TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 11-45

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

The determination for Tennessee excise tax purposes of a limited liability company's net earnings or loss, where the limited liability company has in effect an election under Section 754 of the Internal Revenue Code of 1986, as amended.

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

The Taxpayer is organized as a limited liability company (an "LLC") and is classified as a partnership for federal income tax purposes. The Taxpayer does business in Tennessee. The Taxpayer is owned by two members, one of whom sells his entire interest in the Taxpayer to a third party (the "purchasing member"). In the same taxable year in which the sale of the member's interest occurs, the Taxpayer makes an election under Section 754 of the Internal Revenue Code of 1986, as amended (an "IRC § 754 election"), such that the purchasing member's basis in the Taxpayer's assets is stepped up under Section 743(b) of the Internal Revenue Code (an "IRC § 743(b) basis adjustment") to the amount that the purchasing member paid for the selling member's interest. Subsequently, the Taxpayer sells an asset that was allocated a portion of the IRC § 743(b) basis adjustment, resulting in gain to the Taxpayer.

Alternatively, the Taxpayer distributes an asset to one of its members, and then steps up its basis in the remaining partnership property in accordance with Section 734(b) of the Internal Revenue Code (an "IRC § 734(b) basis adjustment"). The Taxpayer then sells an asset that was allocated a portion of the IRC § 734(b) basis adjustment, resulting in gain to the Taxpayer.

QUESTIONS

1. Is the adjustment to the purchasing member's distributive share of gain or loss from the sale of an asset, resulting from an IRC § 743(b) basis adjustment as part of an IRC § 754 election, taken into account in determining the Taxpayer's net earnings or loss for Tennessee excise tax purposes?

2. Is the adjustment to the Taxpayer's basis in its assets resulting from the distribution of an asset to a member and the corresponding IRC § 734(b) basis adjustment as part of an IRC § 754 election taken into account in determining the Taxpayer's net earnings or loss for Tennessee excise tax purposes upon a subsequent sale of a different Taxpayer asset?

RULINGS

The Tennessee franchise and excise tax laws neither recognize nor disallow an IRC § 754 election. Rather, each taxpayer must calculate its individual Tennessee tax liability in accordance with the applicable franchise and excise tax provisions.

1. For Tennessee excise tax purposes, the Taxpayer's net earnings or loss will be determined without making any addition or subtraction relating to the adjustment to the purchasing member's distributive share of partnership gain or loss from the sale of an asset that was allocated a portion of the IRC § 743(b) basis adjustment pursuant to an IRC § 754 election, because the adjustment to the purchasing member's distributive share does not constitute an additional item of income or loss to the Taxpayer.

2. The Taxpayer's net earnings or loss for Tennessee excise tax purposes are determined based upon the Taxpayer's federal ordinary income, as adjusted under TENN. CODE ANN. § 67-4-2006 (Supp. 2010). Therefore, upon a subsequent sale of a different Taxpayer asset, the Taxpayer's net earnings or loss will reflect any adjustment to the Taxpayer's basis in its assets resulting from the distribution of an asset to a member and the corresponding IRC § 734(b) basis adjustment as part of an IRC § 754 election, to the extent such adjustment is reflected in the Taxpayer's federal ordinary income.

ANALYSIS

1. <u>The IRC § 743(b) basis adjustment and the Tennessee excise tax</u>

    a. *Overview of the IRC § 743(b) basis adjustment*

For federal income tax purposes, when an interest in an entity that is taxed as a partnership is sold, the amount paid becomes the purchaser's basis in the newly acquired partnership interest (also known as "outside basis"). Additionally, the purchaser assumes the seller's pro rata share of the partnership's adjusted basis in its property (also known as "inside basis"). If the partnership's assets have appreciated sufficiently, the difference between the new partner's inside and outside basis can be substantial; this disparity can deprive the new partner of depreciation deductions and inflate his share of the gain from subsequent property dispositions. To avoid such undesired effects, the partnership has the option of making an IRC § 754 election to equalize the new partner's inside and outside basis pursuant to an IRC § 743(b) basis adjustment. The IRC § 754 election is effective with respect to the taxable year in which the election is made, as well as all subsequent taxable years.

