

August 20, 2009

FAMILY-OWNED NON-CORPORATE ENTITIES (FONCE) CHANGES TO EXEMPT STATUS



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On June 25, 2009, Governor Bredesen signed the 2009 Technical Corrections Act (the "Act") in to law. This act, produced annually by the Tennessee Department of Revenue, provides a number of amendments and additions to the State's tax laws. Among the numerous changes in this year's act are substantial modifications to laws affecting family-owned, non-corporate entities, or FONCE's as they are more commonly known. These changes could have immediate and lasting impact on which companies that formerly qualified as a FONCE, but now may no longer be exempt from Tennessee Franchise & Excise taxes ("F&E Taxes"). This can include limited partnerships and limited liability companies, which are popular ownership entities.

Restrictions on FONCE's. A FONCE is defined in Tennessee Code Annotated § 67-4-2008(a)(11). Companies meeting this definition are entitled to an exemption from F&E Taxes. In order to qualify, the company must be "family-owned," meaning that 95% of the company must be owned by family members specified within § 67-4-2008(a)(11)(B). Further, "substantially all" of the company's activity must be the production of "passive investment income," farming, or a combination of the two. "Substantially all" has been interpreted to mean at least 66.67% of the company's activity, and farming is defined within § 67-4-2008(a)(6).

A major source of income for many FONCE's is "passive investment income." This type of income includes royalties, dividends, interests, annuities, and sales or exchange of stock or securities¹, and rents. It is this last source, rents, which will see drastic changes under the new laws. Only rents from residential or farm property

¹ But not sales or exchanges of real property, so capital gains on the sale of real estate do not qualify as "passive income" even under current law. This means that, even if you own a FONCE which fully qualifies on an ongoing basis, for an exemption due to residential rent or farm income, the FONCE may not qualify if you sell a material amount of the real property for a gain. To avoid this consequence you can consider electing unlimited liability (discussed below), but you must generally take steps in the year prior to the anticipated sale.

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will continue to qualify as “passive investment income.” This is a major change as rents will no longer include revenue from commercial and industrial properties.

The 2009 Act defines residential property in much the same way that § 67-5-501(10) has done previously. The major difference is that, in determining passive investment income, rental of up to four-unit residential structures may be included. Farm property is also defined within § 67-5-501(3), with this definition being adopted by the 2009 Act.

This new distinction will require evaluation of whether a FONCE holding commercial and industrial properties on which it collects rents can continue to meet the “substantially all” test. If this test is failed (and a FONCE will fail the test if it owns only commercial or industrial property), the FONCE will no longer be able to maintain its exempt status. This has long-term planning implications for companies that wish to avoid paying F&E Taxes.

One possible solution is to become an “obligated member entity.” To do this, the FONCE must file certain paperwork with the Secretary of State, wherein each member or partner elects unlimited liability. This must be completed on or before October 1, 2009, to be effective for 2009. By waiving limited liability, the company can continue to operate without paying F&E Taxes. This waiver, however, does expose the members/limited partners to individual liability, and should not be elected without serious consideration of the extent and nature of the FONCE’s liabilities, and whether liability insurance is in place to minimize the effect of those liabilities. The same is true for a FONCE that elects to dissolve or convert to a general partnership.

Reasonable Rent. Another major change moving forward with the 2009 Act is the implementation of the concept of “reasonable rent.” This portion limits the amount of rent that can be paid on industrial or commercial property to an affiliated company, even if the affiliated company owning the property is itself exempt from F&E taxes. The monthly rental amount may not exceed 2% of the property tax appraised value of the property. Any rent in excess of 2% requires an adjustment by both the lessee and the lessor. If an adjustment is not made, due to negligence, the penalty is 50% of the adjustment. Although this penalty may be waived in whole or part, there must be good or reasonable cause.

This change will affect companies paying rent on commercial or industrial property to an affiliated entity, regardless of whether the affiliate to whom the rent is paid is exempt from F&E Taxes. This is another issue that FONCE’s must consider moving forward. If your company rents industrial or commercial property from an affiliate (for example, a FONCE that is owned by the same family), then this is an item which must be analyzed.

New Reporting Requirements. In addition to all of the new provisions described above, Section 33 of the Act added new reporting requirements. If any entity claims to be exempt from F&E taxes, it must file an “application for exemption” (a new form to be devised by the Commissioner of Revenue) within certain time periods every year, or it will not be exempt, even if it otherwise qualifies for an exemption.

In light of the new changes, it is important that companies consult a qualified attorney to help them in continued compliance with the law. Henry & McCord would be happy to provide such service. You may contact James H. Henry II or John R. LaBar at 931-455-9301 to schedule an appointment.

