with the securities and exchange commission under § 6 of the Securities Exchange Act of 1934, codified in 15 U.S.C. § 78f, or is a national securities exchange of a foreign country and regulated in a substantially similar manner by a foreign financial regulatory authority.

<sup>308</sup> *Over-the-counter* or *off-exchange* trading is done directly between two parties and is not a registered or national securities exchange.

<sup>309</sup> Code V was added to the 2019 Form 1065 instructions.

<sup>310</sup> The audit workpaper will automatically populate Schedule K. Never enter a negative number on Schedule J1, Line 6.

<sup>311</sup> Tenn. Code Ann. § 67-4-2006(a)(4)(B).

<sup>312</sup> TENN. COMP. R. & REGS. 1320-06-01-.21.

<sup>313</sup> See I.R.S. Topic No. 554 – Self-Employment Tax – for more information.

<sup>314</sup> Some uncertainty exists concerning whether LLC members are subject to self-employment tax on their distributive share of business earnings. The IRS issued a proposed regulation many years ago that addressed this question, but there was so much controversy over it that it never made it to temporary or final regulation status. Most tax preparers, wishing to err on the side of caution, consider LLC member distributions arising out of trade or business activities and guaranteed payments to be self-employment income, and the Department has not questioned that position.

<sup>315</sup> As with certain other items reported on federal Schedule K, the self-employment number is reported merely for informational purposes so that the amount and character of this item is retained when it is passed through to the owners via Schedule K-1. However, this item does not impact the owners' individual federal income tax liabilities because federal self-employment taxes are paid *in addition to* individual federal income taxes on the individual return (Form 1040).

<sup>316</sup> Tenn. Code Ann. § 67-4-2006(a)(4)(C).

<sup>317</sup> See the previous discussion about audit time management when Schedule K reversals are involved, at section *Schedule J1, Line 6*.

<sup>318</sup> A complete list of all the codes (and associated meanings) used on Schedule K-1 can be found in the instructions to Form 1065. See <https://www.irs.gov/pub/irs-pdf/i1065.pdf>

<sup>319</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(K).

<sup>320</sup> See Tenn. Code Ann. § 67-4-2006(b)(1)(I) and the manual section on Schedule J additions.

<sup>321</sup> Tenn. Code Ann. § 67-4-2006(a)(7).

<sup>322</sup> Tenn. Code Ann. § 67-4-2006(a)(2).

<sup>323</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(K).

<sup>324</sup> Tenn. Code Ann. § 67-4-2006(a)(8).

<sup>325</sup> Tenn. Code Ann. § 67-4-2007(a).

<sup>326</sup> Nonprofits are generally classified as corporations for federal income tax purposes; Tenn. Code Ann. § 67-4-2006(a)(1), which defines “net earnings” or “net loss” for corporations, provides that the net earnings of a corporation for Tennessee excise tax purposes is federal taxable income *before* the federal net operating loss deduction and special deductions.

<sup>327</sup> Tennessee conforms to the federal UBTI law under IRC §512 and accompanying regulations. Therefore, Tennessee conforms to the UBTI “silo” provisions enacted under the 2017 federal Tax Cuts and Jobs Act.

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<sup>328</sup> This adjustment generally does not apply to S-Corporations, entities filing as partnerships, or SMLLCs owned by individuals.

<sup>329</sup> Tenn. Code Ann. §§ 67-4-2006(b)(1)(D), 67-4-2006(b)(2)(D).

<sup>330</sup> The Coronavirus Aid, Relief and Economic Security Act (CARES Act) increased the charitable contribution deduction limit to 25% for the 2020 tax year.

<sup>331</sup> The form instructions state: A negative amount may be reported on line 21, columns (b), (c), and (d), as applicable, the excess of charitable contributions made during the tax year over the amount of the charitable contribution limitation amount. If a contribution carryforward is utilized in the current tax year, the carryforward utilized is reported as a positive amount on columns (b), (c), and (d), as applicable.

<sup>332</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(E).

<sup>333</sup> *Id.*

<sup>334</sup> The carryback is reported on federal Form 1139 or 1120X.

<sup>335</sup> This line reads “Deductions on this return not charged against book income this year.”

<sup>336</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(E).

<sup>337</sup> Excluding Schedule J, Line 28b, which is an informational line.

<sup>338</sup> Tenn. Code Ann. § 67-4-2004(26).

<sup>339</sup> Tenn. Code Ann. § 67-4-2004(24).

<sup>340</sup> Tenn. Code Ann. § 67-4-2004(1).

<sup>341</sup> Tenn. Code Ann. § 67-1-804(b)(2).

<sup>342</sup> The add-back for depreciation does not apply to the election to expense certain property under IRC Section 179.

<sup>343</sup> Under the Tax Cuts and Jobs Act of 2017, bonus depreciation may apply to used assets. The definition of property eligible for 100 percent bonus depreciation was expanded to include used qualified property acquired and placed in service after Sept. 27, 2017, if certain requirements are met.

<sup>344</sup> State depreciation expense means depreciation computed using the same depreciation method and class lives used for federal income tax purposes (i.e., MACRS), only without considering previous or current use of “bonus depreciation.”

<sup>345</sup> If an asset is disposed of before the end of its life, the income statement account “gain or loss on disposal of asset” will be different for federal and state tax purposes. The difference is reported on Schedule J, Line 17.

<sup>346</sup> The instructions to Line 3 state “Enter any depreciation under the provisions of IRC Section 168 not permitted for excise tax purposes due to Tennessee permanently decoupling from federal bonus depreciation.”

<sup>347</sup> If the asset being disposed of was partially purchased with a trade-in that was not fully depreciated and had taken bonus depreciation, there would be a difference in the federal and state gain/loss on disposal.

<sup>348</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(I).

<sup>349</sup> Tenn. Code Ann. § 67-4-2007(f).

<sup>350</sup> Effective June 30, 2008, subsection (C) was added to include obligated member entities.

<sup>351</sup> Tenn. Code Ann. § 67-4-2007(f); See [Important Notice #08-06](#)

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<sup>352</sup> When an otherwise nontaxable entity or individual is required to report the gain, they must file Form FAE170 and complete Schedules B and C and Schedule J, Line 4. The entity or individual should include on the front page of the tax return its taxable year, FEIN or SSN, name and address. The entity or individual should indicate in an attachment to the return that they are filing the return due to the provision at Tenn. Code Ann. § 67-4-2007(f). The tax return and payment are due on the 15th day of the fourth month following the close of the entity's or individual's taxable year. The excise tax due is 6.5% of the gain on the sale of the asset.

<sup>353</sup> Tenn. Code Ann. § 67-4-2007(f)(1)(A).

<sup>354</sup> Tenn. Code Ann. § 67-4-2007(f)(1)(B).

<sup>355</sup> Tenn. Code Ann. § 67-4-2007(f)(1)(C).

<sup>356</sup> Tenn. Code Ann. § 67-4-2007(f)(1)(D).

<sup>357</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(I).

<sup>358</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(A).

<sup>359</sup> Tenn. Code Ann. §§ 67-4-2109(c), 67-4-2009(1), and 56-4-217.

<sup>360</sup> Tenn. Code Ann. § 67-4-2006(b)(1).

<sup>361</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(B).

<sup>362</sup> See IRS Publication 550 <http://www.irs.gov/pub/irs-pdf/p550.pdf>

<sup>363</sup> See Bank Qualified Bonds <http://www.irs.gov/pub/irs-tege/13%20Phase%20Lesson%2013%20-%20Bank%20Qualified%20Bonds%20-%20Section%20265.pdf>

<sup>364</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(C).

<sup>365</sup> *Id.*

<sup>366</sup> See TENN. COMP. R. & REGS. 1320-06-01-.20. *Oak Ridge Land Co. v. Roberts*, No. E2012-00458-COA-R3-CV, 2012 WL 5962002 (Tenn. Ct. App. Nov. 29, 2012) found that Rule 20 does not conflict with the statute by requiring that only book basis be allowed since the statute does refer to value.

<sup>367</sup> Non-Cash Contributions – GAAP: ASC 720-25.

<sup>368</sup> An “affiliate” is any entity with more than 50% ownership interest, as defined at Tenn. Code Ann. § 67-4-2004(1)(A).

<sup>369</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(N).

<sup>370</sup> The FONCE exemption also considers the number of rental units, but the limitation is different.

<sup>371</sup> Tenn. Code Ann. § 67-5-501(4).

<sup>372</sup> Tenn. Code Ann. §§ 67-4-2006(b)(1)(J) and (b)(2)(L); See *Hilloak Realty Co. v. Chumley*, 233 S. W. 3d 816 (Tenn. Ct. App. 2007).

<sup>373</sup> See the “F&E Exemptions Requiring an Evaluation” section in Chapter 2 of this manual for additional information and examples regarding partially-exempt obligated member entities.

<sup>374</sup> Tenn. Code Ann. § 67-4-2008(a)(9)(D).

<sup>375</sup> Tenn. Code Ann. §§ 67-4-2006(b)(1)(J) and 67-4-2006(b)(2)(L).

<sup>376</sup> For example, guaranteed payments to partners would be specifically allocated to the partners who receive such payments. Also, amounts subject to self-employment taxes would be distributed only to those partners who are subject to self-employment taxes (e.g., individuals, not corporations).

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<sup>377</sup> See [Important Notice #19-13](#)

<sup>378</sup> Note, this amount is adjusted annually for inflation, which adjustment is reported by the IRS.

<sup>379</sup> See [Important Notice #22-03](#)

<sup>380</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(C).

<sup>381</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(A); TENN. COMP. R. & REGS. 1320-06-01-.21(2).

<sup>382</sup> Tenn. Code Ann. § 67-4-2006(c)(5).

<sup>383</sup> The legislation that introduced this deduction – [Public Chapter 98 \(2005\)](#) – included associations and organizations that are exempt from federal income tax under 26 U.S.C. § 501(c)(6). However, 501(c)(6) associations and organizations were subsequently removed from the list of eligible entities for purposes of this deduction, pursuant to [Public Chapter 1019 \(2006\)](#).

