Disregarding 754 elections?
A Harbinger of Things to Come

by J. Leigh Griffith, JD, LLM, CPA
On Sept. 12, 2011, the Tennessee Department of Revenue (the “Department”) issued Revenue Ruling 2011-45 (the “Ruling”) responding to a request made on Oct. 30, 2006 concerning the application of the Tennessee excise tax on the sale of assets by a limited liability company classified as a partnership for Federal income tax purposes. In this Ruling, the Department presented its surprising view as to the effect of an election under Section 754 (“754 election”) of the Internal Revenue Code of 1986 as amended (the “Code”) with respect to the computation of gain on the sale of assets by a limited liability company (a partnership for Federal tax purposes) with a 754 Election in effect.

In an aggressive interpretation, the Department determined that a partnership’s taxable income for Tennessee excise tax purposes would be determined of gain on the sale of assets by a limited liability company (a partnership for Federal tax purposes) with a 754 Election in effect.

Although the ruling only addressed gain on sale, if the 743(b) adjustment is not reflected in the tax basis of the partnership’s assets, depreciation and amortization logically would be determined independent of such adjustment. Therefore, it is likely that virtually every franchise and excise tax return involving a partnership with (i) a “substantial built-in loss” and a transfer of interests since Oct. 22, 2004 or (ii) a 754 election is incorrect in the eyes of the Department.

The ruling did determine that if a 754 election was in effect and a distribution of property to a member resulting in a Code Section 734(b) adjustment to basis of the remaining partnership property as a result of the distributee partner recognizing gain or loss, such adjustment would be honored by the Department.

Is this aggressive position a harbinger of things to come?

Background – Federal Tax Law
Under Subchapter K of the Code, a partnership is sometimes conceptually treated as an entity and sometimes treated as an aggregate of its partners.1 Consistent with the entity theory, a partnership has an “inside” basis (the basis of assets held by the partnership) and an “outside” basis (the basis of the partners in the partnership). If someone purchases the partnership interest of a partner, the outside basis of the partnership interest purchased is adjusted to reflect the purchase price the purchaser paid the selling partner plus the share of partnership debt that is attributable to the interest purchased. Unless there is a 754 election in effect or there is a substantial built-in loss (the outside basis is substantially [$250,000 or more] less than the inside basis), the “inside” basis remains the same. Section 743(b) provides that a partnership with a substantial “built in loss” must adjust the basis of the partnership property even in absence of a 754 election. A partnership which makes an affirmative one time 754 election must adjust the basis of the partnership property pursuant to Code Section 743(b) so that the inside and outside basis of the partnership is the same with respect to the transferee partner. The 754 election/743(b) adjustment utilizes an aggregate theory overlay to the basis of partnership property where it is applicable.

Pursuant to Code Section 1001, gain from sale of property shall be the excess of the amount realized over the adjusted basis of the property. Code Sections 1011 and 1012 provide that basis is the cost of such property, except as otherwise provided in subchapter K (relating to partners and partnerships) and adjusted as provided in Code Section 1016 (depreciation, amortization and other items). As described above, a 743(b) adjustment shall increase/decrease the adjusted basis of the partnership property by the excess/deficit of the basis to the transferee partner of his interest in the partnership over the transferee partner’s proportionate share of the adjusted basis of the partnership property.

Code Section 703 provides for the determination of taxable income of a partnership in the same manner as in the case of an individual except that items described in Code Section 702(a) must be separately stated and certain enumerated deductions will not be allowed to a partnership.

Tennessee Taxation
For purposes of the excise tax, net earnings of a partnership is the amount of ordinary income or loss determined under the applicable provisions of the 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 with adjustments.2 This provision was inserted into the statute to treat an LLC as a taxable entity. Until this ruling was issued, most practitioners believed that, insofar as Tennessee Franchise and Excise Tax is concerned, the entity view prevailed in all instances over the aggregate view. Many practitioners are likely to continue to believe that is the case.

Presumably, the rationale for the Ruling is the Department’s concern that a sale of a limited liability entity’s ownership interest is not subject to excise tax whereas a sale of such an entity’s property is subject to the excise tax computation of gain or loss. The Department was undoubtedly concerned that following the federal tax rules when a sale of a partnership interest occurred for a price in excess of the proportionate inside basis results in no Tennessee excise tax, yet if a 754 election was in effect, there would be a 743(b) adjustment to the basis of the partnership’s assets reducing future Tennessee tax. If the sale was for an amount less than a proportionate amount of the inside basis, following the federal tax rules would increase future Tennessee excise tax. Most (if not virtually all) practitioners believed that a sale of a partnership interest in a partnership with a 754 election in effect resulted in an adjustment in the basis of partnership property for Tennessee tax purposes without the partnership

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recognizing Tennessee taxable income, gain or loss.