By making the IRC § 754 election, the partnership causes the purchaser's inside basis to increase or decrease so that it equals the purchaser's outside basis. Specifically, Treas. Reg. § 1.743-1(b) provides that, in the case of the transfer of an interest in a partnership by sale or exchange, a partnership either: 1) increases the adjusted basis of partnership property by the excess of the transferee's basis for the transferred partnership interest over the transferee's share of the adjusted basis to the partnership of the partnership's property; or 2) decreases the adjusted basis of partnership property by the excess of the transferee's share of the adjusted basis to the partnership of the partnership's property over the transferee's basis for the transferred partnership interest. Treas. Reg. § 1.743-1(e) requires that the basis adjustment made pursuant to IRC § 743(b) be allocated among the individual items of partnership property in accordance with IRC § 755 (for purposes of this revenue ruling, an asset that was allocated a portion of the IRC § 743(b) basis adjustment will be referred to as an "IRC § 743(b) asset").

IRC § 743(b) and Treas. Reg. § 1.743-1(j)(1) provide that the IRC § 743(b) basis adjustment constitutes an adjustment to the basis of partnership property *with respect to the transferee partner only*; no adjustment is made to the common basis of partnership property. As a result, the adjustment to the purchasing partner's inside basis under IRC § 743(b) has no effect on the partnership's computation of its taxable income. *See* Treas. Reg. § 1.743-1(j)(3)(ii) (Examples 1-3). Rather, the IRC § 754 election affects only the purchaser's distributive share of items of partnership income, deduction, gain, or loss that relate to a partnership asset that was allocated a portion of the basis adjustment pursuant to the IRC § 754 election.

Treas. Reg. § 1.743-1(j)(2) sets forth the method for computing the partnership's income and the partners' distributive shares of items of partnership income, deduction, gain, or loss when the partnership has an IRC § 754 election in effect. First, the partnership computes its items of income, deduction, gain, or loss at the partnership level under IRC § 703.[1] Next, the partnership allocates the partnership items among the partners in accordance with IRC § 704,[2] and adjusts the partners' capital accounts accordingly. The partnership then adjusts the purchaser's distributive shares of the items of partnership income, deduction, gain, or loss to reflect the effects of the purchaser's basis adjustment under IRC § 743(b). These adjustments to the purchaser's distributive shares do not affect the purchaser's capital account. Adjustments to the

[1] IRC § 703 states that a partnership shall compute its taxable income in the same manner as an individual, except that the partnership must separately state certain items of gain, loss or deduction, and cannot claim certain deductions allowed to individuals.

[2] IRC § 704 provides that, with certain exceptions, a partner's distributive share of income, gain, loss, deduction, or credit is determined by the partnership agreement.

purchaser's distributive shares must be reflected on Schedules K and K-1 of the partnership's federal income tax return. No adjustment is made to the distributive shares of the other partners.

b. The IRC § 743(b) basis adjustment and the Tennessee excise tax

For Tennessee excise tax purposes, the Taxpayer's net earnings or loss will be determined without making any addition or subtraction relating to the adjustment to the purchasing member's distributive share of partnership gain or loss from the sale of an asset that was allocated a portion of the IRC § 743(b) basis adjustment pursuant to an IRC § 754 election, because the adjustment to the purchasing member's distributive share does not constitute an additional item of income or loss to the Taxpayer.