<sup>384</sup> *Id.*

<sup>385</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(M).

<sup>386</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(F).

<sup>387</sup> See Tenn. Code Ann. §§ 67-4-2006(b)(1), 67-4-2006(b)(2)(G) and (H).

<sup>388</sup> Tenn. Code Ann. § 67-4-2006(c)(5).

<sup>389</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(O).

<sup>390</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(L).

<sup>391</sup> § 118 of the Internal Revenue Code.

<sup>392</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(S).

<sup>393</sup> See the previous section regarding Schedule J, Line 13 for an explanation of why a taxpayer might have to prepare a pro forma Form 8990 for excise tax purposes.

<sup>394</sup> ET-5 – Deductible Business Interest Expense Carried Forward from Tax Years 2018 and 2019.

<sup>395</sup> Recall that when a pass-through entity distributes items of income or loss to its owners, these items retain their character; thus, when a pass-through entity reports tax-exempt interest income to a corporate owner via Schedule K-1, such income does not enter into the corporation's federal taxable income; rather, the income is reported on Form 1120 as an information item.

<sup>396</sup> Tax Cuts and Jobs Act of 2017 – Pub. L. No 115-97.

<sup>397</sup> P.C. 1011.

<sup>398</sup> The federal IRC §163(j) limitation applies to businesses having average annual gross receipts of more than \$26 million for the prior three tax years.

<sup>399</sup> 50 percent of adjusted taxable income for the 2019-2021 tax years, under the federal CARES Act.

<sup>400</sup> Tennessee follows IRC §118 as it existed before the TCJA of 2017.

<sup>401</sup> P.C. 306, enacted May 2019.

<sup>402</sup> Form FAE170, Schedule J, Lines 12 and 27, for the adjustments on a 2022 franchise and excise tax return.

<sup>403</sup> For tax years beginning after December 31, 2025, the federal Section 250 deduction is reduced to 21.875% of FDII plus 37.5% of 1) GILTI and 2) IRC §78 gross up dividend income relating to GILTI.

<sup>404</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(T).

<sup>405</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(P); [Important Notice #19-13](#)

<sup>406</sup> Tenn. Code Ann. § 67-4-2006(a)(1).

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<sup>407</sup> The federal Schedule K/K-1 line items and reporting codes referred to in this example are based on the 2018 federal forms.

<sup>408</sup> See IRC §§ 1400Z-1 and 1400Z-2.

<sup>409</sup> <https://www.irs.gov/credits-deductions/opportunity-zones-frequently-asked-questions>

<sup>410</sup> *Id.*

<sup>411</sup> <https://www.irs.gov/credits-deductions/businesses/invest-in-a-qualified-opportunity-fund>

<sup>412</sup> Public Chapter 743 (2022).

<sup>413</sup> In the case of R&D expenditures that are attributable to foreign research, within the meaning of IRC §41(d)(4)(F), the federal tax amortization period is 15 years.

<sup>414</sup> An example is the “interest income” on Schedule M-3, Part II, Line 13. Interest income received from obligations of states and their political subdivisions would be reported on this line, column c, as a permanent difference. In addition, this amount would be reported on federal Form 1120, page 4, Line 9 “tax exempt interest received or accrued during the tax year,” and on federal Form 8916-A, Part II, Line 6.

<sup>415</sup> The federal effective date was on or after December 31, 2004, for corporations and 2006 for partnerships.

<sup>416</sup> Taxpayers filing federal Forms 1120-REIT, 1120-RIC, 1120-H, and 1120-SF, would use Schedule M-1, rather than Schedule M-3.

<sup>417</sup> The corporate and partnership versions of Schedule M-3 are similar, but different. For example, because of the pass-through nature of the partnership, it does not have lines for charitable contribution limitations and carryovers.

<sup>418</sup> Due to complex book and tax rules, most differences could include both temporary and permanent differences. However, this chart only lists the primary difference type.

<sup>419</sup> IRC §1031(a)(1).

<sup>420</sup> Treas. Reg. §1.1031(a)-1(b).

<sup>421</sup> Personal use property, such as a personal residence, does not qualify for like-kind exchange treatment.

<sup>422</sup> IRC §1031(a)(2).

<sup>423</sup> IRC §1031(h).

<sup>424</sup> Treas. Reg. §1.1031(a)-1(a)(2).

<sup>425</sup> According to IRC §1031(d), an assumption of liabilities by the other party to a like-kind exchange is a form of consideration to the party whose liabilities are assumed; an assumption of liabilities is to be treated as *other property or money* (i.e., non-like-kind property).

<sup>426</sup> Such prerequisites are beyond the scope of this manual.

<sup>427</sup> IRC §1031(b).

<sup>428</sup> IRC §1031(c).

<sup>429</sup> There are several Internal Revenue Code provisions that require a portion (or all) of the gain on the sale of depreciable property to be recaptured as ordinary income. This is because part of the gain is attributed to depreciation for which the taxpayer previously received the benefit of a deduction against ordinary income for federal income tax purposes. This does not change the total amount of the gain to be recognized; rather, it only changes the character of the gain.

<sup>430</sup> For a corporation, the total gain should be traced to Form 1120, Lines 8 and 9 via Schedule D and Form 4797, respectively. For S corporations and entities taxed as partnerships, the gain

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amounts can be similarly traced, with ordinary gain being reported on page 1 of the federal return and capital gain being reported on Schedule K.

<sup>431</sup> The amount of capital investment in a property for tax purposes; for purchased property, basis is generally the purchase price (cost) of the property.

<sup>432</sup> Cost (or other basis) less allowable depreciation, as well as other basis adjustments permitted, for federal income tax purposes.

<sup>433</sup> IRC §1031(d).

<sup>434</sup> The fair market value of like-kind property received can be found on Form 8824, Line 16; the adjusted basis of like-kind property given up can be found on Form 8824, Line 18; the sum of boot received in the exchange can be found on Form 8824, Line 15.

<sup>435</sup> Although the entity received boot in the example exchange, it *still* takes a substituted basis in the replacement property. The gain it recognized is attributed to the boot received. Boot basis is measured separately from replacement property basis. The basis that an entity takes in boot received in a like-kind exchange is the fair market value of the boot on the date of the exchange.

<sup>436</sup> This is the case for corporations. For S corporations and entities taxed as partnerships, any ordinary gain will be found on page 1 of the federal return and the capital gain will be found on Schedule K.

<sup>437</sup> This example ignores the effect of subsequent depreciation of the replacement property.

<sup>438</sup> Codified at 26 U.S.C.

<sup>439</sup> Tenn. Code Ann. § 67-4-2006(a).

<sup>440</sup> Codified at Tenn. Code Ann. § 67-4-2006(b)-(c).

<sup>441</sup> The property received in a like-kind exchange.

<sup>442</sup> The property given up in a like-kind exchange.

<sup>443</sup> Some states have clawback provisions, which require a taxpayer to track (for state tax purposes) gains or losses deferred through like-kind exchanges where the replacement property is located outside of the state and to report and pay tax to the state on the gain recognized upon the ultimate sale or disposition of the replacement property, even if the taxpayer no longer has nexus with said state. Tennessee excise tax law does not contain such a provision.

<sup>444</sup> Tenn. Code Ann. § 67-4-2015(a).

<sup>445</sup> Except for a taxpayer that is a member of a consolidated net worth affiliated group or captive REIT affiliated group, in which case the taxpayer's property factor is based on GAAP books and records. However, property is still included in the property factor at its "original cost," as defined by franchise and excise tax Rule 28.

<sup>446</sup> TENN. COMP. R. & REGS. 1320-06-01-.28(1)(a).

<sup>447</sup> Recall, the fair market value of the replacement property less any deferred gain, or plus any deferred loss, equals the adjusted (substituted) basis of the replacement property received.

<sup>448</sup> Generally, this will include any amounts reported on Form 8824, Lines 12 and 15, excluding any reduction included on Line 15 for exchange expenses.

<sup>449</sup> Generally, this will include all amounts reported on Form 4797, Line 20.

<sup>450</sup> TENN. COMP. R. & REGS. 1320-06-01-.32(1)(b).

<sup>451</sup> Tenn. Code Ann. § 67-4-2106(a)-(b).

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<sup>452</sup> Tenn. Code Ann. § 67-4-2106(b) *does* permit an exception to the use of GAAP in calculating a taxpayer's net worth subject to the franchise tax for taxpayers who do not maintain their books and records in accordance with GAAP.

<sup>453</sup> Tenn. Code Ann. § 67-4-2108(a)(1).

<sup>454</sup> Tenn. Code Ann. § 67-4-2108(a)(3).

<sup>455</sup> Under GAAP, the taxpayer might also employ use of the specialized accounting rules for *nonmonetary transactions* codified at ASC 845.

<sup>456</sup> Other than a taxpayer who is required to file as a unitary group on a combined basis for franchise tax purposes.

<sup>457</sup> So long as the method fairly reflects the property's value.

<sup>458</sup> For additional details regarding this exception, please refer to Chapter 9 (*Franchise Tax*) of this manual and the section entitled *GAAP Books and Records*.

<sup>459</sup> Codified at Tenn. Code Ann. § 67-4-2108(a)(3).

<sup>460</sup> These forms and schedules are not intended to represent a completed federal return. Only the forms and schedules pertinent to the example like-kind exchange in this chapter are presented to illustrate how any gains or losses from the exchange would be traced to the federal return. In practice, gains or losses from a like-kind exchange would be aggregated with all other reportable gains and losses of the taxpayer on the federal return.

<sup>461</sup> TENN. COMP. R. & REGS. 1320-06-01-.21, Tenn. Code Ann. § 67-4-2006.

<sup>462</sup> For certain taxpayers that incurred a loss for tax years ending prior to July 15, 1990, the loss carryforward is limited to seven years, per Tenn. Code Ann. § 67-4-2006(c)(1). Any NOL incurred by a member of the unitary group that has been apportioned to Tennessee in a year prior to filing a combined return may be carried forward seven years as a net operating loss carryover by the unitary group.

