PUBLICATION

Spotlight on Tennessee: Revenue Ruling Impacts Calculation of LLC Taxable Income

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Recently, the Tennessee Department of Revenue (TDR) released Revenue Ruling #11-45 (the Ruling) which provides guidance to LLCs taxed as partnerships for purposes of the Tennessee Franchise and Excise tax. This ruling is noteworthy insofar as it is a departure from federal tax law, and in most cases will likely result in an increase in taxable income for state tax purposes.

Section 754 Election

The Ruling specifically addresses a situation in which the LLC taxpayer has made a Section 754 election under the Internal Revenue Code (IRC). A Section 754 election is made by an entity taxable as a partnership in order to adjust the partnership's basis in its assets (inside basis) in a manner that reflects the purchase of an existing partner's interest by a new partner using rules found in Section 743(b) of the IRC.

Generally, a partner's basis in a partnership interest is equal to his proportionate share of the partnership's basis in its assets with various adjustments over the life of the partnership. If a person buys an interest from a partner, the purchaser's basis in the new interest will be equal to the purchase price paid, but the partnership's basis in its assets remains unchanged. Absent a Section 754 election, the default rule is that the new partner is allocated his share of any gain that arises from the disposal of partnership assets despite the fact that the asset appreciation may have occurred prior to him joining the partnership and may be reflected already in the price that he paid. In other words the default rule could result in double taxation of the appreciation allocable to the partnership interest in question: once in the hands of the former, selling partner, and again when any partnership's gain is allocated to the new, buying partner. A Section 754 election effectively overrides the default rule and allows a partnership to adjust its basis in its assets to reflect the new partner's basis in his partnership interest. This "special basis" is only used to calculate gain or loss with respect to the new partner and does not benefit any of the other partners.

The Ruling

As mentioned above, the Ruling addresses a situation involving an LLC that has made a Section 754 election under the IRC, and the resulting tax consequences thereof. In a departure from federal tax law, the Ruling states that the Section 743(b) basis adjustment may not be taken into account for purposes of computing net earnings for purposes of the Tennessee excise tax. As the basis adjustment generally results in less taxable gain if the partnership disposes of an asset, disallowance of the basis adjustment is likely to result in an increase in net income for Tennessee taxpayers.

This Ruling is contradictory not only to federal law, but also Tennessee law. T.C.A. Section 67-4-2006(a)(4)(A) defines net earnings (for purposes of the excise tax) as the amount of ordinary income determined under the IRC. Nothing in T.C.A. Section 67-4-2006 expressly authorizes the exclusion of the Section 743(b) adjustment when calculating the excise tax base, and nothing in T.C.A. Section 67-4-2006 generally authorizes exclusion of an item merely because it is not allocated to all partners. In fact, other provisions of T.C.A. Section 67-4-2006(a)(4)(A) require items such as guaranteed payments made to only one partner to be included in the excise tax base. The TDR's Ruling erroneously relied on federal regulation which states that the Section

743(b) adjustment is made with respect to the new purchasing partner only, and, via such misplaced emphasis, fails to acknowledge that the same sentence of the regulation requires the adjustment to be made "to the basis of partnership property" (emphasis added). The TDR goes on to say that the Section 743(b) adjustment has no effect on a partnership's computation of its taxable income. This is a surprising statement for most tax practitioners because the adjustment is made at the partnership level for federal tax purposes and will be reflected in the partnership's federal tax return.

The TDR also seems to contradict its own logic as the Ruling goes on to recognize a Section 754 election insofar as Section 734 basis adjustments are concerned. For partnerships with a Section 754 election in effect, these adjustments are made when money or property is distributed to a partner, typically in full or partial redemption of his partnership interest. A Section 734 basis adjustment is used by a partnership to adjust its basis in its assets for gain or loss realized by a partner receiving the money or property from the partnership. The Ruling follows federal law in this regard and respects the Section 734 basis adjustment for purposes of calculating gain or loss realized. In doing so, the TDR relies on the exact same T.C.A. Section that should have preserved the Section 743(b) basis adjustments, but makes no distinction as to why it should apply in one circumstance and not the other.

Conclusion

As this is a Revenue Ruling, this ruling states a general policy on behalf of the TDR, but the ruling does not have the force of law. As stated above, the ruling appears in part to be contradictory to Tennessee law. Transactions can often be accomplished either by sales of interests by an outgoing partner to existing or new partners or by a redemption of an outgoing partner with or without an admission of a new partner. Therefore, partnerships and LLCs subject to the Tennessee excise tax may wish to consider structuring transactions in ways to take advantage of the federal tax rules that the TDR has announced that it will follow and avoid those that the TDR refuses to follow. To discuss this ruling, or the TDR's possible positions on similar issues, in greater detail, please feel free to contact any of the attorneys within the Firm's Tax Department.