

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING #98-47**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Whether an LLC is subject to Tennessee franchise, excise taxes and whether a corporation's interest in an LLC doing business in Tennessee subjects the corporation to franchise, excise taxes.

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

A corporate entity (Parent) is a foreign corporation with a Certificate of Authority to transact business and conduct affairs in Tennessee. It is domiciled and headquartered in the [REGION] with significant operations in various states. It is currently structured with substantially all U.S. operations (manufacturing, distribution, wholesale, retail and licensing of its trademarks to unrelated third parties) included in one legal entity. It also owns 100% of the stock in three corporations that are not the subject of this ruling request. One of the corporations owns de minimis levels of the corporate stock of competitors. Another is a modest size foreign manufacturer that sells 100% of its output to its parent. The third corporation is a foreign sales corporation under federal law.

For what is described as good business reasons, primarily isolation of business risks, the Parent is considering segregation of its various activities into separate legal entities. Such legal entities will either be corporations or limited liability companies (LLC(s)) that will be taxed as partnerships or corporations pursuant to Tres. Reg. § 301.7701. After the drop down of the various operations into the separate legal entities, the principal assets of the Parent will be trademarks, trademark licensing agreements with affiliates and non-affiliates, and other intangible assets consisting primarily of ownership interests in subsidiaries. Each corporation, including the Parent, or LLC will continue the historic operations of its respective business segment formerly

conducted by the Parent as separate divisions. The Parent will own 100% of its corporate subsidiaries.

The business entity conducting the manufacturing operations formally conducted by the Parent will be a board managed LLC (Manufacturing LLC) and will be classified as a partnership for federal income tax purposes. Manufacturing LLC will have Tennessee manufacturing operations.

The business entity conducting the wholesale operations formally conducted by the Parent will be organized as a C corporation (Wholesale) and will be subject to state income/franchise taxes. Wholesale will be the general partner equivalent in Manufacturing LLC and thus, Wholesale will be subject to Tennessee franchise, excise taxes.

Manufacturing LLC will have two members. Wholesale will be a Class A member of Manufacturing LLC and will own a 1% capital and profits interest. The Parent will be a Class B member of Manufacturing LLC and will own a 99% capital and profits interest.

The Board of Governors for Manufacturing LLC will consist of three individuals. Wholesale will have the right to elect 1 board member and the Parent will have the right to elect 2 board members. The board member elected by Wholesale will be an employee of Wholesale. One of the board members elected by the Parent will be an employee of Manufacturing LLC. The other board member elected by the Parent will be an independent individual from outside the Parent's business group. This board member will have significant business experience and will also be on the board of directors of the Parent.

None of the individuals elected to Manufacturing LLC's Board of Governors will be employees or officers of the Parent, compensated or otherwise, nor will they have any financial interest in the Parent that is material to their overall financial situation. (It is possible that such persons may own a relatively small amount of stock in the Parent, but no Parent elected board member will have a controlling interest in the Parent) The board of Manufacturing LLC will elect a chief manager from one of their 3 board members. The chief manager will have charge of the day-to-day operations of Manufacturing LLC.

Certain major business decisions will require the affirmative vote of a majority of the financial interests in Manufacturing LLC (the consent of the Parent). The major business decisions requiring such consent are listed as follows:

1. The decision to liquidate, dissolve or discontinue the operations of Manufacturing LLC.
2. The decision to sell, exchange, lease, mortgage or otherwise transfer all or substantially all of Manufacturing LLC's assets.
3. The decision to incur any indebtedness of Manufacturing LLC outside the ordinary course of its business.

4. The decision to make any material change in the nature of the business of Manufacturing LLC.
5. The approval of admission of additional members.
6. The approval of amendments or changes to the articles of organization or operating agreement of Manufacturing LLC.
7. The approval of the merger of Manufacturing LLC with or into another entity.
8. The approval of indemnification of any member of Manufacturing LLC.

Other than its 1% interest in Manufacturing LLC, Wholesale will, as discussed below, engage in other various business operations. Some of these business operations will be performed in Tennessee. For example, Wholesale will own inventory for sale at a Tennessee warehouse operated by Manufacturing LLC and will, on behalf of Manufacturing LLC, arrange for the manufacture of products outside of the U.S. Additionally, Wholesale will have employees in Tennessee that will perform various corporate functions (MIS, accounting, human resources) for related entities, quality control functions and will have a regional sales person who solicits sales of tangible personal property to retail customers. The orders are then approved outside of Tennessee and shipped to various locations at the direction of Wholesale's customers.