<sup>463</sup> Tenn. Code Ann. § 67-4-2006(c)(8).

<sup>464</sup> See [Revenue Ruling 96-14](#)

<sup>465</sup> Tenn. Code Ann. § 67-4-2006(c)(2).

<sup>466</sup> Tenn. Code Ann. § 67-4-2006(c)(3).

<sup>467</sup> Tenn. Code Ann. § 67-4-2006(c)(4).

<sup>468</sup> [Revenue Ruling 07-14](#), [Revenue Ruling 06-26](#), [Revenue Ruling 06-20](#)

<sup>469</sup> A Type F reorganization is a mere change in identity, form, or place of organization of one corporation. See [Revenue Ruling 07-14](#), page 5.

<sup>470</sup> Commonly known as "Check the Box" classification.

<sup>471</sup> See [Revenue Ruling 06-25](#)

<sup>472</sup> A Chapter 11 bankruptcy is a reorganization, whereas a Chapter 7 bankruptcy results in a total liquidation that ends the business. Only Chapter 11 bankruptcy is pertinent to this discussion.

<sup>473</sup> I.R.C. § 108(a)(1)(A), (B), or (C).

<sup>474</sup> Tenn. Code Ann. § 67-4-2006(c)(8).

<sup>475</sup> Federal Form 982, page 2 (last section) gives the order in which the seven listed attributes must be adjusted unless a special election is made.

<sup>476</sup> See page 4, Part II, "Basis Reduction" of form instructions.



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<sup>477</sup> If an entity does not meet the requirements of “fresh start,” it still needs to: 1) report the adjusted liabilities at present value, and 2) report any debt forgiveness as an extraordinary item on the income statement, net of any related income tax effect.

<sup>478</sup> Tenn. Code Ann. §§ 67-4-2012, 67-4-2013, 67-4-2112, 67-4-2113; TENN. COMP. R. & REGS. 1320-06-01-.27, .34, .35, .38, and .42.

<sup>479</sup> <http://www.mtc.gov/>

<sup>480</sup> Tenn. Code Ann. § 67-4-2004(4).

<sup>481</sup> Tenn. Code Ann. § 67-4-2010(b).

<sup>482</sup> Tenn. Code Ann. § 67-4-2011(a)-(e) – allocation of earnings.

<sup>483</sup> Tenn. Code Ann. §§ 67-4-2004(14)(A), 67-4-2010, 67-4-2110.

<sup>484</sup> See Tenn. Code Ann. § 67-4-2004(49)(A).

<sup>485</sup> A 1959 federal law known as Public Law 86-272 prohibits a state from imposing an income tax on a company if the company is only soliciting orders for sales of tangible personal property that are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the state.

<sup>486</sup> Tenn. Code Ann. § 67-4-2012(l).

<sup>487</sup> The sales factor is double weighted for tax years beginning before July 1, 2016. Public Chapter 514 (2015).

<sup>488</sup> TENN. COMP. R. & REGS. 1320-06-01-.27, .30, and .32.

<sup>489</sup> Tenn. Code Ann. §§ 67-4-2111(l) and 67-4-2012(l). The single sales factor provision is effective for tax years beginning on or after January 1, 2017.

<sup>490</sup> The Tennessee Supreme Court has stated that when a statute does not define a term, it is proper to look to common usage to determine the term's meaning. See, e.g., *Beare Co. v. Tenn. Dep't of Revenue*, 858 S.W.2d 906, 908 (Tenn. 1993); see also *Tenn. Farmers Assurance Co. v. Chumley*, 197 S.W.3d 767, 782-83 (Tenn. Ct. App. 2006).

<sup>491</sup> The standard apportionment method should be used when an electing taxpayer is no longer a qualifying manufacturer.

<sup>492</sup> Tenn. Code Ann. §§ 67-4-2012(m) and 67-4-2111(m).

<sup>493</sup> A publicly traded partnership is an entity that is treated as a partnership for federal income tax purposes, files with the SEC, and its shares are traded on a registered national securities exchange or national securities exchange of a foreign country. Tenn. Code Ann. § 67-4-2012(m)(2)(D).

<sup>494</sup> Tenn. Code Ann. § 67-4-2012(m)(2)(D).

<sup>495</sup> Tenn. Code Ann. § 67-4-2023.

<sup>496</sup> “Domestic person” means any person with more than twenty percent (20%) of the average of its property, payroll and receipts factors, as each factor is calculated for a separate entity under § 67-4-2111, in the United States; therefore, non-domestic persons are persons who do *not* meet the 20% threshold.

<sup>497</sup> Tenn. Code Ann. §§ 67-4-2012(b), (e), and (g).

<sup>498</sup> Tenn. Code Ann. §§ 67-4-2108(a)(6)(E).

<sup>499</sup> Tenn. Code Ann. §§ 67-4-2006(b)(1)(J) and (b)(2)(L). This reversal was made on Schedules J1, J2, J3, or J4 prior to 2017.

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- <sup>500</sup> Tenn. Code Ann. §§ 67-4-2012(b)-(d) and 67-4-2111(b); TENN. COMP. R. & REGS. 1320-06-01-.27 and .29.
- <sup>501</sup> TENN. COMP. R. & REGS. 1320-06-01-.27(3).
- <sup>502</sup> TENN. COMP. R. & REGS. 1320-06-01-.28(1)(a).
- <sup>503</sup> TENN. COMP. R. & REGS. 1320-06-01-.28(2).
- <sup>504</sup> TENN. COMP. R. & REGS. 1320-06-01-.28(2)(a).
- <sup>505</sup> TENN. COMP. R. & REGS. 1320-06-01-.18(1); [Revenue Ruling 01-06](#)
- <sup>506</sup> “Reasonable rent” means rent that does not exceed 2% per month of the appraised value for property tax purposes. Tenn. Code Ann. § 67-4-2006(b)(1)(N).
- <sup>507</sup> TENN. COMP. R. & REGS. 1320-06-01-.28(2)(b).
- <sup>508</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(C) defines “finished goods inventory.”
- <sup>509</sup> Tenn. Code Ann. § 67-4-2111(b)(1).
- <sup>510</sup> Tenn. Code Ann. § 67-4-2012.
- <sup>511</sup> TENN. COMP. R. & REGS. 1320-06-01-.28(1)(b).
- <sup>512</sup> TENN. COMP. R. & REGS. 1320-06-01-.27(2).
- <sup>513</sup> TENN. COMP. R. & REGS. 1320-06-01-.27(1).
- <sup>514</sup> TENN. COMP. R. & REGS. 1320-06-01-.29.
- <sup>515</sup> Tenn. Code Ann. § 67-4-2115(b).
- <sup>516</sup> Tenn. Code Ann. § 67-4-2012(e).
- <sup>517</sup> Tenn. Code Ann. § 67-4-2004(12).
- <sup>518</sup> TENN. COMP. R. & REGS. 1320-06-01-.30(1)(d).
- <sup>519</sup> *Id.*
- <sup>520</sup> Tenn. Code Ann. § 67-4-2014.
- <sup>521</sup> Tenn. Code Ann. § 67-4-2012(e).
- <sup>522</sup> TENN. COMP. R. & REGS. 1320-06-01-.30(1)(b).
- <sup>523</sup> *Id.*
- <sup>524</sup> Tenn. Code Ann. § 67-4-2014.
- <sup>525</sup> Tenn. Code Ann. § 67-4-2012(f).
- <sup>526</sup> TENN. COMP. R. & REGS. 1320-06-01-.31.
- <sup>527</sup> Base of operations generally is the permanent place where the employee begins and ends work each day and where they receive instructions, communicate with customers, and perform other business functions.
- <sup>528</sup> State of Tennessee Department of Labor and Workforce Development Division of Employment Security Handbook For Employers, June 13, 2019 – *Having Employees in More Than One State*, page 26/60.
- <sup>529</sup> TENN. COMP. R. & REGS. 1320-06-01-.38(2)(c).
- <sup>530</sup> TENN. COMP. R. & REGS. 1320-06-01-.30(1)(b).
- <sup>531</sup> Tenn. Code Ann. § 67-4-2004(46).
- <sup>532</sup> Tenn. Code Ann. § 67-4-2004(20).
- <sup>533</sup> Tenn. Code Ann. §§ 67-4-2012(k), 67-4-2111(k); [Important Notice #12-05](#)
- <sup>534</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(1)(e)-(f).
- <sup>535</sup> Tenn. Code Ann. §§ 67-4-2012(i) and 67-4-2111(i).
- <sup>536</sup> TENN. COMP. R. & REGS. 1320-06-01-.32(1)(b).

