TENNESSEE DEPARTMENT OF REVENUE

REAGAN FARR, COMMISSIONER

REPORT ON

FAMILY-OWNED NON-CORPORATE ENTITIES

MARCH 2009

STATE OF TENNESSEE
DEPARTMENT OF REVENUE
ANDREW JACKSON STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37242

PHIL BREDESEN
Governor

REAGAN FARR
Commissioner

March 19, 2009

The Honorable Randy McNally
Chairman of the Senate Finance, Ways and Means Committee
307 War Memorial Building
Nashville, TN 37243

The Honorable Craig Fitzhugh
Chairman of the House Finance, Ways and Means Committee
33 Legislative Plaza
Nashville, TN 37243

Honorable Gentlemen:

I am pleased to present to you the following information related to the exemption from Tennessee franchise and excise tax provided to family-owned non-corporate entities pursuant to Tenn. Code Ann. § 67-4-2008(a)(11).

As you are aware, the 105th General Assembly enacted legislation directing the Department of Revenue to compile information pertaining to the family-owned non-corporate entity exemption and submit to the Finance, Ways and Means Committees of the Senate and the House of Representatives a summary report of the information so compiled. *See* Chapter 1106, § 68, of the Public Acts of 2008. The report is to contain an analysis of the utilization, costs and benefits of the exemption as well as findings and recommendations pertaining to continuation of the exemption.

The attached report lays out those findings and a recommendation that the family-owned non-corporate entity exemption be amended to exclude commercial rents.

I am available at any time to assist you as you consider this matter during the current legislative session.

Sincerely,

Reagan Farr

Executive Summary

Tennessee has a little-known tax exemption that sounds friendly enough: the "family-owned non-corporate entity," or FONCE. Indeed, this exemption does benefit families, but the current provisions contain a loophole that allows some of the wealthiest families in our state, and many outside of the state, to avoid paying business franchise or excise taxes on commercial real estate investments. While the wealthy are able to avoid paying taxes due to this loophole, working families struggling through the nation's weak economy still are paying their fair share of taxes.

In 2008, the General Assembly had the opportunity to correct this inequity by closing this commercial real estate loophole. Instead, legislators were forced to balance the state budget by redirecting dollars from other sources. At the time, the Department of Revenue estimated the commercial real estate loophole allowed Tennessee's wealthiest families to avoid over $15 million in tax. Surveys over the summer and fall show the number is significantly higher.

During the summer and fall of 2008, the Department of Revenue requested that all FONCEs registered as exempt from franchise and excise tax complete a Disclosure of Activity form. At the request of the General Assembly, the department performed a cost/benefit analysis using the information provided on these forms. *See* Chapter 1106, § 68, of the Public Acts of 2008. The resulting recommendation is to return the FONCE exemption to its original intended purpose by removing commercial real estate activities from the scope of the exemption.

Original legislation in 2008 proposed that commercial rents no longer be considered passive investment income, thereby disqualifying some entities from tax-exempt status. In order to learn more about the number and types of entities that would be affected by such legislation, the department mailed 8,797 forms to FONCEs in Tennessee as well as outside the state. In the process of completing the report, the department learned that:

- Current FONCE provisions allow more than 3,200 entities to shield more than $5 billion in commercial real estate properties from franchise and excise tax.
- On average, each of these entities controls more than $1.6 million worth of commercial property.
- This loophole results in estimated lost revenue of $25 million. (This estimate accounts for the anticipated restructuring of some entities to avoid franchise and excise tax.)
- Approximately 20% of these FONCEs are owned by out-of-state investors that control over $1 billion worth of commercial property, making Tennessee a tax haven for out-of-state, wealthy investors who want to shield their commercial property investments from taxes.

The misleading label of "small business" placed on affected entities derailed legislation to close the loophole in 2008. However, as shown by the data above and following in detail, entities affected by the legislation primarily include wealthy investment properties and large enterprises, not small businesses.