Tennessee imposes an excise tax on the net earnings of certain persons, including limited liability companies, doing business within Tennessee. TENN. CODE ANN. §§ 67-4-2007(a) (Supp. 2010) and 67-4-2004(37) (Supp. 2010). TENN. CODE ANN. § 67-4-2006(a)(4)(A) defines "net earnings" or "net loss" of a taxpayer that is treated as a partnership for federal tax purposes as an amount equal to "the amount of ordinary income or loss determined under the applicable provisions of the Internal Revenue Code, including, but not limited to, guaranteed payments to partners and capital gains, which additional items are not already included in ordinary income or loss." This amount is further adjusted as set forth in TENN. CODE ANN. § 67-4-2006(b)-(c), which requires specific addition and subtraction adjustments to arrive at a taxpayer's net earnings or loss. Importantly, TENN. CODE ANN. § 67-4-2006(b)-(c) does not provide for the addition to, or subtraction from, a taxpayer's net earnings or loss of an amount equal to the adjustment made to *a purchasing partner's distributive share* of partnership income or loss from the sale of an IRC § 743(b) asset. No other provision in the Tennessee excise tax law requires or otherwise allows such an adjustment to net earnings or loss.

The starting point for calculating the Taxpayer's Tennessee net earnings or loss is therefore its federal ordinary income or loss, as determined under the Internal Revenue Code. If the Taxpayer's ordinary income does not already include items of income or loss such as guaranteed payments to partners, dividend and interest income, and capital gains or losses, the Taxpayer must add such items to its net earnings or loss in accordance with TENN. CODE ANN. § 67-4-2006(a)(4)(A). Thus, if the Taxpayer's ordinary income does not already include the gain or loss from the sale during the taxable year of an IRC § 743(b) asset, the Taxpayer must add such gain or loss to its ordinary income.

To determine its income or loss from the sale of an IRC § 743(b) asset under the applicable provisions of the Internal Revenue Code, the Taxpayer must use its common basis in the asset. Under IRC § 1001(a), the Taxpayer's gain from the sale of partnership property equals the excess of the amount realized from the sale over the Taxpayer's adjusted basis in the asset. In the case of a loss, the loss equals the excess of the Taxpayer's adjusted basis in the asset over the amount realized from the sale. IRC § 1011(a) provides that, in the case of a partnership, the adjusted basis for determining the gain or loss from the sale of property shall be the basis determined under Subchapter K (*i.e.*, the portion of the Internal Revenue Code relating to partners and partnerships) and other applicable provisions.

Under the Internal Revenue Code, the Taxpayer's gain or loss on the sale of an IRC § 743(b) asset is determined based on the *common basis* of the partnership property; the adjustment to the *purchasing member's inside basis* under IRC § 743(b) has no effect on the common basis of partnership property. Treas. Reg. § 1.743-1(j)(1); *see also* Treas. Reg. § 1.743-1(j)(3)(ii) (Examples 1-3). As discussed in detail above, IRC § 743(b) and Treas. Reg. § 1.743-1(j)(1) provide that the IRC § 743(b) basis adjustment constitutes an adjustment to the basis of partnership property *with respect to the transferee partner only*. In other words, the Taxpayer's gain or loss on the subsequent sale of an IRC § 743(b) asset is not determined based on the purchasing member's inside basis. Thus, to determine the amount of gain or loss from the sale during the taxable year of an IRC § 743(b) asset that must be included in the Taxpayer's Tennessee net earnings or loss, the Taxpayer must use the common basis of the partnership property.

Importantly, the adjustment to the *purchasing member's distributive share* of income or loss from the sale of an IRC § 743(b) asset does not constitute an "additional item" of income or loss that must be included in the Taxpayer's net earnings or loss under TENN. CODE ANN. § 67-4-2006(a)(4)(A). Simply stated, the Taxpayer's income or loss from the sale of an IRC § 743(b) asset is determined first, based on the common basis of the partnership property. Next, for the ultimate purpose of determining the purchasing member's federal taxable income, the Taxpayer makes an adjustment to the purchasing member's distributive share of that item of income or loss in accordance with Treas. Reg. § 1.743-1(j)(2), discussed above. The adjustment to the purchasing member's distributive share does not change the amount of income or loss realized by the Taxpayer upon the sale of the IRC § 743(b) asset. Thus, the Taxpayer will not increase or decrease its net earnings or loss by the amount of the adjustment to the purchasing member's distributive share of gain or loss from the sale of an IRC § 743(b) asset.