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- <sup>537</sup> *Sherwin-Williams Co. v. Johnson*, 989 S.W.2d 710 (Tenn. Ct. App. 1998).
- <sup>538</sup> TENN. COMP. R. & REGS. 1320-06-01-.32(1)(a)1-6.
- <sup>539</sup> Includes cash received, fair market value of other property received, net liabilities assumed by other party, and fair market value of like-kind property received.
- <sup>540</sup> TENN. COMP. R. & REGS. 1320-06-01-.32(1)(a)2.
- <sup>541</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(N).
- <sup>542</sup> TENN. COMP. R. & REGS. 1320-06-01-.32(1)(a)1.
- <sup>543</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(N).
- <sup>544</sup> Tenn. Code Ann. § 67-4-2006(b)(2)(O).
- <sup>545</sup> Tenn. Code Ann. §§ 67-4-2012(h) and (i).
- <sup>546</sup> Tenn. Code Ann. §§ 67-4-2012(h)(1) and (2).
- <sup>547</sup> TENN. COMP. R. & REGS. 1320-06-01-.33(2).
- <sup>548</sup> TENN. COMP. R. & REGS. 1320-06-01-.33(1)(d); [Letter Ruling 13-14](#)
- <sup>549</sup> TENN. COMP. R. & REGS. 1320-06-01-.33(1)(e).
- <sup>550</sup> Revenue Rulings [95-05](#), [95-27](#), [04-12](#), and [13-14](#)
- <sup>551</sup> TENN. COMP. R. & REGS. 1320-06-01-.33(1)(b).
- <sup>552</sup> TENN. COMP. R. & REGS. 1320-06-01-.33(1)(c).
- <sup>553</sup> [Revenue Ruling 13-14](#)
- <sup>554</sup> TENN. COMP. R. & REGS. 1320-06-01-.33(1)(d).
- <sup>555</sup> TENN. COMP. R. & REGS. 1320-06-01-.33(1)(e).
- <sup>556</sup> Public Chapter 514 (2015).
- <sup>557</sup> Tenn. Code Ann. § 67-4-2012(i); TENN. COMP. R. & REGS. 1320-06-01-.42.
- <sup>558</sup> Tenn. Code Ann. §§ 67-4-2012(i)(2) and (3).
- <sup>559</sup> Tenn. Code Ann. § 67-4-2012(i)(4).
- <sup>560</sup> TENN. COMP. R. & REGS. 1320-06-01-.42.
- <sup>561</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(1)(d).
- <sup>562</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(1)(e).
- <sup>563</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)(3)(i)(I).
- <sup>564</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4).
- <sup>565</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f) and (6)(a)(4).
- <sup>566</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(1)(f).
- <sup>567</sup> Tenn. Code Ann. § 67-4-2012(c)(2).
- <sup>568</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d).
- <sup>569</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c).
- <sup>570</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(b).
- <sup>571</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d).
- <sup>572</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)IV.
- <sup>573</sup> *Id.*
- <sup>574</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)II.
- <sup>575</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)III.
- <sup>576</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II).
- <sup>577</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(I) and (II).
- <sup>578</sup> TENN. COMP. R. & REGS. 1320-06-01-.42(1)(e)2.

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- 579 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(I)II.  
580 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II).  
581 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)III.  
582 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)IV.  
583 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(I).  
584 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(III).  
585 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(III)I.  
586 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii).  
587 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(III)II.  
588 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f).  
589 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)2.  
590 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)1.  
591 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(b).  
592 *Id.*  
593 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d).  
594 *Id.*  
595 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c).  
596 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(ii).  
597 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d).  
598 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(II).  
599 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(I) and (II).  
600 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i).  
601 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d).  
602 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(ii).  
603 *Id.*  
604 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)2(ii) and 3(i)(I).  
605 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)2(ii) and 3(i)(II).  
606 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(II).  
607 *Id.*  
608 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(d)3(i)(I).  
609 TENN. COMP. R. & REGS. 1320-06-01-.42(6).  
610 TENN. COMP. R. & REGS. 1320-06-01-.42(5) and (6).  
611 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii) and (iii).  
612 TENN. COMP. R. & REGS. 1320-06-01-.42(7)(b).  
613 TENN. COMP. R. & REGS. 1320-06-01-.42(7)(a).  
614 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii).  
615 *Id.*  
616 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b).  
617 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(d).  
618 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b).  
619 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(c).  
620 *Id.*  
621 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b) and (e).

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- 622 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(e).
- 623 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b)-(c).
- 624 TENN. COMP. R. & REGS. 1320-06-01-.42(4).
- 625 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f).
- 626 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(I).
- 627 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f).
- 628 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II).
- 629 *Id.*
- 630 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f).
- 631 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(ii)(II)IV.
- 632 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii).
- 633 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f).
- 634 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c)2(iii)(II).
- 635 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(a) and (6)(a)3.
- 636 TENN. COMP. R. & REGS. 1320-06-01-.42(6)(a)1.
- 637 *Id.*
- 638 *Id.*
- 639 TENN. COMP. R. & REGS. 1320-06-01-.42(6)(a)2.
- 640 TENN. COMP. R. & REGS. 1320-06-01-.42(6)(a)4.
- 641 TENN. COMP. R. & REGS. 1320-06-01-.42(6)(a)5.
- 642 TENN. COMP. R. & REGS. 1320-06-01-.42.
- 643 TENN. COMP. R. & REGS. 1320-06-01-.42(4)(c).
- 644 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(b).
- 645 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(c).
- 646 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f).
- 647 TENN. COMP. R. & REGS. 1320-06-01-.42(6).
- 648 TENN. COMP. R. & REGS. 1320-06-01-.42(5)(f) and (6)(a)5.
- 649 Tenn. Code Ann. § 67-4-2012(i), prior to Revenue Modernization Act of 2015.
- 650 TENN. COMP. R. & REGS. 1320-06-01-.34(2), prior to September 2016 revision.
- 651 TENN. COMP. R. & REGS. 1320-06-01-.34(4)(b)1-2, prior to September 2016 revision.
- 652 Tenn. Code Ann. § 67-4-2012(j), prior to Revenue Modernization Act of 2015.
- 653 Tenn. Code Ann. § 67-4-2004(10).
- 654 Tenn. Code Ann. § 67-4-2012(j).
- 655 TENN. COMP. R. & REGS. 1320-06-01-.34.
- 656 Tenn. Code Ann. § 67-4-2012(j)(1)(B).
- 657 Tenn. Code Ann. § 67-4-2012(i).
- 658 Tenn. Code Ann. § 67-4-2012(j)(2)(C).
- 659 Tenn. Code Ann. § 67-4-2012(j)(2)(B).
- 660 Tenn. Code Ann. § 67-4-2013(b)(3)(H).
- 661 Tenn. Code Ann. § 67-4-2013(b)(3)(G).
- 662 TENN. COMP. R. & REGS. 1320-06-01-.42.
- 663 Tenn. Code Ann. §§ 67-4-2010(b) and 67-4-2110(b).
- 664 TENN. COMP. R. & REGS. 1320-06-01-.42.

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- <sup>665</sup> Tenn. Code Ann. §§ 67-4-2014 and 67-4-2112.
- <sup>666</sup> TENN. COMP. R. & REGS. 1320-06-01-.35.
- <sup>667</sup> Tenn. Code Ann. § 67-4-2013.
- <sup>668</sup> Tenn. Code Ann. § 67-4-2013(a)(5).
- <sup>669</sup> Tenn. Code Ann. § 67-4-2013(a)(1)-(4), (7).
- <sup>670</sup> The Federal Motor Carrier Act of 1980 deregulated the routes that motor carriers could use and the geographic regions they could serve, and as a result, the “franchise miles” wording in Tenn. Code Ann. § 67-4-2013(a)(2)(B) is meaningless.
- <sup>671</sup> An International Fuel Tax Agreement (IFTA) report is filed by motor carriers quarterly and includes the mileage traveled by state.
- <sup>672</sup> Tenn. Code Ann. § 67-4-2111(b)(3).
- <sup>673</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(B).
- <sup>674</sup> Tenn. Code Ann. § 67-4-2013(a).
- <sup>675</sup> Tenn. Code Ann. § 67-4-2013(a)(1)-(7).
- <sup>676</sup> Tenn. Code Ann. § 67-4-2013(a)(5).
- <sup>677</sup> Tenn. Code Ann. §§ 67-4-20013(a)(6) and 67-4-2113(7).
- <sup>678</sup> See Tenn. Code Ann. §§ 67-4-2012(l) and 67-4-2111(l) for the criteria to be considered a manufacturer for the purpose of making the SSF election.
- <sup>679</sup> *Id.*
- <sup>680</sup> Tenn. Code Ann. §§ 67-4-2009(6)(A), 67-4-2109(e)(1)-(2).
- <sup>681</sup> Tenn. Code Ann. §§ 67-4-2009(1), 67-4-2109(c), and 56-4-217.
- <sup>682</sup> *Id.*
- <sup>683</sup> *Id.*
- <sup>684</sup> Tenn. Code Ann. § 67-2-101 *et seq.*
- <sup>685</sup> Tenn. Code Ann. § 67-4-2009(7).
- <sup>686</sup> Tenn. Code Ann. § 67-4-2007(d).
- <sup>687</sup> Tenn. Code Ann. §§ 67-4-2009(8)(C), 67-4-2009(9)(C).
- <sup>688</sup> *Id.*
- <sup>689</sup> Tenn. Code Ann. §§ 67-4-2009(8)(B)(v), 67-4-2009(9)(B)(v).
- <sup>690</sup> Tenn. Code Ann. §§ 67-4-2009(8)(B)(i), 67-4-2009(9)(B)(i).
- <sup>691</sup> Tenn. Code Ann. §§ 67-4-2009(8)(l), 67-4-2009(9)(H).
- <sup>692</sup> Tenn. Code Ann. §§ 67-4-2009(8)(B)(ii), 67-4-2009(9)(B)(ii).
- <sup>693</sup> Tenn. Code Ann. §§ 67-4-2009(8)(B)(v), 67-4-2009(9)(B)(iv).
- <sup>694</sup> Tenn. Code Ann. §§ 67-4-2009(8)(G), 67-4-2009(9)(F).
- <sup>695</sup> Tenn. Code Ann. § 67-4-2009(9).
- <sup>696</sup> Important Notice #17-26 [Repealed].
- <sup>697</sup> Tenn. Code Ann. § 67-4-2009(3)(B).
- <sup>698</sup> Tenn. Code Ann. § 67-4-2009(3)(C)(i).
- <sup>699</sup> Tenn. Code Ann. § 67-4-2009(3)(H).
- <sup>700</sup> Tenn. Code Ann. § 67-4-2009(3)(l).
- <sup>701</sup> Tenn. Code Ann. §§ 67-6-102(46)(A)(i), 67-4-2009(3).
- <sup>702</sup> The minimum required capital investment for the job tax credit is \$500,000 and the taxpayer must create at least 25 new jobs (if located in a tier 3 enhancement county, 20 new jobs; if

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located in a tier 4 enhancement county, 10 new jobs). The taxpayer must actually qualify for the job tax credit in order to claim the standard industrial machinery credit for computers and related peripheral devices; a mere attempt to qualify for the job tax credit is insufficient.