Manufacturing LLC will do contract manufacturing in Tennessee for Wholesale and will sell 100% of the products that it manufactures to Wholesale. In connection with its contracts with Manufacturing LLC, Wholesale will, from time to time, send employees to Manufacturing LLC's plant in Tennessee for purposes of quality control and consultation.

Manufacturing LLC is Wholesale's sole supplier of the products that it manufactures in accordance with its contracts with Wholesale. Such products will be held in distribution centers located both within and without Tennessee. The distribution center located in Tennessee is the warehouse owned and operated by Manufacturing LLC. All sales by Wholesale will take place outside Tennessee at its corporate headquarters, its customers' headquarters, or at trade shows. At the direction of Wholesale, the products sold will be shipped from the distribution centers to national/regional retail chains doing business throughout the U.S. Some of the products shipped from Wholesale's inventories in the Tennessee warehouse owned and operated by Manufacturing LLC will be shipped to Tennessee destinations.

After the restructure, the Parent will have no physical presence in Tennessee. Its only connection with Tennessee will be its trademark license agreements with Wholesale and its stock interests in corporations and membership interests in limited liability companies that have taken over some of its operations and that are doing business in Tennessee. However, the Parent will retain its Certificate of Authority to transact business and conduct affairs in Tennessee.

The parent will license its trademarks to both related and unrelated parties. None of the licensees are headquartered/domiciled in the state of Tennessee. The licensees (both related and unrelated) have the right to manufacture (either directly or outsourced) product bearing Parent's trademark and then to sell the product to national or regional retail chains. Parent will

receive a royalty based on the sales of product by the licensee(s). Inasmuch as some of the licensees' customers have Tennessee locations, a fraction of the licensees' product is likely to be purchased at the retail store level in Tennessee.

A diagram of the material elements of the proposed structure was attached to the ruling request for reference. The following summary of the business operations of each entity that is the subject of the ruling request was also presented with the ruling request:

The Parent

- A. Owns and licenses all trademarks.
- B. Owns 100% of all direct subsidiaries and business entities other than Manufacturing LLC in which it owns a 99% interest.
- C. Manages trademarks and other intangibles and monitors and negotiates trademark licenses with both related and unrelated parties. All related party transactions will reflect arm's length pricing.

II

Wholesale

- A. Conducts all aspects of wholesale business to customers, both related (retail) and unrelated parties, including product design and market research. Sales to related parties will be on an arm's length basis.
- B. Employees would be responsible for various corporate functions, such as accounting, human resources, MIS, etc. Such services will be provided to other related entities for an arm's length management fee.
- C. Wholesale will obtain a corporate charter and will operate and be taxed as a C corporation for federal income tax purposes.
- D. Owns 1% (general partner equivalent) interest in Manufacturing LLC and, consistent with this interest, manages and controls the operations of this LLC.

III

Retail

- A. Operates all retail stores, except for certain locations that may be held in separate single member limited liability companies.

B. Owns and manages retail locations operated through single member limited liability companies.

IV

Manufacturing LLC

A. Owns and operates all the manufacturing activities and facilities and has responsibility for all other product procurement functions. Also owns and operates the primary distribution center in Tennessee and related assets. Sells finished products to Wholesale. All related party transactions will reflect arm's length pricing.

B. Perform value added functions, (storage, inventory control, pick and pack, and shipment) for Wholesale. All related party transactions will reflect arm's length pricing.

V

[REGIONAL] Distribution Center

A. Owns and operates midwest based distribution center and related assets.

B. Perform value added functions (storage, inventory control, pick and pack, and shipment) for Wholesale. All related party transactions will reflect arm's length pricing.

QUESTIONS PRESENTED

1. Is Manufacturing LLC subject to Tennessee franchise, excise taxes?
2. Does the Parent's membership interest in Manufacturing LLC create sufficient nexus in Tennessee to subject the Parent to Tennessee franchise, excise taxes?

RULINGS

1. No.
2. No, but it has franchise, excise tax nexus in Tennessee as a result of its trademark license agreements with Wholesale. (See: *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), Certiorari Denied 11-29-93 (114 S.Ct. 550)).

ANALYSIS

1. MANUFACTURING LLC IS NOT SUBJECT TO TENNESSEE
FRANCHISE, EXCISE TAXES

Treas. Reg. § 301.7701-3(a) and (b) (1997), set forth in part below, provides as follows with regard to the classification of certain business entities for federal tax purposes:

(a) In general. A business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election.