Department's Technical Position
In its interpretation of the Code and Treasury Regulations, the Department concluded in the Ruling that the 743(b) adjustment to partnership property was not really an adjustment to partnership property as the basis adjustment did not go into the common basis of partnership property but was only with respect to the transferee partner.

Therefore, in the view of the Department, such an adjustment did not reduce the partnership's taxable gain or increase the loss on the sale of such property. The Ruling cites Treasury Regulation Section 1.743-1(j)(1) and (3) including (Examples 1-3) providing that the adjustment is to the basis of partnership property with respect to the transferee partner and no adjustment is made to the common basis of partnership property. The Department concludes that 'as a result, the adjustment to the purchasing partner's inside basis under Code Section 743(b) has no effect on the partnership's computation of its taxable income.'

The Ruling also focuses on Treasury Regulation Section 1.743-1(j) and its multi-step process for determining the distributive share of the transferee partner if a 743(b) adjustment exists. This process computes Code Section 703 items of income, deduction, gain or loss, then allocates such items among the partners in accordance with Code Section 704, and as a last step, 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 Code Section 743(b). Since the capital account of the purchasing partner was not increased/decreased by the difference between the purchase price and the selling partner's capital account, the 743(b) adjustment does not effect such partner's capital account.

In short, in the Department's view, the articulation of Treasury Regulation Section 1.743-1(j) that the transferee partner has a special basis for those partnership properties adjusted under Code Section 743(b) means the partnership's basis is not actually adjusted and the partnership's gain/loss (amount realized less basis) is not impacted by the 743(b) adjustment. The Department views the adjustment as simply one made to a purchasing partner's distributive share of partnership income or loss from the sale of an asset and apparently neither a part of the partnership's income nor an additional item under T.C.A. Section 67-4-2006(a)(4) which is not already included in ordinary income or loss of the partnership. Not surprisingly, this view will often (perhaps generally if we regain a stable economy) result in a larger Tennessee taxable income than the sum of the income, gain and loss allocated or distributed to the partners and result in a higher tax to the partnership.

Potential Problems with the Department's Position
The fundamental flaws with the Department's position may be ignoring (i) the fact that the basis of the partnership property is increased per the express wording of Code Section 743(b), (ii) the Code's computation of gain and loss on the sale of an asset is the amount realized over the adjusted basis and (iii) T.C.A. Section 67-4-2006(a)(4)(A)'s articulation of "net earnings" or "net loss" as: "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 ..."

1. The language of the Code and Treasury Regulations repeatedly refers to the 743(b) Adjustment as an adjustment to the basis of the partnership's property. Code Section 743(b)(1) states "increase the adjusted basis of the partnership property" and Code Section 743(b)(2) states: "decrease the adjusted basis of the partnership's property."

2. The determination of gain or loss on the sale of an asset for federal tax purposes is clear as well.

Code Section 1001 provides gain or loss is computed as the excess of the amount realized over the adjusted basis of the property as provided in Code Section 1011.

Code Section 1011 provides that the adjusted basis shall be the basis determined under Code Section 1012 or other applicable sections of subchapter K.

Code Section 1012 provides that basis shall be the cost of such property, except as otherwise provided in subchapter K. Code Section 743(b) is found in subchapter K of the Code and calls for an adjustment to the basis of the partnership property.

Code Section 755 provides the rules for the allocation of the 743(b) Adjustment (as well as the Code Section 734(b) adjustment) among the assets constituting partnership property.

The Department's position ignores T.C.A. 67-4-2006(a)(4)'s definition of "net earnings" or "net loss" as including additional items not already included in ordinary income or loss. The Department's interpretation also would appear to ignore the fact that the 743(b) Adjustment's effect flows through the partnership's tax return (IRS Form 1065) and is reported on Form 1065 K-1 as other income or other deductions when reporting the partner's share of distributive income and items of income from the partnership. This is clearly not an adjustment outside of the partnership, although it is an adjustment to partnership basis that is solely for the benefit or detriment of a transferee partner.