<sup>703</sup> Tenn. Code Ann. §§ 67-4-2009(3)(A)(ii), 67-4-2109(a).

<sup>704</sup> Tenn. Code Ann. § 67-6-102(46)(H)(i)(a).

<sup>705</sup> See Tenn. Code Ann. § 67-4-2009(3)(I)(i)-(iv), 67-4-2109(a)(7). A required capital investment is an investment in real or tangible personal property, including computer software owned or leased in Tennessee, as valued under generally accepted accounting principles (GAAP). The investment is considered made as of the date of payment or the date on which the taxpayer enters into a legally-binding commitment or contract for purchase or construction.

<sup>706</sup> Tenn. Code Ann. § 67-6-102(46)(A).

<sup>707</sup> *Id.*

<sup>708</sup> *Id.*

<sup>709</sup> *Id.*

<sup>710</sup> *Id.*

<sup>711</sup> Tenn. Code Ann. § 67-6-102(46)(B).

<sup>712</sup> Tenn. Code Ann. § 67-6-102(46)(C).

<sup>713</sup> Tenn. Code Ann. § 67-6-102(46)(D)(ii).

<sup>714</sup> Tenn. Code Ann. § 67-6-102(46)(E).

<sup>715</sup> Tenn. Code Ann. § 67-6-102(46)(H).

<sup>716</sup> Tenn. Code Ann. § 67-6-102(46)(K).

<sup>717</sup> Tenn. Code Ann. § 67-6-102(46)(A)(i).

<sup>718</sup> Tenn. Code Ann. § 67-6-102(46)(G).

<sup>719</sup> Tenn. Code Ann. § 67-6-102(46)(M).

<sup>720</sup> Tenn. Code Ann. § 67-6-102(46)(F).

<sup>721</sup> Tenn. Code Ann. § 67-6-102(46)(J).

<sup>722</sup> Tenn. Code Ann. § 67-6-102(46)(L).

<sup>723</sup> *The Beare Co. v. Department of Revenue*, 858 S.W.2d 906, 908 (Tenn. 1993).

<sup>724</sup> Tenn. Code Ann. § 67-4-2009(3)(E).

<sup>725</sup> See Tenn. Code Ann. § 67-4-2009(3)(F). "Useful life" is considered the depreciable life the asset has for federal income tax purposes. Tenn. Code Ann. § 67-4-2009(3)(D).

<sup>726</sup> Tenn. Code Ann. § 67-4-2009(3)(D).

<sup>727</sup> *Id.*

<sup>728</sup> Tenn. Code Ann. § 67-4-2009(3)(I)(i)-(iv).

<sup>729</sup> See Tenn. Code Ann. § 67-4-2009(3)(A)(ii).

<sup>730</sup> See Tenn. Code Ann. § 67-4-2109(b).

<sup>731</sup> Tenn. Code Ann. § 67-4-2009(3)(I).

<sup>732</sup> Tenn. Code Ann. § 67-4-2009(3)(I)(vi); [Revenue Ruling 11-07](#)

<sup>733</sup> See Tenn. Code Ann. § 67-4-2009(3)(A)(ii).

<sup>734</sup> See Tenn. Code Ann. § 67-4-2009(3)(I)(vii).

<sup>735</sup> Legislative summaries found on the state's website provide a quick summary of yearly changes beginning in 2002. In addition, the forms section of the website provides various versions of Schedule X for: 1) tax years beginning on or after July 1, 2016, 2) tax years beginning

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on or after January 1, 2009, 3) tax years beginning January 1, 2006, through December 31, 2008, and 4) tax years beginning before January 1, 2006. See [Important Notice #07-02](#) for 2006 JTC changes.

<sup>736</sup> Tenn. Code Ann. § 67-4-2109(b)(1).

<sup>737</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(E).

<sup>738</sup> Defined in Tenn. Code Ann. § 67-4-2109(a)(5).

<sup>739</sup> Means a facility in this state that houses the international or national headquarters of a taxpayer, where headquarters staff employees are located and employed and where the primary headquarters-related functions and services are performed. A *regional* headquarters only qualifies if it has filed a business plan prior to July 1, 2015. Tenn. Code Ann. § 67-6-224(b)(3).

<sup>740</sup> See [Letter Ruling 17-16](#)

<sup>741</sup> Tenn. Code Ann. § 67-4-2109(a)(7).

<sup>742</sup> Tenn. Code Ann. § 67-4-2109(a)(2)(A).

<sup>743</sup> Tenn. Code Ann. § 67-4-2109(a)(2)(B)-(C).

<sup>744</sup> Part 2 was added by a 2016 amendment to the code and expands the definition.

<sup>745</sup> Tenn. Code Ann. § 67-4-2109(a)(6)(A)(i).

<sup>746</sup> Tenn. Code Ann. § 56-7-22.

<sup>747</sup> However, the Commissioner of Revenue, with the approval of the Commissioner of Economic and Community Development, is authorized to approve job tax credits in cases where the newly created position existed in this state as a job position of the taxpayer or of another business entity less than 90 days prior to being filled by the taxpayer, *if* all other requirements to obtain the credit have been satisfied by the taxpayer and the Commissioners of Revenue and Economic and Community Development have determined that allowance of the credit is in the *best interests of the state*. Tenn. Code Ann. § 67-4-2109(b)(3)(E).

<sup>748</sup> Tenn. Code Ann. § 67-4-2109(a)(6)(B)(i).

<sup>749</sup> Tenn. Code Ann. § 67-4-2109(a)(6)(C).

<sup>750</sup> Tenn. Code Ann. § 67-4-2109(a)(3).

<sup>751</sup> Tenn. Code Ann. § 67-4-2109(a)(6)(D).

<sup>752</sup> See definitions at Tenn. Code Ann. §§ 11-11-203 and 11-11-204(c).

<sup>753</sup> For jobs created on or after July 1, 2017, and applications submitted on or after July 1, 2017.

<sup>754</sup> Tenn. Code Ann. § 67-4-2109(a)(6)(A)(ii).

<sup>755</sup> Tenn. Code Ann. § 50-7-306.

<sup>756</sup> Tenn. Code Ann. § 67-4-2109(a)(4).

<sup>757</sup> Tenn. Code Ann. § 67-4-2109(b)(3)(B).

<sup>758</sup> *Id.*

<sup>759</sup> Tenn. Code Ann. § 67-4-2109(b)(1)(C).

<sup>760</sup> *Id.*

<sup>761</sup> *Id.*

<sup>762</sup> Prior to July 1, 2011, the allotted time period in which to make the capital investment and job creation was 12 months.

<sup>763</sup> Tenn. Code Ann. § 67-4-2109(b)(1).

<sup>764</sup> Prior to July 1, 2016, taxpayers creating jobs in any of the enhancement county Tiers (1, 2, or 3) had to create a minimum of 25 jobs to qualify for the job tax credit. Effective for tax years



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ending on or after July 1, 2016, a Tier 4 enhancement county was established along with revised minimum job creation requirements of 25 (Tiers 1 and 2), 20 (Tier 3), and 10 (Tier 4). Tenn. Code Ann. §§ 67-4-2109(b)(1)(C) and 67-4-2109(b)(3)(C).

<sup>765</sup> The JTC standard and additional annual credits will be allowed for new high-skill, high-wage qualified jobs in high-technology areas, emerging occupations, or skilled manufacturing, regardless of whether net employment is increased. However, this applies only to new jobs created by a taxpayer who failed to meet the net increase requirement due to worker layoffs or reductions, where such workers have been certified by the federal Department of Labor's Office of Trade Adjustment Assistance as having been adversely affected by foreign trade, so as to be eligible for assistance in accordance with the federal Trade Adjustment Assistance Reform Act of 2002, compiled in U.S.C. Title 19. A taxpayer must meet the other JTC requirements and must provide evidence to the Commissioner of Revenue of the certification of eligibility for assistance for the taxpayer's adversely affected worker group. Tenn. Code Ann. § 67-4-2109(b)(3)(G).

<sup>766</sup> Tenn. Code Ann. § 67-4-2109(b)(3)(A); [Letter Ruling 13-23](#)

<sup>767</sup> Tenn. Code Ann. § 67-4-2109(b)(1)(B).

<sup>768</sup> Tenn. Code Ann. § 67-6-206(d).

<sup>769</sup> Tenn. Code Ann. § 67-4-2109(b)(3)(C). A QBE in a Tier 3 or Tier 4 enhancement county has 5 years in which to create the minimum required number of jobs.

<sup>770</sup> If the taxpayer qualifies for the additional annual credit for higher level investments, the credit increases to \$5,000 per qualified job. Tenn. Code Ann. § 67-4-2109(b)(3)(A).

<sup>771</sup> A taxpayer that has established its international or national headquarters in this state and has met the requirements to qualify for the credit provided in Tenn. Code Ann. § 67-6-224, or a taxpayer that has established an international, national, or regional warehousing or distribution hub in this state and has met the requirements to be a qualified new or expanded warehouse or distribution facility, may offset up to 100% of its franchise and excise tax liability if the Commissioners of Revenue and Economic and Community Development determine that increasing the percentage of offset permitted to the taxpayer is in the best interests of the state. They will determine the percentage of tax liability allowed to be offset and the period during which the increased offset may continue. Tenn. Code Ann. § 67-4-2109(b)(3)(F).

<sup>772</sup> The carryforward time limit may be modified for applications received and approved by the Commissioner of Revenue and the Commissioner of Economic and Community Development *on or before January 1, 2011*. If the required capital investment exceeds \$1 billion, the time limitations otherwise applicable to the carryforward of unused JTCs will not apply, and any unused credit may be carried forward until fully used, if the Commissioners of Revenue and Economic and Community Development have determined that the allowance of the additional carryforward is in the best interests of the state. Tenn. Code Ann. § 67-4-2109(b)(3)(D).

<sup>773</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(E).

<sup>774</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(A).

