

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 08-20**

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

Whether the Tennessee franchise and excise tax obligated member entity exemption is available to a limited liability company that is the surviving entity in a tax-free A reorganization and that elects to be treated as a corporation for federal income tax purposes.

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

Oldco Corporation is a Tennessee corporation doing business in Tennessee. Oldco Corporation has two individual shareholders, and is classified as a corporation for federal income tax purposes. In December 2007, the two shareholders of Oldco Corporation form a new Tennessee limited liability company ("Newco LLC") by making nominal contributions of \$100 each. Newco LLC elects to be classified as a corporation for federal income tax purposes in accordance with Treas. Reg. § 301.7701-2(b)(2). Both Oldco Corporation and Newco LLC have a calendar year end to their taxable years.

In December 2007, Oldco Corporation merges out of existence and into Newco LLC, in accordance with Tenn. Code Ann. § 48-21-102. For federal income tax purposes, the merger will be treated as a tax-free reorganization pursuant to Section 368(a)(1)(A) of the Internal Revenue Code of 1986, as amended (an "A Reorganization"). The result of the transaction is that the entity operating the business changes from a C corporation to a Tennessee limited liability company that is classified as a corporation for federal income tax purposes. Effective January 1, 2008, the individual members of Newco LLC amend and sign Newco LLC's articles of organization to provide that each member will be personally liable for all of Newco LLC's debts, obligations and liabilities to the same extent as a general partner in a general partnership.

QUESTIONS

1. Assuming that effective January 1, 2008, Newco LLC otherwise meets the requirements set forth in Tenn. Code Ann. § 67-4-2008(a)(9) to be an obligated member entity exempt for purposes of Tennessee franchise and excise taxation, does the merger of Oldco Corporation into Newco LLC preclude Newco LLC from qualifying for the exemption under Tenn. Code Ann. § 67-4-2008(a)(9) with respect to the taxable year 2008?
2. Assuming that effective January 1, 2008, Newco LLC otherwise meets the requirements set forth in Tenn. Code Ann. § 67-4-2008(a)(9) to be an obligated member entity exempt for purposes of Tennessee franchise and excise taxation, does Newco LLC's election to be classified as a corporation for federal income tax purposes preclude its qualifying for the exemption with respect to the taxable year 2008?
3. If the transfer of assets and liabilities from Oldco Corporation to Newco LLC is tax-free for purposes of federal income taxation as an A Reorganization, will the transfer also be treated as tax-free for Tennessee excise tax purposes?
4. If the assets of the business are sold in 2008, resulting in gain for federal income tax purposes, will such gain be subject to Tennessee excise taxation?
5. Would it make any difference if Newco LLC entered into a contract for the sale of the assets in December 2007, but actually closed on the sale in January 2008?
6. Would the answers to Questions 1-4 above be different if both Oldco Corporation and Newco LLC were taxed as S corporations for federal income tax purposes?

RULINGS

1. No. The merger of Oldco Corporation into Newco LLC as part of an A reorganization in and of itself does not preclude Newco LLC from qualifying for the exemption under Tenn. Code Ann. § 67-4-2008(a)(9) (2007) with respect to the taxable year 2008.
2. No. Assuming that Newco LLC otherwise meets the requirements set forth in Tenn. Code Ann. § 67-4-2008(a)(9) (2007), Newco LLC's election to be classified as a corporation for federal income tax purposes does not preclude its qualifying for the exemption as an obligated member entity.
3. A taxpayer that is a party to an A reorganization and that realizes gain or loss from the transaction will include such gain or loss in its Tennessee net earnings or loss only to the extent that such gain or loss is recognized and included in its federal taxable income or loss.
4. Yes. Gain from the sale of Newco LLC's assets in 2008 will be subject to Tennessee excise taxation, even if Newco LLC meets the requirements set forth in Tenn. Code Ann. § 67-4-2008(a)(9) (2007) with respect to the taxable year 2008.
5. The date of the contract and the closing of the sale have no direct bearing on the inclusion of gain from the sale of the assets in Newco LLC's Tennessee net earnings. Rather, Newco LLC

must include the gain from the sale of its assets in its Tennessee net earnings in the same taxable year in which such gain is recognized and included in its federal taxable income.

