

# PUBLICATION

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## Spotlight on Tennessee: Hidden Income Tax Can be Trap for Unwary

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A common assumption is that Tennessee does not impose a State income tax on individuals, general partnerships and sole proprietorships. However, that assumption may not always be accurate. Prudent business planning is necessary to avoid this possible trap.

**I. Background.** The imposition of a broad based income tax on individuals in Tennessee is considered by many to be constitutionally impermissible in view of decisions by the Tennessee Supreme Court dating back many decades. For instance, in the 1932 case of *Evans v. McCabe*, the Supreme Court determined that a general graduated state income tax was unconstitutional whether it was viewed as a property type tax or a privilege type tax. Further, in the 1948 decision of *Jack Cole Co. v. MacFarland*, the Supreme Court determined that a privilege tax on the receipt or realization of net earnings by an individual was also constitutionally invalid. In contrast, the Supreme Court in the 1924 decision of *Bank of Commerce & Trust Co. v. Senter*, blessed the State's broad based business income tax, known as the excise tax, which is imposed upon the privilege of doing business in corporate form in this State.

The business excise tax was originally applicable only to corporations and similar business forms, but was extended in 1999 to also include limited liability companies, limited partnerships and various other limited liability type organizations. Today, the business excise tax is imposed at the rate of 6 ½ % of the net earnings of those entities for the privilege of doing business for profit in this State. However, individuals, sole proprietorships and general partnerships, while also conducting business in Tennessee, have remained outside the scope of the business excise tax because of the above-referenced constitutional concerns surrounding any broad based income tax levied on individuals. (Individuals and partnerships legally domiciled in Tennessee are among the type of "persons" subject to a constitutionally authorized limited income tax, known as the "Hall" tax, which today is imposed at the rate of 6% upon income derived by way of dividends from stocks or by way interest on bonds.)

**II. 2004 Enactment.** In 2004, Public Chapter 592 was enacted in this State. Included in that 2004 legislation was an amendment to the business excise tax which established a new tax provision found at Tennessee Code Annotated, Section 67-4-2007(f). That Section arguably created a completely new Tennessee tax that is hidden within the existing business excise tax.

Section 67-4-2007(f)(1) states in part that "(a)ny entity or individual not otherwise subject to the ...[business excise tax]... shall pay to the commissioner an excise tax equal to ...[6 ½%]... of the gain from the sale of any asset..." if certain criteria are present. Those criteria are set forth in subsection (1) essentially as follows:

**A.** The business taxpayer subject to the business excise tax (i) distributes an asset to an entity or individual not subject to the business excise tax, (ii) the entity or individual not subject to that business tax then sells the asset within 12 months of receiving it, and (iii) the taxpayer subject to the business excise tax which made the initial distribution ceased to exist prior to the sale; or

**B.** The entity or individual not otherwise subject to business excise tax received the asset through a merger, liquidation or similar transaction with a taxpayer subject to that business tax during the 12 month period prior to the sale of the asset; or

C. During the 12 month period immediately before the sale of the asset, the entity selling the asset is a limited liability company, a limited partnership or a limited liability partnership which qualified for the business excise tax exemption by virtue of having had all of its members/partners elect unlimited liability for the entity's debts; or

D. The asset was owned, during the 12 month period immediately prior to the sale, by an "affiliate" (which includes one or more chains of includible corporations having a common parent) subject to the business excise tax.

This 2004 excise tax, with each of the criteria at A, B and C above, was effective for any asset sale occurring on or after July 1, 2004. The criteria at D above was added by legislation in 2008, effective for transactions occurring on or after July 1, 2008.

Despite the occurrence of one of the specified circumstances, the excise tax created Section 67-4-2007(f) does not apply according to subsection (2) to the gain from the sale of an asset by any entity having not-for-profit status. In addition, that Section 67-4-2007(f)(2) states that any gain from the sale of an asset cannot be taxed twice as the result of the "same transaction."

As part of that 2004 legislation which enacted Section 67-4-2007(f), the business excise tax was also amended so as to revise one of the additions to net earnings or net losses in computing the business excise tax liability of the business entity. That revised addition, found at Section 67-4-2006(b)(1)(I), states as follows:

There shall be added to a taxpayer's net earnings or net losses:

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Any gain not already included in the taxpayer's net earnings or loss on the sale of an asset distributed by the taxpayer to an entity or individual not otherwise subject to the tax imposed by this part, when such asset is sold within twelve (12) months of the date of distribution. Thus, in such a case, the gain for excise tax purposes is recognized by the taxpayer making the asset distribution rather than the seller. However, if the taxpayer making the asset distribution ceases to exist prior to the sale, the gain shall be reported and tax paid by the seller in accordance with § 67-4-2007(f).

When the criteria set forth in Section 67-4-2007(f) are applicable with respect to an otherwise nontaxable entity or individual, that entity or individual must report the gain on the sale of the asset by filing a Franchise, Excise Tax Return with the Tennessee Department of Revenue. That Return is currently on Form FAE 170, and the applicable portions of the Form for otherwise nontaxable entities and individuals include Schedules B and C together with Line 4 on Schedule J. Presumably the electronic funds transfer program, under Section 67-1-703(b), would also be applicable as to the payment of this excise tax.

**III. Constitutional?** Is this excise tax on otherwise nontaxable entities and individuals constitutional in light of the earlier decisions by the Tennessee Supreme Court? The response is debatable, but not conclusive on either side of the issue. The excise tax created by Section 67-4-2007(f) arguably is intended as a separate and distinct tax upon the otherwise nontaxable entity or individual - that is, such nontaxable entity or individual "...shall pay to the commissioner an excise tax ... ." As such, the tax does not appear to be merely a means of collecting the business excise tax which would have been owed by the business entity making the distribution had that entity continued to exist and instituted the sale. Only the courts will be able to decide this question - but in the meantime you should consider options to protect your position should Section 67-4-2007(f) apply to your facts.

**IV. Summary.** This excise tax created in 2004, and expanded in 2008, represents yet another potential trap that must be considered in connection with those factual criteria specified in Section 67-4-2007(f). Those criteria need to be carefully analyzed in each situation to determine whether this excise tax could apply or may be avoided through possible restructuring of the proposed transaction. In any event, ignoring the pitfalls of Section 67-4-2007(f) has the potential for posing serious consequences. As stated in Section 67-4-2007(f)(3), the failure to pay and report this excise tax shall subject the otherwise nontaxable entity or individual to a penalty pursuant to Section 67-1-804(b)(4) - which imposes a penalty of 50% of the underpayment.