<sup>775</sup> The numbers listed are the minimum jobs required for the standard credit. The minimum number of jobs required was revised for tax years ended on or after July 1, 2016, with taxpayers only having to create 20 qualified jobs in a Tier 3 enhancement county and 10 qualified jobs in a Tier 4 enhancement county. Tenn. Code Ann. § 67-4-2109(b)(1)(C). The best interest of the state

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provision that would allow fewer than 25 qualified jobs was found at Tenn. Code Ann. § 67-4-2109(b)(3)(B) and was deleted by Public Chapter 451, effective July 1, 2019.

<sup>776</sup> Tenn. Code Ann. § 67-4-2109(b)(3)(C).

<sup>777</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(D).

<sup>778</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(B).

<sup>779</sup> The increase to \$5,000 per qualified job applies to *all* qualified jobs, regardless of their wage rate. Tenn. Code Ann. § 67-4-2109(b)(3)(A). *See also* [Letter Ruling 13-23](#)

<sup>780</sup> Tenn. Code Ann. § 67-4-2109(a)(3).

<sup>781</sup> Tenn. Code Ann. § 67-4-2004(3).

<sup>782</sup> Tenn. Code Ann. §§ 67-4-2109(b)(3)(I) and 67-4-2109(g)(9)(i) were deleted from the code for tax years beginning on or after January 1, 2019. Before deletion, these code sections provided that if in the “best interests of the state,” the Commissioners of Revenue and Economic and Community Development may lower the number of jobs that must be created in order to qualify for the additional annual credit for higher level investments, but the amount of the credit will also be reduced in direct proportion to the reduction in the job creation requirement. The job creation requirement can never be lowered by more than 50%.

<sup>783</sup> Prior to the 2015 Revenue Modernization Act, an integrated supplier or an integrated customer qualified for the additional annual credit with the six-year duration, regardless of the level of its capital investment or the number of jobs created. Tenn. Code Ann. § 67-4-2109(b)(2)(B)(iii). An integrated supplier or customer was a supplier located within the footprint of the project site as defined at Tenn. Code Ann. § 67-4-2004(28).

<sup>784</sup> Tenn. Code Ann. § 67-6-224(b)(5).

<sup>785</sup> The rate is \$5,000 instead of \$4,500 because of the special provision at Tenn. Code Ann. § 67-4-2109(b)(3)(A).

<sup>786</sup> See [Letter Ruling 11-17](#) for more information.

<sup>787</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(B)(vii).

<sup>788</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(B)(vi).

<sup>789</sup> *Forever carry-forward if in “best interests of the state”* – If the required capital investment exceeds one billion dollars (\$1,000,000,000), the time limitations otherwise applicable to the carry-forward of unused job tax credits under subdivision (b)(1)(D) and subdivision (b)(2)(B)(vi) shall not apply, and any unused credit may be carried forward until fully utilized, if the Commissioner of Revenue and the Commissioner of Economic and Community Development have determined that the allowance of the additional carry-forward is in the best interests of the state. This applies only to applications received and approved by the Commissioner of Revenue and the Commissioner of Economic and Community Development on or before January 1, 2011. Tenn. Code Ann. § 67-4-2109(b)(3)(D).

<sup>790</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(D).

<sup>791</sup> Tenn. Code Ann. § 57-4-2109(b)(3)(A).

<sup>792</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(G).

<sup>793</sup> Public Chapter 383, effective June 1, 2011, created the “additional annual credit for job creation in adventure tourism zones” at Tenn. Code Ann. § 67-4-2109(b)(2)(C). Public Chapter 378, effective May 14, 2013, modified the minimum number of new jobs for enterprises located in Tier 2 and 3 enhancement counties for the “additional annual credit.” Public Chapter 1019,

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effective for tax years beginning on or after July 1, 2016, added Tier 4. Tenn. Code Ann. § 67-4-2109(b)(2)(C).

<sup>794</sup> Tenn. Code Ann. §§ 67-4-2109(b)(1) and (b)(2)(C).

<sup>795</sup> Tenn. Code Ann. § 67-4-2109(a)(5).

<sup>796</sup> Tenn. Code Ann. § 67-4-2109(a)(6).

<sup>797</sup> Prior to 2013, the creation of at least 25 jobs in any county was required.

<sup>798</sup> Tenn. Code Ann. § 67-4-2109(b)(2)(D).

<sup>799</sup> Effective April 19, 2016, Public Chapter 845 redirected responsibilities originally required of ECD to the Department of Tourist Development.

<sup>800</sup> Tenn. Code Ann. § 67-4-2109(f)(2).

<sup>801</sup> Tenn. Code Ann. § 67-4-2109(q), effective July 1, 2015.

<sup>802</sup> Tenn. Code Ann. § 67-4-2109(q)(F).

<sup>803</sup> The 3-year survey no longer exists, so the 5-year survey is used, per ECD.

<sup>804</sup> TENN. COMP. R. & REGS. 1320-06-01-.30(1)(d).

<sup>805</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(G).

<sup>806</sup> [Revenue Ruling 06-20](#)

<sup>807</sup> [Revenue Ruling 12-17](#)

<sup>808</sup> Tenn. Code Ann. § 67-4-2009(6)(C).

<sup>809</sup> A qualified job may be part-time, seasonal and not offer health insurance if the job duties entail adventure tourism and it is located in an adventure tourism district. These jobs count as half a job.

<sup>810</sup> The Recommended Documentation sheet was first mailed in 2014. This sheet formalized the Department's guidance on recommended documentation but did not change it.

<sup>811</sup> Schedule G may provide evidence that owned assets in the state increased, but only additions that resulted in the creation of qualified jobs are considered part of the RCI.

<sup>812</sup> Tenn. Code Ann. § 67-4-2109(b)(1)(E).

<sup>813</sup> A qualified job may be part-time, seasonal and not offer health insurance if the job duties entail adventure tourism and it is located in an adventure tourism district. These jobs count as half a job.

<sup>814</sup> The applicable investment period is found on the Business Plan. It generally cannot exceed three years, unless a statutory exception is met. Tenn. Code Ann. § 67-4-2109(a)(4).

<sup>815</sup> \$10 million for businesses engaged in convention or trade shows enterprises.

<sup>816</sup> Alternatively, taxpayers may provide data in other formats including highlighting items on a depreciation schedule.

<sup>817</sup> This work may be done in conjunction with the audit of Schedule G.

<sup>818</sup> Audit work in this area should cease when the required capital investment (\$500,000 or \$10,000,000) threshold has been verified. If the additional annual credit for higher level investments is claimed, these thresholds could be tested at this time.

<sup>819</sup> ASC 842 is the new GAAP standard regarding leases, effective for fiscal years beginning after December 15, 2018.

<sup>820</sup> The start date is the date shown on Line 1 of the Business Plan that reads "Effective Date of Business Plan," and the end date is generally three years later.

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<sup>821</sup> See the previous sections above on *Finance Leases* and *Operating Leases* for more information regarding includable and excludable lease payments.

<sup>822</sup> Copies of the schedules provided by a taxpayer should be made and audit work should be noted on the copy versions.

<sup>823</sup> 36 months, if adventure tourism positions located in an adventure tourism district.

<sup>824</sup> 26 consecutive weeks, for positions providing seasonal employment in an adventure tourism zone.

<sup>825</sup> Audit years prior to 2018 used a worksheet called Job Tax Credit – Net Increase Calculation. This worksheet was revised and renamed JTC Reconciliation for use in audits conducted after January 2017.

<sup>826</sup> However, the Commissioner of Revenue, with the approval of the Commissioner of Economic and Community Development, is authorized to approve job tax credits in cases where the newly created position existed in this state as a job position of the taxpayer or of another business entity less than 90 days prior to being filled by the taxpayer, *if* all other requirements to obtain the credit have been satisfied by the taxpayer and the Commissioners of Revenue and Economic and Community Development have determined that allowance of the credit is in the *best interests of the state*. Tenn. Code Ann. § 67-4-2109(b)(3)(E).

<sup>827</sup> 36 months, if an adventure tourism position that was located in an adventure tourism district that is part-time, seasonal, or not offered health insurance. Tenn. Code Ann. § 67-4-2109(A)(6)(2)(B)(ii).

<sup>828</sup> However, the Commissioner of Revenue, with the approval of the Commissioner of Economic and Community Development, is authorized to approve job tax credits in cases where the newly created position existed in this state as a job position of the taxpayer or of another business entity less than 90 days prior to being filled by the taxpayer, *if* all other requirements to obtain the credit have been satisfied by the taxpayer and the Commissioners of Revenue and Economic and Community Development have determined that allowance of the credit is in the *best interests of the state*. Tenn. Code Ann. § 67-4-2109 (b)(3)(E).

<sup>829</sup> Adventure tourism positions located in an adventure tourism zone may be part-time and seasonal (26 weeks). Audit procedures should be adjusted accordingly. Some of these positions will count as one-half of one position. Tenn. Code Ann. § 67-4-2109(a)(6)(A)(ii).

<sup>830</sup> Tenn. Code Ann. § 67-4-2109(a)(6)(A)(i).

<sup>831</sup> An adventure tourism job located in an adventure tourism district can be a qualified job and not offer health insurance. Tenn. Code Ann. § 67-4-2109(a)(6)(A)(ii)(a).

<sup>832</sup> See the earlier discussion on *Net Increase in Qualified Jobs during the Investment Period*. It covers the counting of qualified jobs in periods after the minimum increase has been met.

<sup>833</sup> [Revenue Ruling 00-23](#). A REIT that derives its income from participation interests in real estate mortgage loans is “carrying on the business of a financial institution” and should file on Form FAE174.

<sup>834</sup> See federal Form 8875 instructions for additional TRS information.

<sup>835</sup> Tenn. Code Ann. § 67-4-2004(39) provides the definition. It includes a national securities exchange of a foreign country.

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<sup>836</sup> *Over-the-counter* or *off-exchange* trading is done directly between two parties and is not a registered or national securities exchange.

<sup>837</sup> Tenn. Code Ann. § 67-4-2004(7).

<sup>838</sup> Tenn. Code Ann. § 67-4-2004(8).