6. The answers to Questions 1-4 above would not change if Oldco Corporation and Newco LLC were taxed as S corporations.

ANALYSIS

Tennessee imposes an excise tax at the rate of 6.5 percent on the net earnings of certain “persons” doing business within Tennessee. Tenn. Code Ann. § 67-4-2007(a) (2006). Tennessee also imposes a franchise tax at the rate \$0.25 per \$100, or major fraction thereof, on a taxpayer’s net worth. Tenn. Code Ann. § 67-4-2106(a) (2007). Persons subject to the franchise and excise taxes include, but are not limited to, limited liability companies and corporations. Tenn. Code Ann. § 67-4-2004(30) (2007).

Tenn. Code Ann. § 67-4-2008(a)(9) (2007) exempts from the Tennessee excise tax an “obligated member entity,” provided that the documentation set forth in Tenn. Code Ann. § 67-4-2008(b)-(d) (2007) is filed on or before the first day of the taxable year for which a return is filed.¹ Tenn. Code Ann. § 67-4-2105(a) (2007) provides an exemption from the Tennessee franchise tax for any entity exempt from the excise tax under the provisions of Tenn. Code Ann. § 67-4-2008.

Tenn. Code Ann. § 67-4-2004(28) (2007) defines an “obligated member entity” as “a limited liability company, limited partnership or limited liability partnership, all of whose members or partners are fully liable for the debts, obligations and liabilities of the entity, as provided in § 67-4-2008(b)-(d), and that have filed appropriate documentation to that effect with the secretary of state.” A limited liability company that wishes to claim exemption from the Tennessee franchise and excise taxes as an obligated member entity must satisfy the specific requirements set forth in Tenn. Code Ann. § 67-4-2008(d) (2007). Tenn. Code Ann. § 67-4-2008(d) requires that one or more members of the limited liability company be identified in the company’s articles of organization (or amended articles) as being personally liable for all of the debts, obligations and liabilities of the limited liability company to the same extent as a general partner in a general partnership.

1. The merger and Newco LLC’s ability to qualify for the exemption.

The merger of Oldco Corporation into Newco LLC as part of an A Reorganization in and of itself does not preclude Newco LLC from qualifying for the obligated member entity exemption under Tenn. Code Ann. § 67-4-2008(a)(9) with respect to the taxable year 2008. The Tennessee franchise and excise tax laws contain no provision that would prevent a party to a plan of

¹ Note that an obligated member entity may also be partially exempt from the Tennessee franchise and excise taxes. Tenn. Code Ann. § 67-4-2008(a)(9)(D) (2007) provides that, to the extent that any obligated member, or any owner of an obligated member, provides limited liability protection, the obligated member entity shall owe franchise and excise taxes on the portion of its income and equity that is attributable to such obligated member.

reorganization described in IRC § 368(a) from qualifying for the exemption under Tenn. Code Ann. § 67-4-2008(a)(9), if the entity otherwise satisfies the statutory requirements.

2. Newco LLC's classification as a corporation and the obligated member entity exemption.

Assuming that Newco LLC otherwise meets the requirements set forth in Tenn. Code Ann. § 67-4-2008(a)(9), Newco LLC's election to be classified as a corporation for federal income tax purposes does not preclude its qualifying for exemption as an obligated member entity.

As noted above, Tenn. Code Ann. §§ 67-4-2008(a)(9) and 67-4-2105(a) provide an exemption from the Tennessee franchise and excise taxes for an "obligated member entity," which is defined under Tenn. Code Ann. § 67-4-2004(28) as a "limited liability company, limited partnership or limited liability partnership, all of whose members or partners are fully liable for the debts, obligations and liabilities of the entity," as provided in Tenn. Code Ann. § 67-4-2008(b)-(d).²

Newco LLC is a limited liability company that has elected to be classified as a corporation for federal income tax purposes. Tenn. Code Ann. §§ 67-4-2007(d) and 67-4-2106(c) provide that, for purposes of Tennessee franchise and excise taxation, a business entity "shall be classified as a corporation, partnership, or other type of business entity, consistent with the way the entity is classified for federal income tax purposes." At first glance, it therefore might appear that Newco LLC will be considered a corporation for purposes of determining whether it comes within the exemption for obligated member entities under Tenn. Code Ann. § 67-4-2008(a)(9). As a corporation, Newco LLC would not be entitled to claim the exemption, because it would not come within the definition of an "obligated member entity" under Tenn. Code Ann. § 67-4-2004(28).