As discussed above, the Department has focused on the concept of "common basis" in the Treasury Regulations and developed the view that (i) "common basis" is the only basis of the partnership property and (ii) the 743(b) adjustment is not an adjustment to partnership property impacting the determination of
gain or loss (or presumably depreciation or amortization). The Department has focused on the mechanical rules of the Treasury Regulation (the purpose of which is to assure that the impact of the adjustment be allocated to the transferee partner) to develop the interpretation that the basis adjustment to partnership property does not impact “net earnings” for Tennessee excise tax purposes even though the impact flows through the partnership’s tax return as well as the Schedule K-1 of the transferee partner.

The Code specifically directs that the tax effect of the adjustment flow to the transferee partners when it requires that the increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner. The Treasury Regulation’s adjustment to a transferee partner’s distributive share does not mean that the 743(b) adjustment is not an adjustment reflected in the basis of the partnership property and impacting gain or loss on the sale of partnership property under Code Section 1001 or depreciation or amortization with respect to partnership property. It simply means that such share of partnership income, gain and loss must be allocated to such partner and is with respect to such partner only. The statutory language and the Treasury Regulations clearly provide that the basis of partnership property is adjusted. The Code does not say the distributive share of the transferee partner is adjusted.

Tennessee has determined to impose its excise tax on the partnership entity. Tennessee has defined “net earnings” and “net loss” on which to impose the excise tax on a partnership as the ordinary income or loss determined under the applicable provisions of the Code, including additional items which are not already included in ordinary income or loss. The 743(b) adjustment to the basis of partnership property may be with respect to transferee partners only, but it is an adjustment to the basis of the partnership property. The federal effect of the adjustment flows through the partnership’s tax return on Schedule K as other income or other loss and the Schedule K-1 of the transferee partner as other income or other deduction. Under principles of federal tax law, the gain or loss on the sale of property is the difference between the amount realized and the basis of the property. Although potentially a bit confusing when (a) the Treasury Regulations are attempting to apply a hybrid aggregate/entity concept overlay and directing that the ramifications be allocated to the transferee partner while (b) Tennessee is using a pure entity concept, the 743(b) Adjustment is clearly an adjustment to the basis of the partnership’s assets and gain or loss under the federal tax law and basis is used to determine the amount recognized.

Conclusion
For those partnerships with a negative 743(b) adjustment, should tax return preparers consider filing amended returns and claiming refunds as well as filing ongoing returns reflecting the position of the Department? For those partnerships with a positive 743(b) adjustment, the return preparer should advise the taxpayer of this development and determine what is the prudent course of events. It should be noted that the Department does not consider itself bound by the Ruling and, because it was not a letter ruling, technically it is not even binding with respect to “a taxpayer for which” the Ruling was issued.

In the author’s view, the Department is taking a very aggressive position that is neither supported by years of conduct by the Department and taxpayers nor by the T.C.A. definition of “net earnings” or “net loss” with respect to a partnership. The position does rest at the intersection of the aggregate and entity concepts and an asymmetry in the tax law. However, the Code could not be clearer that the basis of the partnership’s property is adjusted and it is the basis of the partnership’s property that generates the gain or loss on sale or depreciation and amortization during operation. The federal partnership tax return must include the 743(b) adjustment as Other Income or Other Loss on Schedule K of the return and the 743(b) adjustment effect must be included on the Schedule K-1 of the transferee partner as Other Income or Other Deductions. To say that the gain and loss on such partnership property as a result of the 743(b) adjustment is not impacted; that a partner’s distributive share is not a portion of the partnership’s income, gain and loss; and that the adjustment effect is not an item that is encompassed in T.C.A. Section 67-4-2006(a)(4) is aggressive and surprising. If the Department follows this interpretation, many taxpayers will be forced to litigate, as the amounts involved will frequently be significant.

1 For Federal tax purposes, a partnership includes a general partnership, a limited partnership, a limited liability partnership, a domestic limited liability company that has not elected to be taxable as an association taxable as a corporation and any other entity that is taxable as a partnership for Federal income tax purposes.
2 The outside basis can also change as a result of death of a partner. The estate will take a fair market value basis (plus share of debt) in the partnership interest. Code Section 743(b).
3 T.C.A. § 67-4-2006(a)(4).
4 Code Section 743(b) requires a mandatory allocation of the impact of the 743(b) Adjustment when it provides “… such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only.”
5 Form 1065 instructions (2010 year), page 9 requires 743(b) adjustments to be reported as Other Income or Other Deductions. They must be reported on Schedule K of the form 1065 and on the transferee partner’s Schedule K-1.

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