The department anticipates proceeding again with legislation that closes this commercial real estate loophole by excluding commercial rents from the definition of qualified "passive investment income" for purposes of the FONCE exemption. A pitfall of the 2008 proposal was the lack of definite information about the properties that exploited this loophole to shield commercial investment property from franchise and excise tax. The department's research has shown that the great majority of entities that will be affected by the proposed legislation are owned by well-to-do, high income individuals, many of whom live outside of Tennessee. It is unfair to make Tennessee's small and large businesses pay franchise and excise taxes, while wealthy commercial real estate owners get a free pass out of state tax obligations.

I. Background and History of the FONCE Exemption

In 1999, the General Assembly expanded the franchise and excise tax to include "non-corporate" entities that provide limited liability protection to their owners, such as limited liability companies ("LLCs") and limited partnerships ("LPs"). Previously, the tax applied only to corporations, S corporations, and other corporate entities such as business trusts. The reason for this change was to treat all limited liability entities the same for franchise and excise tax purposes.

Prior to 1999, companies were able to use LLCs and LPs to structure their operations in a manner that allowed them to escape 99% of their Tennessee corporate tax liability. During the tax debates of 1998 and 1999 this structure became known as the "Kroger Loophole" and was estimated to cost Tennessee more than $300 million dollars annually in lost revenues. During the 1999 session, the General Assembly passed legislation to close the "Kroger Loophole" by taxing all limited liability entities at the entity level thereby eliminating the ability to avoid corporate taxation by using LLCs and LPs and tax planning. One of the main arguments used during this debate was the fundamental fairness argument that two businesses competing in the commercial marketplace should not have substantially different tax liabilities simply because of ownership or corporate form. The passage of this legislation brought fairness back to Tennessee's corporate tax scheme and prevented the further erosion of Tennessee's tax base due to tax planning.

Although the 1999 "Kroger Loophole" closing legislation achieved its goal of bringing fairness back to Tennessee's tax structure there were some unintended consequences. The most important of which was the imposition of corporate franchise and excise tax on family-owned LLCs and LPs that earn passive investment income which was already subject to Tennessee's Hall Income tax. Historically, these entities were subject to the Hall income tax, which applies to interest and dividend income. In 2000, the General Assembly sought to rectify the situation.

Thus, the FONCE exemption[1] was enacted to put these family-owned entities back into the same position as before the 1999 legislation; that is, subject to the Hall income tax but exempt from franchise and excise tax. Unfortunately, in enacting the exemption, certain categories of income

[1] In order to qualify for the FONCE exemption, the entity must meet two criteria: 1) at least 95% of the entity's ownership must be held by family members, and 2) at least 66.67% of the entity's activity must be either the production of passive investment income or a combination of the production of passive investment income and farming. "Passive investment income" is defined by the statute as gross receipts derived from royalties, dividends, interest, annuities, gain on the sale of stock, and rents. "Rents," as the term is used in the definition of "passive investment income," includes rents from residential property, farm property, industrial and commercial property, and tangible personal property such as equipment.

not subject to the Hall income tax were included in the definition of "passive investment income," which had the unintended consequence of recreating an unlevel playing field for businesses.

As detailed more fully below, more than 5,500 non-corporate entities are currently exempt from taxation under the FONCE provision. Of those entities, more than 3,200 qualify for the exemption because they receive substantially all of their income from the business of leasing commercial real estate. Those 3,200 entities hold commercial property worth more than $5 billion and generate revenue of just under $700 million annually. (See appendix A.)

The following discussion and recommendation are focused on these commercial real estate enterprises. The proposed legislation would have no impact on FONCEs that derive at least 66.67% of their income from renting farm or residential property or from royalties, dividends, interest, annuities, or gain on the sale of stock. The proposed legislation would also have no impact on non-corporate entities that derive at least 66.67% of their income from farming activities, as those entities are entitled to a completely separate statutory exemption.