(b) Classification of eligible entities that do not file an election--

(1) Domestic eligible entities. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is--

- (i) A partnership if it has two or more members; or
- (ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) Foreign eligible entities--

(i) In general. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is--

- (A) A partnership if it has two or more members and at least one member does not have limited liability;
- (B) An association if all members have limited liability; or
- (C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

T.C.A. § 48-211-101, enacted by the Tennessee legislature in 1994, makes the following provisions concerning the classification of a Limited Liability Company for Tennessee tax purposes:

For purposes of all state and local Tennessee taxes, a foreign or domestic LLC shall be treated as a partnership or an association taxable as a corporation as such classification is determined for federal income tax purposes. The members of a foreign LLC treated as a partnership are subject to all state and local Tennessee taxes in the same manner and extent as partners in a foreign partnership. The members of a domestic LLC are subject to all state and local Tennessee taxes in the same manner and extent as partners in a domestic partnership.

Questions involving statutory construction must be answered in the light of reason, keeping in mind the object of the statute. *State v. Williams*, 854 S.W.2d 904 at 908 (Tenn. Cr. App. 1993) citing *State v. Netto*, 486 S.W.2d 725 at 728 (Tenn. 1972). It is an accepted rule of statutory interpretation to presume that, in enacting a provision, the legislature did not intend an absurdity, and that such a result must be avoided, if possible, by reasonable construction of the

statute. *State v. Harrison*, 692 S.W.2d 29 at 31 (Tenn. Cr. App. 1985), citing *Epstein v. State*, 366 S.W.2d 914 (Tenn. 1963).

No statutory interpretation will be adopted that defeats the purpose of the law, provided the language of the statute will admit, fairly and rationally, an interpretation which sustains that purpose. 23 Tenn. Juris., *Statutes*, § 36 (1985). In the event a statute is capable of more than one construction, it should be construed so as to effect, rather than defeat, its purpose. *Knox County, ex rel. Kessel v. Personnel Board*, 753 S.W.2d 357 (Tenn. App. 1988) citing *State v. Netto*, 486 S.W.2d 725 (Tenn. 1972).

The obligation to pay taxes arises only by force of legislative action and the nature and extent of that is determined by the legislative meaning. Therefore, all rules of statutory construction are relevant in the interpretation of revenue measures. C. Sands, *Sutherland Statutory Construction* § 66.03 (4th ed. vol. 3 1974). However, the rule of statutory construction to which all others must yield is that the intent of the legislature must prevail. *Southern v. Beeler et al.*, 195 S.W.2d. 857 at 864 (Tenn. 1946).

T.C.A. § 48-211-101 was enacted in 1994 prior to the adoption of Treas. Reg. § 301.7701-3 (1997) and does not specifically address federal income tax classification elections by eligible limited liability companies under Treas. Reg. § 301.7701. However, a statute need not expressly state what is necessarily implied in order to render it effectual. *Clanton v. Cain-Sloan Co.*, 677 S.W.2d 441 (Tenn. 1984) citing *Firestone Textile Co. v. Meadows*, 666 S.W.2d 730 at 732 (Ky. 1985); Cf. *State ex rel. Branch & Co. v Sinking Fund Com'rs*, 1 Tenn. Cas. (Shannon) 490, 502 (Tenn. 1875).

The apparent legislative intent of T.C.A. § 48-211-101 is to classify limited liability companies for Tennessee state and local tax purposes in the same way that they are classified for federal income tax purposes. To interpret the statute in any other manner would lead to inconsistencies and difficult, if not impossible, compliance problems for both the taxpayer and the Department.

Accordingly, for Tennessee franchise, excise tax purposes, the Tennessee Department of Revenue will treat a limited liability company in the same manner as it is classified for federal income tax purposes including federal income tax classifications resulting from the default provision contained in Treas. Reg. § 301.7701-3(b) (1997).

As a result of the default provisions of Treas. Reg. § 301.7701-3(b) (1997), Manufacturing LLC is treated as a partnership for federal income tax purposes. Accordingly, it will be treated as a partnership for Tennessee franchise, excise tax purposes.

Partnerships are not among the business entities named in T.C.A. §§ 67-4-806(a) and 67-4-903(a) as being subject to Tennessee franchise, excise taxes. Therefore, Manufacturing LLC is not subject to Tennessee franchise, excise taxes.

2. THE PARENT'S MEMBERSHIP INTEREST IN MANUFACTURING LLC
DOES NOT SUBJECT IT TO TENNESSEE FRANCHISE, EXCISE TAXES
BUT, ITS LICENSE AGREEMENTS WITH WHOLESALE CREATE
NEXUS FOR SUCH TAXES

It is so well established that it is axiomatic that a foreign corporation that owns stock in a corporation doing business in Tennessee can not be subjected to Tennessee franchise, excise tax solely because of such stock ownership. Therefore, the Parent's ownership of 100% of the stock of Wholesale, or any other corporation doing business in Tennessee, is of no consequence with respect to determining whether the Parent is subject to franchise, excise taxes.