However, the language of the definition of "obligated member entity" under Tenn. Code Ann. § 67-4-2004(28) is clear and unambiguous. As noted above, an obligated member entity is defined as a "limited liability company, limited partnership or limited liability partnership" that satisfies the requirements of Tenn. Code Ann. § 67-4-2008(a)(9). The Tennessee Supreme Court has stated that when the statutory language is clear and unambiguous, "we must apply its plain meaning in its normal and accepted use, without a forced interpretation that would limit or expand the statute's application." *Eastman Chemical Co. v. Johnson*, 151 S.W.3d 503, 507 (Tenn. 2004). Here, the legislature chose to use the specific terms "limited liability company, limited partnership or limited liability partnership" in the definition of an "obligated member entity," without additional limiting language. To read the relevant statutory provisions as exempting, for example, only limited liability companies that are classified as partnerships or sole proprietorships for federal income tax purposes would impermissibly limit the statute's application.

² A limited liability company that wishes to claim exemption from the Tennessee franchise and excise taxes as an obligated member entity must satisfy the specific requirements set forth in Tenn. Code Ann. § 67-4-2008(d). Limited partnerships must satisfy the requirements set forth in Tenn. Code Ann. § 67-4-2008(b); limited liability partnerships must satisfy the requirements set forth in Tenn. Code Ann. § 67-4-2008(c).

Newco LLC is a limited liability company, and therefore comes within the definition of an “obligated member entity.” Assuming that Newco LLC otherwise meets the requirements set forth in Tenn. Code Ann. § 67-4-2008(a)(9), Newco LLC’s election to be classified as a corporation for federal income tax purposes will not preclude its qualifying for exemption as an obligated member entity.

3. Treatment of the reorganization as tax-free for Tennessee excise tax purposes.

A taxpayer that is a party to an A reorganization and that realizes gain or loss with respect to the transaction will include such gain or loss in its Tennessee net earnings or loss only to the extent that such gain or loss is recognized and included in its federal taxable income.

The Tennessee franchise and excise tax laws neither recognize nor disallow the nonrecognition of gain or loss to a corporation under IRC § 361(a) with respect to a reorganization described in IRC § 368(a)(1)(A) (*i.e.*, an A Reorganization). Rather, each taxpayer must calculate its individual Tennessee tax liability in accordance with the applicable franchise and excise tax provisions. Oldco Corporation and Newco LLC are classified as corporations for federal income tax purposes. Tenn. Code Ann. §§ 67-4-2007(d) and 67-4-2106(c) provide that, for purposes of Tennessee franchise and excise taxation, a business entity shall be classified as a corporation, partnership, or other type of business entity, consistent with the way the entity is classified for federal income tax purposes.

Oldco Corporation and Newco LLC are taxed as corporations for federal income tax purposes. They must therefore determine their Tennessee net earnings or loss in accordance with the provisions applicable to corporations. Tenn. Code Ann. § 67-4-2006(a)(1) defines “net earnings” or “net loss” of a corporation as “federal taxable income or loss before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241-247 and 249” as adjusted by Tenn. Code Ann. § 67-4-2006(b) and (c). Subsections (b) and (c) require specific addition and subtraction adjustments to a taxpayer’s net earnings or loss to arrive at its Tennessee taxable income; none of these adjustments applies to gain or loss realized in pursuance of a plan of reorganization described in IRC § 368(a). Thus, Oldco Corporation and Newco LLC will include in Tennessee net earnings or loss any gain or loss from the A Reorganization that is recognized and included in federal taxable income or loss. If gain or loss that is realized as a result of the A Reorganization is not recognized and included in federal taxable income or loss, the gain or loss will not be included in Tennessee net earnings or loss.