II. The FONCE Survey

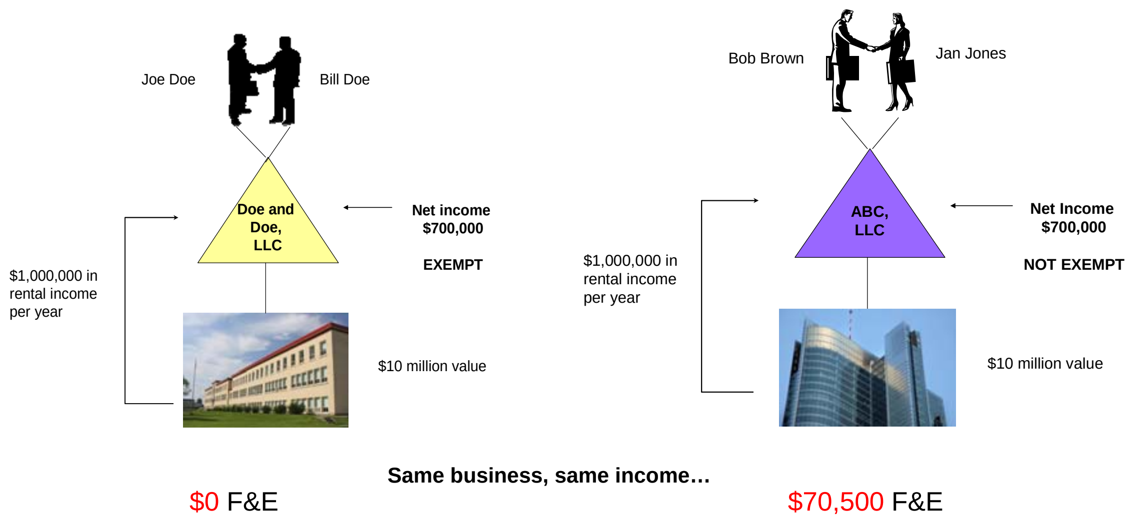
On June 13, 2008, the department mailed a request for information to 8,797 entities registered as exempt under the FONCE provision. To date, the Department has received 7,205 responses. Of those responding, 5,557 qualify for the FONCE exemption. Another 466 qualify for a separate exemption from taxation because, for example, they engage in farming activities or hold a personal residence. Of those responding, 1,018 do not qualify for any exemption. The department is seeking additional information concerning the remaining 164 responses.

Other findings showed that not only are wealthy Tennessee families taking advantage of this loophole, but also out-of-state investors who locate their investments here to shield them from tax that would likely have been paid in their home state. Of the 3,200 FONCEs that hold commercial real estate, 20% are held by out-of-state investors and are worth just over $1 billion collectively. Investors from 43 other states have located their holdings in Tennessee. The states who have the most owners are California (189), Virginia (96) and Colorado (39). California ($468,879,568), Virginia ($92,246,560) and Kentucky ($81,460,866) are the states where owners hold the highest value. (See appendix B.)

III. An Issue of Fundamental Fairness

Closing the corporate rent loophole is necessary to restore fundamental fairness to Tennessee's tax structure. For example, two brothers own Doe and Doe, LLC, which owns and leases an office building. Doe and Doe, LLC qualifies for the FONCE exemption. Meanwhile, two unrelated individuals form ABC, LLC to own and lease a similar office building across the street. Because the owners are unrelated, ABC, LLC is subject to franchise and excise taxes.

The survey results confirm that a significant number of entities are exempt from franchise and excise taxation based solely on their ownership by family members, notwithstanding the fact that they are engaged in exactly the same commercial leasing activity as their non-exempt competitors. Thus, removing commercial rents from the definition of "passive investment income" is a matter of fundamental fairness.

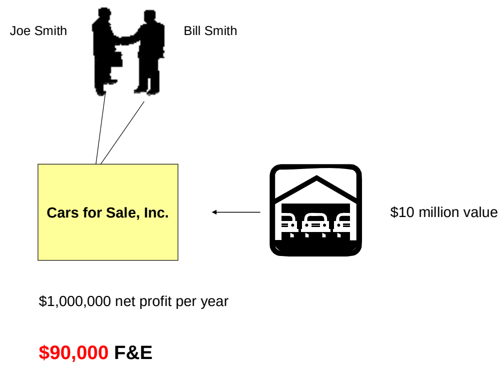


Assume that each LLC's office building is valued at $10 million. Additionally, assume that each LLC brings in $1,000,000 in rental income each year with a net income of $700,000. Even though the LLCs are competing with one another in the commercial real estate industry, their respective tax liabilities differ greatly. ABC, LLC will owe $70,500 in franchise and excise taxes each year. However, Doe and Doe, LLC will have a tax bill of $0.