<sup>839</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(O).

<sup>840</sup> Financial institution means a subsidiary of a regulated financial corporation. Tenn. Code Ann. § 67-4-2004(17).

<sup>841</sup> See Tenn. Code Ann. § 67-4-2006(e)(1). A financial institution has a disclosure requirement if it receives dividends, directly or indirectly, from a captive REIT. A [Captive REIT Disclosure](#) form must be filed to disclose the dividends received. If the required disclosure is not made, the deduction allowed under subdivision (b)(2)(A) with respect to any direct or indirect dividends from the captive REIT is disallowed, and the taxpayer will be subject to a negligence penalty. Tenn. Code Ann. § 67-1-804(b)(2).

<sup>842</sup> See [Important Notice #14-12](#). An outdated FAQ, since removed from the Department's website, advised that an SMLLC wholly-owned by a REIT would be treated as a separate entity for franchise and excise tax purposes; this guidance *should not* be followed. Rather, the general rule concerning SMLLCs owned by a corporation *should* be followed. Since a REIT is corporation, an SMLLC owned by a REIT is disregarded and included in both the REIT's state and federal income tax returns.

<sup>843</sup> QRSS, TRSS, LPs and LLCs are never REITs. They are never allowed to make a federal REIT election.

<sup>844</sup> The Department previously posted to its website a now-outdated FAQ that stated that a federally-disregarded SMLLC wholly-owned by a REIT would be treated as a separate entity for franchise and excise tax purposes. However, this FAQ addressed prior law that was repealed in 2006. Because the FAQ is no longer applicable to any open tax periods, the Department has removed this guidance from its website.

<sup>845</sup> See Tenn. Code Ann. §§ 67-4-2006(a)(9), 67-4-2007(e)(3), 67-4-2114(d). Also, the members will designate one member to file the combined return, and each member subject to tax in this state shall be jointly and severally liable for the tax of the affiliated group.

<sup>846</sup> Tenn. Code Ann. § 67-4-2006(b)-(c).

<sup>847</sup> Tenn. Code Ann. § 67-4-2006(a)(9).

<sup>848</sup> Tenn. Code Ann. § 67-4-2012(a)(2).

<sup>849</sup> Tenn. Code Ann. §§ 67-4-2013(d), 67-4-2111(b)(2)(A), 67-4-2111(e)(2)(A), 67-4-2111(g)(2).

<sup>850</sup> Beginning July 1, 2010.

<sup>851</sup> See [Revenue Ruling 13-22](#), page 2. The DPD can only be taken by a REIT.

<sup>852</sup> LPs and LLCs that are part of a CRAG would be combined with other affiliates that report on Schedule J4.

<sup>853</sup> Tenn. Code Ann. §§ 67-4-2006(a)(5), 67-4-2019.

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<sup>854</sup> The REIT ownership percentage can be confirmed by the Schedule K-1 issued by an LP/LLC to its owner.

<sup>855</sup> Tenn. Code Ann. § 67-4-2004(17).

<sup>856</sup> Tenn. Code Ann. § 67-4-2004(14)(B)-(D).

<sup>857</sup> Tenn. Code Ann. § 67-4-2004(49).

<sup>858</sup> Tenn. Code Ann. §§ 67-4-2006(a)(3), 67-4-2007(e)(2)(A), 67-4-2106(b).

<sup>859</sup> Tenn. Code Ann. § 67-4-2004(52).

<sup>860</sup> Tenn. Code Ann. §§ 67-4-2007(e)(2)(A), 67-4-2106(b), 67-4-2114(c).

<sup>861</sup> Tenn. Code Ann. § 67-4-2103(d).

<sup>862</sup> Tenn. Code Ann. § 67-4-2004(2).

<sup>863</sup> Tenn. Code Ann. §§ 67-4-2010, 67-4-2110.

<sup>864</sup> Tenn. Code Ann. §§ 67-4-2013(b), 67-4-2118.

<sup>865</sup> Tenn. Code Ann. § 67-4-2103(f).

<sup>866</sup> Tenn. Code Ann. § 67-4-2004(17).

<sup>867</sup> Tenn. Code Ann. § 67-4-2004(21).

<sup>868</sup> Tenn. Code Ann. § 67-4-2004(45).

<sup>869</sup> Tenn. Code Ann. § 67-4-2004(30).

<sup>870</sup> Tenn. Code Ann. § 67-4-2004(5).

<sup>871</sup> 12 U.S.C. § 1841(a)(5).

<sup>872</sup> 12 U.S.C. § 1841(c)(1)-(2).

<sup>873</sup> Tenn. Code Ann. § 67-4-2004(45).

<sup>874</sup> Federal Home Loan Banks are a system of regional banks from which local lending institutions everywhere in America borrow funds. About 80 percent of U.S. lending institutions rely on the Federal Home Loan Banks. Federal Home Loan Banks are *cooperatives*. Local lenders likely finance much of their community lending through low-cost funds provided by their regional Federal Home Loan Bank.

<sup>875</sup> A thrift bank is a type of small financial institution that primarily accepts deposits and originates home mortgages and includes savings and loan associations, mutual savings banks, and credit unions.

<sup>876</sup> This also includes banks and thrift institutions organized in a foreign country that is engaged in the business of receiving deposits and any corporation organized under 12 U.S.C. §§ 611-631, Edge Act corporations, and any agency of a foreign depository as defined in 12 U.S.C. § 3101.

<sup>877</sup> See the federal law concerning foreign banking at

[https://www.govregs.com/uscode/title12\\_chapter6\\_subchapterI](https://www.govregs.com/uscode/title12_chapter6_subchapterI)

<sup>878</sup> Tenn. Code Ann. § 67-4-2004(5).

<sup>879</sup> <https://www.occ.treas.gov/topics/licensing/national-banks-fed-savings-assoc-lists/index-active-bank-lists.html>

<sup>880</sup> [Letter Ruling 98-31](#)

<sup>881</sup> The greater-than-50% requirement ensures that the subsidiary is included in only one franchise and excise tax return for a given tax period.

<sup>882</sup> "Investment entity" is defined at Tenn. Code Ann. § 67-4-2004(30); "Investment securities" at Tenn. Code Ann. § 67-4-2004(31).

<sup>883</sup> Tenn. Code Ann. § 67-4-2004(5).

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<sup>884</sup> Tenn. Code Ann. § 67-4-2004(38) defines “person.” Any type of “person” may be doing the business of an FI, so non-corporate entities could be included in the unitary return.

<sup>885</sup> *Tennessee Code Annotated*, Title 45.

<sup>886</sup> Factoring is a type of debtor financing in which a business sells its accounts receivables to a third party at a discount. Accounts receivable financing is a form of asset-based lending against accounts receivable. These types of transactions have a variety of names and features, but if they effectively are a loan, then the lender may be an FI.

<sup>887</sup> Financing leases under GAAP constitute doing the business of an FI, whereas operating leases do not.

<sup>888</sup> Tenn. Code Ann. § 67-4-2004(5)(B).

<sup>889</sup> See Tenn. Code Ann. § 67-4-2007(a).

<sup>890</sup> Tenn. Code Ann. § 67-4-2004(14).

<sup>891</sup> Tenn. Code Ann. § 67-4-2004(49). See Chapter 3 of this manual for information regarding nexus. The definition of “substantial nexus” was enacted in 2015 and is effective for tax years beginning on or after January 1, 2016.

<sup>892</sup> Tenn. Code Ann. § 67-4-2004(14)(B)-(C). See also Tenn. Code Ann. § 67-4-2105(d).

<sup>893</sup> Tenn. Code Ann. § 67-4-2004(14)(B)(i)-(viii).

<sup>894</sup> Tenn. Code Ann. § 67-4-2004(14)(C)(i)-(vii).

<sup>895</sup> Tenn. Code Ann. § 67-4-2004(14)(C).

<sup>896</sup> Tenn. Code Ann. § 67-4-2004(49).

<sup>897</sup> Tenn. Code Ann. § 67-4-2004(14)(D).

<sup>898</sup> Tenn. Code Ann. § 67-4-2007(e)(2)(A).

<sup>899</sup> Tenn. Code Ann. § 67-4-2004(52).

<sup>900</sup> See Revenue Rulings [06-27](#), [02-16](#), and [97-59](#)

<sup>901</sup> Tenn. Code Ann. § 67-4-2004(44).

<sup>902</sup> Tenn. Code Ann. § 67-4-2004(8).

<sup>903</sup> Tenn. Code Ann. § 67-4-2006(a)(9).

<sup>904</sup> Tenn. Code Ann. § 67-4-2004(7).

<sup>905</sup> Tenn. Code Ann. § 67-4-2008(4), (10), and (14).

<sup>906</sup> Tenn. Code Ann. § 67-4-2008.

<sup>907</sup> Tenn. Code Ann. § 67-4-2004(52).

<sup>908</sup> Tenn. Code Ann. § 67-4-2007(e)(2).

<sup>909</sup> Tenn. Code Ann. § 67-4-2006(a)(3).

<sup>910</sup> Tenn. Code Ann. § 67-4-2106(b).

<sup>911</sup> Tenn. Code Ann. § 67-4-2007(e)(2)(B)(i)-(ii).

<sup>912</sup> Tenn. Code Ann. § 67-4-2007(e)(2)(C)(ii).

<sup>913</sup> See Tenn. Code Ann. § 67-4-2007(e)(2)(B)-(C) for more information on the criteria that must be met for an LLC, LLP, or LP to *not* be jointly and severally liable.

<sup>914</sup> See <https://www.census.gov/naics/>

<sup>915</sup> Public REITs are allowed to take the dividends paid deduction. This applies to public REITs filing on either Form FAE170 or FAE174.

<sup>916</sup> Meaning, a financial institution that is not affiliated with another entity, and thus, combined reporting does not apply.

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<sup>917</sup> Financial institution unitary groups and hospital companies are required to file combined returns. Tenn. Code Ann. §§ 67-4-2106(b) and 67-4-2112(e).