Note that a corporation that is a party to a tax-free reorganization may recognize gain under IRC § 361(c)(2), which provides that a corporation that distributes certain appreciated property as part of a plan of reorganization must recognize gain as if such property were sold to the distributee at its fair market value. Because the distributing corporation must include such gain in its federal taxable income, the gain would also be included in the distributing corporation’s Tennessee net earnings or loss for the same taxable year.

4. Inclusion in net earnings or loss of gain from the sale of Newco LLC’s assets.

Assuming that Newco LLC meets the requirements set forth in Tenn. Code Ann. § 67-4-2008(a)(9), Newco LLC will be exempt for purposes of Tennessee excise taxation with respect

to the taxable year 2008. However, gain from the sale of Newco LLC's assets in 2008 will nevertheless be subject to Tennessee excise taxation.

Tenn. Code Ann. § 67-4-2007(f)(1)(C) (2007) provides that an entity not otherwise subject to the excise tax must pay excise tax on the gain from the sale of any asset, if the entity "qualified for the exemption provided in § 67-4-2008(a)(9) during the twelve-month period immediately prior to the sale."

The Taxpayer has indicated that the individual members of Newco LLC will amend and sign Newco LLC's articles of organization effective January 1, 2008, to provide that each member will be personally liable for all of Newco LLC's debts, obligations and liabilities to the same extent as a general partner in a general partnership. The Taxpayer has also indicated that the sale of Newco LLC's assets will take place during the taxable year 2008. Because Newco LLC will have qualified for the obligated member entity exemption under Tenn. Code Ann. § 67-4-2008(a)(9) during the twelve-month period prior to the sale of the assets, the sale of Newco LLC's assets will be subject to Tennessee excise taxation.

5. Timing of recognition of gain from the sale of Newco LLC's assets.

The date of the contract and the closing of the sale of Newco LLC's assets have no direct bearing on the inclusion of gain from the sale of the assets in Newco LLC's Tennessee net earnings. Rather, Newco LLC must include the gain from the sale of its assets in its Tennessee net earnings in the same taxable year in which such gain is recognized and included in Newco LLC's federal taxable income.

As noted above, Newco LLC must determine its Tennessee net earnings or loss in accordance with the provisions applicable to corporations. Tenn. Code Ann. § 67-4-2006(a)(1) defines "net earnings" or "net loss" of a corporation as "federal taxable income or loss before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241-247 and 249" as adjusted by Tenn. Code Ann. § 67-4-2006(b) and (c). Subsections (b) and (c) require specific addition and subtraction adjustments to a taxpayer's net earnings or loss to arrive at its Tennessee taxable income; none of these adjustments require the inclusion of gain in Tennessee net earnings in a year other than the year in which such gain is recognized and included in federal taxable income.

Accordingly, Newco LLC will include the gain from the sale of its assets in its Tennessee net earnings in the same taxable year in which such gain is recognized and included in Newco LLC's federal taxable income.

6. S Corporation status.

The answers to Questions 1-4 above would not change if Oldco Corporation and Newco LLC elected S corporation status under IRC § 1362(a).

For purposes of determining Tennessee net earnings or loss, the federal S corporation election is disregarded. As noted above, Tennessee imposes an excise tax on the "net earnings" of certain persons, including corporations, doing business within Tennessee. Tenn. Code Ann. §§ 67-4-2007(a) and 67-4-2004(30). Tenn. Code Ann. § 67-4-2006(a)(2) (2007) states that, in the case of a corporation electing S corporation status for federal income tax purposes under 26 U.S.C.

§§ 1361-1363, “net earnings” means “federal taxable income calculated as if the corporation had not elected S status.” If a taxpayer that is classified as a corporation had not elected federal S corporation status, it would have calculated its federal taxable income as though it were a C corporation. Accordingly, it makes no difference for the purposes of Questions 1-4 above whether Oldco Corporation and Newco LLC have elected S corporation status for federal income tax purposes.

Kristin Husat
Senior Tax Counsel

APPROVED: Reagan Farr
Commissioner of Revenue

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