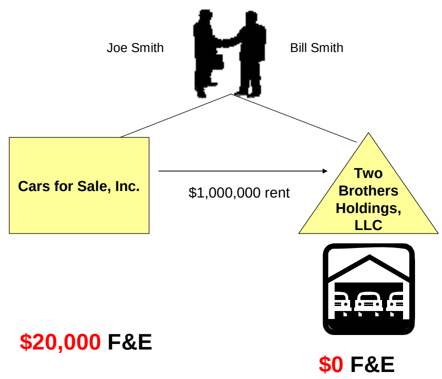
In practical terms, the owners of ABC, LLC will each bring home $35,250 less per year simply because they are not related to one another. As was the case before 1999, companies engaged in exactly the same business in competition with one another are either subject to taxation or exempt from taxation based solely on their ownership structure – in this case related owners versus unrelated owners. The owners of these taxable and non-taxable competitors enjoy equally the liability protection afforded them by utilizing an LLC or LP structure.

As a matter of fundamental fairness, these companies should once again be required to pay franchise and excise tax in exchange for shielding their owners from liability. Franchise and Excise tax should be applied uniformly across the commercial real estate industry without regard to whether the owners share a bloodline. Each business competing in the industry should be required to make the same choice between limited liability protection and tax exemption. Basing an exemption on one's bloodline makes no more sense than basing an exemption on gender or race.

In addition to the fundamental unfairness illustrated above, this commercial real estate loophole has the unintended potential to facilitate tax avoidance through creative tax planning. For example, let's say two brothers own a corporation, Cars for Sale, Inc., which is an automobile dealership that makes $1,000,000 in taxable net income each year. The brothers also own Two Brothers Holdings, LLC, which qualifies for the FONCE exemption (Cars for Sale, Inc. does not qualify because it is a corporation engaged in business activities that are not passive). Cars for Sale, Inc. owns the real estate upon which the automobile dealership is located. This real estate is valued at $10 million.



Normally, Cars for Sale, Inc. would have a franchise and excise tax liability of $90,000. However, assume that Cars for Sale, Inc. contributes the real property to Two Brothers Holdings, LLC in a tax-free contribution of capital. Two Brothers Holdings, LLC is now the owner of the real estate. Assume as well that Two Brothers Holdings, LLC rents the real property back to Cars for Sale, Inc. for $1,000,000 a year.



Because Two Brothers Holdings, LLC is exempt, it does not owe franchise and excise tax. By shifting its entire net taxable income to the LLC as "rent," Cars for Sale, Inc. will be able to reduce its excise tax liability to zero and its franchise tax liability to $20,000. In other words, the automobile dealership will reduce its total franchise and excise tax liability by $70,000 by taking advantage of the commercial real estate loophole.

This example further illustrates that exempting an enterprise such as commercial leasing based solely on the owners' family ties is poor tax policy.

IV. Protecting the Tax Base – A Commitment to Maintaining Tennessee's Current Tax Scheme

During the last five years, Tennessee has benefited immensely from broad, bi-partisan support for numerous loophole closing measures. Each time the General Assembly acts to close a loophole, it helps ensure that the taxes currently on the books work in the way they were intended, and it helps prevent erosion of the tax base that would otherwise eventually require the State to increase tax rates or find new sources of revenue.

