Spotlight on Tennessee: Possible Universal Settlement For Non-Compliant FONCEs

March 3, 2009

On February 27, the Tennessee Department of Revenue (Department) issued Notice #09-03 (Notice). In that Notice, the Department announced the possibility of universal settlement with certain family-owned non-corporate entities that have professed to be exempt from the Tennessee excise and franchise taxes but which in reality do not meet the applicable statutory exemption requirements. **According to the Notice, action is required not later than May 31, 2009 in order to be eligible for this possible settlement.**

Non-Compliant FONCEs

Tennessee Code Annotated, Section 67-4-2008(a)(11), commonly referred to as the "FONCE" exemption, provides an exemption from the excise and franchise taxes for certain non-corporate entities which are family-owned and where substantially all of the entity's activity is either the production of passive investment income or a combination of the production of passive investment income and farming. The phrase "family-owned" means at least 95% of the ownership units of the entity must be owned by family members as specified in that Section. The "substantially all" requirement is satisfied where at least 66.67% of the income is from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities to the extent of any gains therefrom; or a combination of the production of such income and farming (as "farming" is defined in Subsection (a)(6) of Section 67-4-2008).

Thus, a non-corporate entity which has family ownership can fail to satisfy the FONCE statutory requirements in any one of several ways, including a violation of either the "family-owned" requirement or the "substantially all" requirement. Based upon information collected during 2008, the Department estimates in the Notice that more than 1,000 entities claiming the FONCE exemption do not satisfy such requirements. The Notice states that depending upon the individual circumstances, non-qualified entities may be liable for excise and franchise taxes, penalty, and interest dating back to the 2000 tax period.

Possible Settlement Structure

In an attempt to persuade those non-compliant entities to abide by the Tennessee excise and franchise tax laws, the Notice states that the Department ". . . will consider a universal settlement offer from those entities that file the 2005, 2006, and 2007 franchise and excise tax returns with payment of the tax and accrued interest no later than May 31, 2009." The Notice further states that the ". . . taxpayer must also include a letter requesting to participate in a universal settlement agreement."

So as to apparently expedite this potential settlement arrangement, the Department approves in the Notice that the settlement consideration is available to any non-qualifying FONCEs working directly with the Department or through the tax practitioner of its choosing; but that in order to participate, the tax returns together with the payment (that is, the payment of the tax and the accrued interest) and the cover letter requesting participation in the universal settlement agreement must be sent no later than May 31, 2009 to: Settlement Offer, FONCE, P.O. Box 190644, Nashville, TN 37242-0644.

The Department also warns in the Notice that any settlement ". . . must be approved by the Tennessee Attorney General and the Comptroller of the Treasury; therefore, any particular outcome cannot be guaranteed." However, if a universal settlement is approved, the Department will apparently contact each taxpayer after May 31, 2009 ". . . with confirmation that it meets the terms of settlement and instructions for entering into a legally binding settlement agreement should the taxpayer choose to do so."

Department's Response to Certain Issues Not Addressed

The Department should certainly be applauded for this possible universal settlement arrangement. However, there are a number of issues which are not addressed by the Notice. Just some of those unaddressed issues, together with informal responses from the Department on March 2 regarding those issues, are as follows:

(a) Issue: Unlike the Department's currently existing voluntary disclosure program (VDP), this possible universal settlement agreement appears to first require the entity to disclose its identity by filing the franchise and excise tax returns, and paying the tax and accrued interest no later than May 31, 2009, before the entity has the possibility of receiving any assurance that the Department will accept the entity into the universal settlement. Under the VDP, the entity applying for voluntary disclosure through its tax representative would generally have some assurance of acceptance into that program before identification, filing and payment.

Informal Response: The Department advises that it knows the identity of more than 1,000 non-compliant entities based upon the information collection process conducted by the Department during 2008. The Department advises that it is not currently receptive to any procedure within the universal settlement agreement process by which the non-compliant entity could file the returns and make the payments to the Department under a disclosed fictitious name; and then, if accepted into the settlement arrangement, sign the "legally binding agreement" in its real name. The Department anticipates that such returns and payments must be made in the real name of the non-compliant entity.

(b) Issue: The full terms of the universal settlement are not now known. Rather, after May 31, 2009 the Department will advise the entity if it meets the terms of settlement and then will give instructions for entering into a legally binding agreement should the entity choose to do so. One would certainly expect (but there is no guarantee) that the settlement agreement would contain terms similar in various respects to the Department's terms used in the VDP.

Informal Response: The Department advises that it is working on the terms of the standard settlement agreement, and that such terms will include some provisions which are similar to the VDP, such as waivers of civil and criminal penalties; protection from audit for tax periods prior to 2005; the Department's right to audit the years covered by the franchise and excise tax returns; and the right of the Department to question the entity's eligibility for the settlement agreement in the event that the entity materially misrepresents its pertinent facts.

(c) Issue: The Notice does not address the potential consequences to the non-compliant FONCE which applies for but, for whatever reason, is not accepted by the Department into the universal settlement.

Informal Response: As stated above, the Department advises that it knows the identity of more than 1,000 non-compliant entities based upon the information collection process conducted by the Department last year. Absent some form of fraudulent misrepresentation, the Department anticipates that each such entity requesting permission to participate in the universal settlement agreement will be allowed to do so - provided, however, that the Department obtains the consent of the Tennessee Attorney General and Comptroller of the Treasury for the overall settlement process. The Department may announce on its website when such consents are obtained.

(d) Issue: Is the VDP still available for an allegedly non-compliant FONCE which is not currently under audit by the Department?

Informal Response: The Department advised that the VDP is still available, although the Department would prefer that a non-compliant FONCE participate through the settlement agreement process rather than the VDP. However, the Department did acknowledge that if the non-compliant entity is organized in another state and not of record with the Department for tax purposes but should be, then that entity may not have been identified by the Department through its information gathering process last year. As a result, the VDP would be available to such non-compliant entity, assuming that such entity has not been contacted for or under audit by the Department.

Please note that the Department's informal responses to the above issues are subject to change. Further, there are many other issues which must be analyzed on a case by case basis with respect to any entity considering this universal settlement possibility.

2008 Tax Period

In any event, the universal settlement agreement will not cover the 2008 tax period. The Notice states that a non-compliant FONCE seeking admission to the universal settlement must file a completed franchise and excise tax return for the 2008 tax period on or before the 15th day of the fourth month following the close of that taxable period.

Annual Disclosure Form Required

In an announcement on February 27 separate from the Notice, the Department stated that entities who receive income from passive investments (FONCEs), farms and personal residences must now, in addition to filing the required annual exemption forms, file a disclosure of activity form to continue their exemption. The Department further stated that affordable housing, venture capital funds, diversified investment funds, obligated member entities, asset-backed securitization and security third party indebtedness still must file the annual exemption renewal but not the disclosure form.