



WOOLF, McCLANE, BRIGHT, ALLEN & CARPENTER, PLLC

A T T O R N E Y S

900 Riverview Tower | 900 S. Gay Street | Knoxville, TN 37902-1810

Mailing Address: Post Office Box 900 | Knoxville, TN 37901-0900

Phone: (865) 215-1000 | Fax: (865) 215-1001

www.wmbac.com

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July 27, 2009

Wade H. Farmer, CPA
Blackburn, Childers & Steagall, PLC
P.O. Box 3745
Johnson City, TN 37602

Re: FONCE Exemption Revised

Dear Wade:

You have undoubtedly heard that the Tennessee legislature has revised the family-owned non-corporate entity (“FONCE”) exemption from franchise and excise tax. The purpose of this letter is to explain the changes in the exemption and describe some alternatives available to your clients for avoiding franchise and excise tax if they no longer qualify for the exemption.

As you know, the requirements for the FONCE exemption are that an LLC or limited partnership (1) is at least 95% owned by family members; and (2) receives at least two-thirds of its income from passive investment sources (i.e., rents, interest, and dividends). After the legislature’s changes, however, the only rents that qualify as passive investment income are rents from farm property or residential property. Rent from industrial or commercial property no longer qualifies. “Residential property” is defined as property leased or rented for residential purposes that includes no more than four residential units; thus, rent from apartment complexes and other residential rental buildings larger than four-plexes does not qualify. Additionally, the legislature added a provision clarifying that “farm property” does not include acreage used for recreational purposes by clubs, including golf course hole improvements.

In other words, a family-owned LLC or limited partnership owning commercial or industrial property will no longer qualify for the FONCE exemption and will be subject to franchise and excise taxes beginning this year. There are a couple of strategies to avoid these new franchise and excise taxes, but clients must act before October 1st to implement one of these strategies.

The most common methods for a non-corporate entity to avoid the franchise and excise tax following the FONCE exemption changes are to (1) qualify under the Obligated Member Entity (“OME”) exemption to franchise and excise tax; or (2) convert from a limited liability entity to a general partnership (or a sole proprietorship, in the case of a single-member LLC). In order to

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qualify for the OME exemption, each owner of the entity must file a statement with the Tennessee Secretary of State's office in which the owner elects to be individually responsible for the entity's liabilities and obligations. If any of the entity's owners themselves are limited liability entities, each owner of those entities must also file such a statement.

Of course, filing the OME statement negates any limited liability protection originally provided by the entity. As such, it may be more efficient to convert the limited liability entity to a general partnership or sole proprietorship, which reaches the same result but the client no longer has to pay annual filing fees (typically \$300 per year for LLCs). Whether the client chooses to qualify for the OME exemption or to convert to a general partnership or sole proprietorship, the client will want to maintain adequate liability insurance to insure against any claims arising out of ownership of the property. Of course, all liabilities cannot be insured against, so in the end clients will have the Catch-22 choice of higher taxes or greater liability exposure.

In order to avoid franchise and excise tax liability for the 2009 tax year, appropriate action must be taken by October 1, 2009. The changes to the FONCE exemption are effective now; however, changes to the OME exemption allow an entity to file the required OME statements on or before October 1, 2009, in order to qualify for the OME exemption for this tax year. As a result, it will likely be necessary to file OME paperwork by October 1 even if an entity elects to convert to a general partnership or sole proprietorship.

Another significant change included in the bill limits the amount of the franchise and excise tax deduction a limited liability entity can claim with respect to rent paid to certain affiliated entities. Under the legislature's recent changes, an entity subject to franchise and excise tax and leasing industrial or commercial property from an "affiliate" that is exempt from the tax under the FONCE or OME exemption can deduct rent paid to the affiliate only to the extent that the monthly rent does not exceed 2% of the value of the leased property, as determined for property tax purposes. For franchise and excise tax purposes, "affiliate" means any entity (1) in which the taxpayer (in this case, the non-exempt entity) owns a greater-than-50% interest (i.e., a subsidiary entity); (2) which owns a greater-than-50% interest in the taxpayer (i.e., a parent entity); or (3) in which an entity owning a greater-than-50% interest in the taxpayer also owns a greater-than-50% interest (i.e., a sibling entity).

If you have any questions about the changes introduced by the recent legislation, or if we can assist any of your clients in implementing a strategy to avoid these new franchise and excise taxes, please do not hesitate to contact us.

Very truly yours,



Dale C. Allen

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