Below are several loophole closing measures enacted since 2003, along with the approximate fiscal impact of each:

- Prevented financial institutions from shielding investment income from excise tax through the use of participation loans. *2003 Public Chapter 418. Fiscal impact: $500,000. Vote: 127 Ayes, 0 Nays.*

- Repealed the sales and use tax exemptions for the first $500 of the cost of any burial vault or casket and the first $150 per year of membership dues to a recreation club. *2003 Public Chapter 357. Fiscal impact: $2,000,000. Vote: 100 Ayes, 17 Nays, 10 PNV.*

- Prevented retail outlets from utilizing the franchise tax exemption for finished goods inventory, an exemption that was enacted to encourage the development of manufacturing, warehousing, and distribution facilities. *2004 Public Chapter 924. Fiscal impact: $4 million. Vote: 129 Ayes, 0 Nays.*

- Prevented sham transactions designed to avoid excise tax, by requiring companies to report any deduction of expenses paid to an affiliated company for intangible assets. *2004 Public Chapter 924. Fiscal impact: $15 million. Vote: 129 Ayes, 0 Nays.*

- Prevented companies from avoiding excise tax on the sale of assets through the practice of transferring the asset from a taxable, limited liability entity to a non-taxable, unlimited liability entity immediately prior to sale. *2004 Public Chapter 592. Fiscal impact: $7 million. Vote: 127 Ayes, 0 Nays.*

- Decoupled Tennessee excise tax from new federal accelerated depreciation provisions. *2004 Public Chapter 785. Fiscal impact: $75,000,000. Vote: 84 Ayes, 39 Nays.*

- Restricted the sales tax exemption for pollution control equipment to companies that purchase the equipment to clean up waste produced through their own operations, rather than companies that acquire waste from others and bring it into the state for processing. *2004 Public Chapter 924. Fiscal impact: >$100,000. Vote: 129 Ayes, 0 Nays.*

- Ended tax planning techniques used to take advantage of the franchise and excise tax obligated member entity exemption while continuing to shield owners from liability. *2005 Public Chapter 499. Fiscal impact: >$10 million. Vote: 106 Ayes, 17 Nays, 2 PNV.*

- Provided for the apportionment of financial institution income and net worth based on the ten enumerated receipts factors rather then total gross income. *2005 Public Chapter 499. Fiscal impact: $1,000,000. Vote: 106 Ayes, 17 Nays, 2 PNV.*

- Prevented restaurants from qualifying for as manufacturers for sales and use tax purposes. *2005 Public Chapter 499. Fiscal impact: $250,000. Vote: 106 Ayes, 17 Nays, 2 PNV.*

- Decoupled Tennessee excise tax from new federal deductions for qualified production activity income. *2005 Public Chapter 499. Fiscal impact: $11,000,000. Vote: 106 Ayes, 17 Nays, 2 PNV.*

- Repealed the franchise tax exemption for real estate investment trusts (REITs) in order to prevent companies from shielding commercial property from taxation. *2006 Public Chapter 1019. Fiscal impact: >$20 million. Vote: 103 Ayes, 9 Nays, 8 PNV.*

- Allowed for apportionment of income and net worth to another state only if the company is conducting activities in that state which, if conducted in Tennessee, would constitute doing business in this state. *2006 Public Chapter 1019. Fiscal impact: $5,000,000. Vote: 103 Ayes, 9 Nays, 8 PNV.*

- Required S corporations to include in net earnings any gain attributable to in an Internal Revenue Code § 338(h)(10) election, in order to prevent companies from acquiring a stepped-up basis while avoiding excise tax. *2007 Public Chapter 602. Fiscal impact: $10,000,000. Vote: 74 Ayes, 45 Nays, 1 PNV.*

- Required companies to recognize gain on the sale of an asset based on the asset's true tax basis without any adjustment as a result of the taxpayer not having been subject to Tennessee excise tax during any portion of the period during which the asset was depreciated. *2007 Public Chapter 602. Fiscal impact: $5,000,000. Vote: 74 Ayes, 45 Nays, 1 PNV.*

- Required financial institutions to disclose dividends received from captive REITs in order to address the use of captive REITs to shield investment income from taxation. *2008 Public Chapter 1106. Fiscal impact: >$100,000. Vote: 87 Ayes, 34 Nays, 2 PNV.*

V. Recommendations

The department recommends that the FONCE exemption be amended by removing commercial rents from the definition of "passive investment income." This change would allow for the continued exemption of FONCEs that derive at least 66.67% of their income from royalties, dividends, interest, annuities, gain on the sale of stock, or the rental of residential or farm property. The change would have no effect on the separate and distinct exemption for non-corporate entities engaged in farming or holding a personal residence.