<sup>918</sup> Tenn. Code Ann. § 67-4-2106(b). Tax basis books are not permitted to calculate combined net worth; the exception for Form FAE170 filers to use tax basis books if GAAP records are not maintained by the taxpayer is *not* permitted for Form FAE174 filers.

<sup>919</sup> Tenn. Code Ann. § 67-4-2107(b)(1).

<sup>920</sup> *See* Tenn. Code Ann. §§ 67-4-2014 and 2112. As is the case with variances requested by taxpayers, variances requested by auditors are subject to approval or denial at the Commissioner's discretion.

<sup>921</sup> Tenn. Code Ann. § 67-4-2114(c)(1).

<sup>922</sup> Tenn. Code Ann. § 67-4-2004(46); TENN. COMP. R. & REGS. 1320-06-01-.32(1)(a).

<sup>923</sup> Tenn. Code Ann. § 67-4-2114(c)(1).

<sup>924</sup> Tenn. Code Ann. § 67-4-2118(c)(8).

<sup>925</sup> Tenn. Code Ann. § 67-4-2118(a).

<sup>926</sup> TENN. COMP. R. & REGS. 1320-06-01-.32(1)(b).

<sup>927</sup> The Form FAE174 instructions indicate that the apportionment schedule uses tax basis values.

<sup>928</sup> *See* Tenn. Code Ann. §§ 67-4-2013(b)(3) and 67-4-2118(c).

<sup>929</sup> Tenn. Code Ann. § 67-4-2118(c)(12).

<sup>930</sup> TENN. COMP. R. & REGS. 1320-06-01-.32(1)(b).

<sup>931</sup> Tenn. Code Ann. § 67-4-2118(c).

<sup>932</sup> Effective for tax years beginning on or after July 1, 2016.

<sup>933</sup> *See* Tenn. Code Ann. § 67-4-2111(i)(1)(C).

<sup>934</sup> Tenn. Code Ann. § 67-4-2103(h).

<sup>935</sup> Tenn. Code Ann. § 67-4-2004(2).

<sup>936</sup> Tenn. Code Ann. § 67-4-2103(c).

<sup>937</sup> Tenn. Code Ann. § 67-4-2004(7).

<sup>938</sup> Tenn. Code Ann. § 67-4-2004(17).

<sup>939</sup> *See* the CNW discussion in Chapter 9 of this manual for more information.

<sup>940</sup> Tenn. Code Ann. § 67-4-2106(b).

<sup>941</sup> For tax years beginning prior to January 1, 2011, a deduction was available for a specified percentage of a financial institution affiliated group's securities classified as held to maturity or available for sale; this deduction is no longer available. Tenn. Code Ann. § 67-4-2118(d)(2).

<sup>942</sup> Tenn. Code Ann. § 67-4-2004(2) and (52).

<sup>943</sup> Tenn. Code Ann. § 67-4-2004(17).

<sup>944</sup> Tenn. Code Ann. § 67-4-2004(15).

<sup>945</sup> Tenn. Code Ann. § 67-4-2004(2).

<sup>946</sup> Tenn. Code Ann. § 67-4-2103(f).

<sup>947</sup> Tenn. Code Ann. § 67-4-2118(d)(3).

<sup>948</sup> Tenn. Code Ann. §§ 67-4-2004(18), 67-4-2118(d)(3)-(4).

<sup>949</sup> Tenn. Code Ann. § 67-4-2004(5).

<sup>950</sup> Tenn. Code Ann. § 67-4-2114(d).

<sup>951</sup> Tenn. Code Ann. § 67-4-2106(b).



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<sup>952</sup> Tenn. Code Ann. § 67-4-2108(a)(6)(B).

<sup>953</sup> Tenn. Code Ann. § 67-4-2111(b)(2)(B).

<sup>954</sup> Tenn. Code Ann. § 67-4-2111(b)(4).

<sup>955</sup> Tenn. Code Ann. § 67-4-2111(e)(2).

<sup>956</sup> Tenn. Code Ann. § 67-4-2111(g)(2).

<sup>957</sup> *Id.*

<sup>958</sup> Tenn. Code Ann. § 67-4-2108(a)(3).

<sup>959</sup> Previous guidance *that is no longer followed by the Department* stated that “rent paid by one member of the unitary group to another member is excluded if the property has already been included once as property owned.”

<sup>960</sup> 26 CFR § 1.1502-76.

<sup>961</sup> Tenn. Code Ann. § 67-4-2015(a).

<sup>962</sup> The proration calculation is not shown on the form but should nevertheless be taken into account in reporting the entity’s franchise tax on Schedule F.

<sup>963</sup> Tenn. Code Ann. §§ 67-4-2015(a), 67-4-2115(a).

<sup>964</sup> Tenn. Code Ann. § 67-4-2115(b).

<sup>965</sup> Tenn. Code Ann. § 67-4-2006(a)(3).

<sup>966</sup> *Id.*

<sup>967</sup> According to Tenn. Code Ann. § 67-4-2006(a)(9), CRAGs are taxed as corporations for Tennessee excise tax purposes. A Tennessee taxpayer may only file using one of the four Sub-J schedules found in the excise tax portion of the return; in this case, Schedule J4 is the appropriate schedule for CRAGs.

<sup>968</sup> Tenn. Code Ann. § 67-4-2006(b)(1)(O).

<sup>969</sup> Tenn. Code Ann. § 67-4-2013(b).

<sup>970</sup> Tenn. Code Ann. § 67-4-2013(b)(3)(L).

<sup>971</sup> TENN. COMP. R. & REGS. 1320-06-01-.32.

<sup>972</sup> Tenn. Code Ann. § 67-4-2013(b)(1).

<sup>973</sup> Tenn. Code Ann. § 67-4-2013(b)(2).

<sup>974</sup> Tenn. Code Ann. § 67-4-2006(a)(3).

<sup>975</sup> Tenn. Code Ann. § 67-4-2114(c)(1).

<sup>976</sup> Tenn. Code Ann. § 67-4-2013(d)(2).

<sup>977</sup> Effective for tax years beginning on or after July 1, 2016.

<sup>978</sup> See Tenn. Code Ann. § 67-4-2111(i)(1)(C).

<sup>979</sup> Tenn. Code Ann. § 67-4-2013(d).

<sup>980</sup> *Id.*

<sup>981</sup> Tenn. Code Ann. § 67-4-2006(c)(4).

<sup>982</sup> Tenn. Code Ann. § 67-4-2109(h).

<sup>983</sup> Tenn. Code Ann. § 67-4-2109(h)(3)(B).

<sup>984</sup> Tenn. Code Ann. § 67-4-2109(h)(3)(A).

<sup>985</sup> Tenn. Code Ann. § 67-4-2109(h)(3)(D).

<sup>986</sup> Tenn. Code Ann. §§ 67-4-2109(h)(1)(A) and (h)(2)(A).

<sup>987</sup> Tenn. Code Ann. § 67-4-2109(h)(8).

<sup>988</sup> Tenn. Code Ann. §§ 67-4-2109(h)(1)(B) and (h)(2)(B).

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<sup>989</sup> Tenn. Code Ann. § 67-4-2109(h)(8).

<sup>990</sup> Tenn. Code Ann. § 67-4-2109(h)(3)(E).

<sup>991</sup> Tenn. Code Ann. § 67-4-2109(h)(3)(F).

<sup>992</sup> Tenn. Code Ann. § 67-4-2109(h)(3)(G).

<sup>993</sup> The facts in this Ruling indicate that the syndicated lending relationship is *pari passu* (equal), and loan repayments are paid pro rata in accordance with the amount of each lender's claim.

<sup>994</sup> Loan participation can be made on a senior/subordinated basis or a *pari passu* (equal) basis. The facts in this Ruling indicate that the loan participation would be made on a *pari passu* basis with equal risk sharing for all participating lenders.

<sup>995</sup> Pursuant to Tenn. Code Ann. § 67-4-2109(e), a credit carryforward may be taken only by the taxpayer that generated it.

<sup>996</sup> Tenn. Code Ann. § 67-4-2109(h)(4)-(5).

<sup>997</sup> Tenn. Code Ann. § 67-4-2109(h)(6).

<sup>998</sup> Tenn. Code Ann. § 67-4-2109(k).

<sup>999</sup> Tenn. Code Ann. §§ 67-4-2109(k)(1)(A) and (k)(2)(A).

<sup>1000</sup> Tenn. Code Ann. § 67-4-2109(k)(4).

<sup>1001</sup> Tenn. Code Ann. §§ 67-4-2109(k)(1)(B) and (k)(2)(B).

<sup>1002</sup> Tenn. Code Ann. § 67-4-2109(k)(4).

<sup>1003</sup> Tenn. Code Ann. § 67-4-2109(k)(3)(B).

<sup>1004</sup> Tenn. Code Ann. § 67-4-2109(k)(3)(C).

<sup>1005</sup> Tenn. Code Ann. § 67-4-2109(k)(3)(D).

<sup>1006</sup> Tenn. Code Ann. § 67-4-2109(k)(5).

<sup>1007</sup> Tenn. Code Ann. § 67-4-2109(l)(1).

<sup>1008</sup> Tenn. Code Ann. § 67-4-2109(l)(2).

<sup>1009</sup> Tenn. Code Ann. § 67-4-2109(a)(5).

<sup>1010</sup> Tenn. Code Ann. § 67-4-2109(e)(3).

<sup>1011</sup> 10-K filings of publicly traded companies can be accessed on the SEC EDGAR website at <https://www.sec.gov/edgar/searchedgar/companysearch.html>

<sup>1012</sup> Tenn. Code Ann. § 67-4-2004(15).

<sup>1013</sup> Tenn. Code Ann. § 67-4-2004(18).

<sup>1014</sup> See TENN. COMP. R. & REGS. 1320-06-01-.32.

<sup>1015</sup> Tenn. Code Ann. § 67-4-2004(5).

<sup>1016</sup> See TENN. COMP. R. & REGS. 1320-06-01-.32.