Accordingly, for Tennessee excise tax purposes, the Taxpayer's net earnings or loss will be determined without making any addition or subtraction relating to the adjustment to the purchasing member's distributive share of partnership gain or loss from the sale of an asset that was allocated a portion of the IRC § 743(b) basis adjustment pursuant to an IRC § 754 election.

2. <u>The IRC § 734(b) basis adjustment and the Tennessee excise tax</u>

a. Overview of the IRC § 734(b) basis adjustment

When a partnership that has made an IRC § 754 election distributes property to a partner, the partnership must adjust *its* basis in the remaining partnership property (*i.e.*, inside basis) as set forth in IRC § 734(b). *See* Treas. Reg. § 1.754-1(a). IRC § 734(b) provides that, upon the distribution of partnership property to a partner, the partnership must increase the adjusted basis of the remaining partnership property by the amount of any gain recognized to the distributee partner with respect to the distribution, or in the case of a loss, decrease the adjusted basis of the remaining partnership property by the amount of any loss recognized to the distributee partner. IRC § 734(c) requires that the basis adjustment made pursuant to IRC § 734(b) be allocated among the remaining individual items of partnership property in accordance with IRC § 755.

b. The IRC § 734(b) basis adjustment and the Tennessee excise tax

The Taxpayer's net earnings or loss for Tennessee excise tax purposes are determined based upon the Taxpayer's federal ordinary income, as adjusted under TENN. CODE ANN. § 67-4-2006. Therefore, upon a subsequent sale of a different Taxpayer asset, the Taxpayer's net earnings or loss will reflect any adjustment to the Taxpayer's basis in its assets resulting from the distribution of an asset to a member and the corresponding IRC § 734(b) basis adjustment as part of an IRC § 754 election, to the extent such adjustment is reflected in the Taxpayer's federal ordinary income.

As discussed above, TENN. CODE ANN. § 67-4-2006(a)(4)(A) defines "net earnings" or "net loss" of a taxpayer that is treated as a partnership for federal tax purposes as an amount equal to "the amount of ordinary income or loss determined under the applicable provisions of the Internal Revenue Code, including, but not limited to, guaranteed payments to partners and capital gains, which additional items are not already included in ordinary income or loss." When a taxpayer treated as a partnership sells an asset that was allocated a portion of the IRC § 734(b) basis adjustment (an "IRC § 734(b) asset"), the gain or loss from the sale (as determined under the applicable provisions of the Internal Revenue Code) will therefore be included in the taxpayer's Tennessee net earnings or loss, by virtue of being included in its federal ordinary income.

To determine its income or loss from the sale of an IRC § 734(b) asset under the applicable provisions of the Internal Revenue Code, the Taxpayer must use the adjusted basis in the asset that resulted from the IRC § 734(b) basis adjustment. Under IRC § 1001(a), the Taxpayer's gain from the sale of partnership property equals the excess of the amount realized from the sale over the Taxpayer's adjusted basis in the asset. In the case of a loss, the loss equals the excess of the Taxpayer's adjusted basis in the asset over the amount realized from the sale. IRC § 1011(a) provides that, in the case of a partnership, the adjusted basis for determining the gain or loss from the sale of property shall be the basis determined under Subchapter K (the portion of the Internal Revenue Code relating to partners and partnerships) and other applicable provisions. In the case of an IRC § 734(b) asset, the Taxpayer's adjusted basis in the asset is therefore the basis that resulted from the IRC § 734(b) basis adjustment.

Accordingly, upon a subsequent sale of a different Taxpayer asset, the Taxpayer's net earnings or loss will reflect any adjustment to the Taxpayer's basis in its assets resulting from the distribution of an asset to a member and the corresponding IRC § 734(b) basis adjustment as part of an IRC § 754 election, to the extent such adjustment is reflected in the Taxpayer's federal ordinary income.

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DATE: 9-15-11