VI. A Reasonable Compromise

Each affected entity will be able to elect between maintaining its exempt status and maintaining liability protection for its owners. One simple option already available is to take advantage of the "obligated member entity" exemption.

The term “obligated member entity” just means that the owners (i.e., members of an LLC or partners in a LP) agree to be fully liable for the debts, obligations, and liabilities of the entity. Again, the choice is between protecting the owners from liability and exempting the entity from franchise and excise taxation. Unlike the FONCE exemption, the obligated member entity exemption is not based on the relationship of the owners or the type of activity that produces the income.

The process to become an obligated member entity is quick and easy. The entity must simply file Articles of Amendment or an Amendment to the Certificate of Limited Partnership with the Tennessee Secretary of State’s office. In the amendment, the members or partners will declare that they are personally liable for the debts, obligations, and liabilities of the entity. The document can be filed in a matter of minutes with the Secretary of State’s office.

The commercial rent loophole creates an unlevel playing field for investors competing against each other in a commercial marketplace. By favoring wealthy families over unrelated investors and small business owners, the loophole provides a substantial monetary benefit to business owners based on bloodlines – not abilities.

This loophole has made Tennessee a tax haven for out-of-state investors in commercial real estate. The proposed legislation will close the commercial rent loophole and will provide an opportunity for each FONCE owner to operate in the same way that more than 200,000 Tennessee businesses already do by paying franchise and excise tax or electing to become exempt obligated member entities.

Appendix A
FONCE Survey Results

Surveys mailed		8,797
Responses received		7,205
Total number of FONCEs		5,557
FONCEs holding commercial property		3,235
Total appraised value of commercial property		$5,166,048,322
Total receipts from commercial property		$698,961,007
FONCEs leasing property to an owner of the FONCE or to an affiliated entity		1,234
Appraised value of property		$1,219,994,272
Receipts from property		$188,120,226
Out-of-state FONCEs holding commercial property in Tennessee		600
Appraised value of property		$1,031,594,975
Breakdown by appraised value	# of accounts	Appraised value
$10,000,000 and greater	149	$1,644,526,137
$1,000,000 to $9,999,999	1,059	$2,724,952,957
$500,000 to $999,999	667	$469,082,667
$250,000 to $499,999	648	$234,471,623
$100,000 to $249,999	465	$81,488,107
Less than $100,000	247	$11,526,831
Total	3,235	$5,166,048,322

Appendix B
FONCE Survey Results

APPRAISED VALUES BY CITY TOP 10 CITIES			
	CITY	**ACCOUNTS**	**TOTAL**
1.	Memphis	236	$653,901,109
2.	Nashville	357	$643,442,436
3.	Knoxville	299	$483,632,609
4.	Brentwood	118	$205,803,671
5.	Chattanooga	166	$197,216,979
6.	Franklin	80	$145,929,765
7.	Johnson City	69	$117,853,359
8.	Murfreesboro	73	$89,908,433
9.	Clarksville	60	$87,680,296
10.	Gatlinburg	21	$86,590,172

APPRAISED VALUES BY STATE TOP 10 STATES			
	STATE	**ACCOUNTS**	**TOTAL**
1.	Tennessee	2634	$4,134,453,347
2.	California	189	$468,879,568
3.	Virginia	96	$92,246,560
4.	Kentucky	19	$81,460,866
5.	New York	29	$70,213,253
6.	Georgia	20	$45,280,818
7.	Pennsylvania	8	$34,888,680
8.	Nevada	9	$34,294,136
9.	Texas	27	$18,854,244
10.	Florida	19	$18,773,597

NUMBER OF PROPERTIES BY STATE TOP 10 STATES			
	STATE	**ACCOUNTS**	**TOTAL**
1.	Tennessee	2634	$4,134,453,347
2.	California	189	$468,879,568
3.	Virginia	96	$92,246,560
4.	Colorado	39	$13,259,195
5.	New York	29	$70,213,253
6.	Texas	27	$18,854,244
7.	Oregon	27	$17,431,290
8.	Georgia	20	$45,280,818
9.	Kentucky	19	$81,460,866
10.	Florida	19	$18,773,597