T.C.A. § 67-4-804(a)(7)(A) and (B) provides that a business entity shall not be considered to be doing business in Tennessee so as to be subject to Tennessee franchise, excise taxes solely because it conducts any of the following activities:

(A) Ownership of a limited partnership interest when the activities of such owner are limited as follows:

(i) The limited partner's only business activity in Tennessee is the holding of a limited partnership interest in a partnership located in or doing business in Tennessee; and

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

(B) Ownership of a membership interest in a board-managed limited liability company located in or doing business in Tennessee; provided that such owner is not on the limited liability company's board and does not exercise any power, management or control over the limited liability company, except the power to vote in the election of board members.

T.C.A. § 67-4-804(a)(7)(A) and (B) do not subject a foreign corporate limited partner or LLC member to Tennessee franchise, excise taxes if its activities in Tennessee are limited as follows:

(1) The corporate limited partner has no right to, and in fact does not, exercise any power, management or control over the partnership except such powers or capacities outlined in T.C.A. § 61-2-302 that limited partners may exercise without participating in the management or control of a partnership.

(2) In the event that the foreign corporation owns a membership interest in a board-managed LLC doing business in Tennessee, it will not be subject to Tennessee franchise, excise taxes if it is not on the LLC's board and does not exercise any power,

management or control over the LLC except the power to vote in the election of board members.

(3) The corporate limited partner's only business activity in Tennessee is the holding of a limited partnership interest in a partnership with nexus in Tennessee.

Manufacturing LLC is a board-managed LLC that is being treated as a partnership for federal income tax purposes and thus, as is explained above, is treated as a partnership for Tennessee franchise, excise tax purposes. Therefore, all three of the above outlined statutory criteria must be applied to determine whether the Parent will be subject to Tennessee franchise, excise taxes.

The Parent meets the first and second criteria described above. The only powers of management, control or other powers that it has the right to exercise over Manufacturing LLC are those permissible under T.C.A. § 61-2-302 and, in addition and as will be explained, it does not participate in the management or control of the LLC that is being treated as a partnership. It only has the right to vote in the election of members of Manufacturing LLC's board, its weighted voting rights giving it the ability to elect two of the three board members.

None of the parent's officers or employees are on the board of Manufacturing LLC and none of the board members that it will elect will control or be controlled by the Parent or any of its affiliates nor will they be sufficiently entwined with the Parent to be the Parent's equivalent on the board of Manufacturing LLC. Thus, the Parent is not on the board of Manufacturing LLC and its membership interest in Manufacturing LLC is equivalent to a limited partnership interest.

Accordingly, under the facts presented, the Parent will not be subject to Tennessee franchise, excise taxes by reason of its membership interest in Manufacturing LLC under the facts given.

However, the Parent does not meet the third criteria because it has other business activities in Tennessee besides its limited partnership interest in Manufacturing LLC. These business activities involve the Parent's trademark license agreements with Wholesale from which it is deriving income from Tennessee. These activities must be examined to determine whether they create a franchise, excise tax nexus.

Wholesale is the general partner equivalent in Manufacturing LLC and trademarks licensed to Wholesale by the Parent are placed on products that Manufacturing LLC manufactures in Tennessee in accordance with contracts that it has with Wholesale. Manufacturing LLC is Wholesale's sole supplier of the products that it manufactures in accordance with its contracts with Wholesale. Such products will be held in distribution centers located both within and without Tennessee.

The distribution center located in Tennessee is the warehouse owned and operated by Manufacturing LLC. Although all sales by Wholesale will take place outside Tennessee, Wholesale directs Manufacturing LLC to ship products from the Tennessee distribution center, to national/regional retail chains doing business throughout the U.S. Some of the products

shipped from Wholesale's inventories in the Tennessee warehouse owned and operated by Manufacturing LLC will be shipped to Tennessee destinations.

The royalties that Wholesale pays to the Parent for the use of trademarks are based on a percentage of Wholesale's sales everywhere. Some of these sales are from Tennessee inventories that are shipped, at Wholesale's direction, to destinations in Tennessee.

The legal theories set forth in *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), Certiorari Denied 11-29-93 (114 S.Ct. 550) are applicable to the facts presented. By licensing trademarks to Wholesale, the Parent has carved out a part of Wholesale's income, a part of which would otherwise be taxable in Tennessee. Part of the royalties paid are based on sales of Tennessee inventories that are shipped to Tennessee destinations.

Although the parent will not be subject to Tennessee franchise, excise taxes by reason of its membership interest in Manufacturing LLC, its trademark license agreements with Wholesale will subject it to such taxes.

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APPROVED: Ruth E. Johnson, Commissioner

DATE: 12-7-98