F&E Tax Traps: Beware the family partnership selling property

By Dan W. Holbrook

Family Limited Partnerships (FLPs)[1] are ubiquitous in sophisticated estate planning. Typically parents use them to transfer wealth during life with a minimum of gift tax while retaining effective control, and then pass interests remaining at death at "discounted" values due to partnership state laws that restrict marketability and control. The largest discounts often occur when a FLP owns substantial real property with little dependable cash flow. Accordingly, a frequent question is the tax effect of a FLP's sale of real property.

The tax answer begins with analysis of federal income and estate taxes, including, *inter alia*, basis, potential gain on sale or distribution, and the statute of limitations on valuation. But a complete analysis also requires review of the Tennessee franchise and excise taxes (F&E taxes). Here's why.

Tennessee imposes an annual excise tax of 6 1/2 percent on "net earnings" of any limited liability entity, plus a franchise tax of ? of 1 percent on its "net worth."[2] "Net earnings" includes capital gains.[3] Many FLPs avoid the F&E taxes by fitting within one of two exemptions.[4] First, a FLP is exempt if it is a "95 percent *family-owned entity* (a FOE)."[5] Alternatively, a FLP is exempt if it is an "*obligated member entity* (an OME),"[6] under which all the partners agree to assume all of the partnership liabilities in documentation filed with the Secretary of State, effective as of Jan. 1 of the year after the filing.

F&E Tax Trap #1 — The FOE two-thirds test

To qualify as a FOE, substantially all of the activity of a FLP must be production of passive investment income (or in certain cases, farming). The Tennessee Department of Revenue defines "substantially all" as at least two-thirds of gross revenues.[7] "Passive investment income" includes rents, royalties, interest, dividends, annuities, and gain on sale or exchange of stock or securities, but not gain on sale or exchange of real property. Thus, if a FOE sells real property with a gain that exceeds one-third of that year's gross earnings from all sources, the FLP loses its exemption for the year, and it must pay both F&E taxes in full on *all* net earnings and net worth, not just on the gain on sale of real property.[8]

Unlike a FOE, an OME is not subject to the passive investment income limitation. Thus, an OME can sell real property without incurring the excise tax. Can a FOE avoid Tax Trap #1 by switching to the OME exemption?

F&E Tax Trap #2 — The OME 12-month lookback on qualification

An otherwise exempt FLP must nevertheless pay the 6 1/2 percent excise tax on gain from the sale of "any asset" (not just real property) if the FLP "*qualified for* the exemption provided in §67-4-2008(a)(8) during the twelve-month period immediately prior to the sale."[9] There is a problem of statutory construction, since as written, the cross-reference to §67-4-2008(a)(8) is nonsensical, pointing to an exemption for certain entities providing affordable housing. However, the OME exemption was numbered as §67-4-2008(a)(8) until 2004, and renumbered from (a)(8) to (a)(9) in 2004, without any change to the above cross-reference. Therefore there is little doubt about the intention, and the Department of Revenue has formally indicated it will treat the cross-reference as if it read (a)(9), i.e., the OME exemption.[10] If so, then a FLP that converts to an OME and sells property within the prohibited 12-month lookback period will be liable for the excise tax on the gain from the sale (but not on other earnings, nor does the FLP lose its exemption from the franchise tax).[11]

Planning Tip: The Department of

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Revenue formally takes the position that "qualified for the exemption" means the date documents are executed that remove the limited liability protection to convert to an OME.[12] The Department of Revenue has informally clarified in a telephone conference that the applicable date from which to measure the 12 months is the date on which the documentation is filed with the Secretary of State. If so, then a FLP that plans to sell any real property at a gain can become "qualified for" the OME exemption by filing its documentation, which becomes effective January 1 of the next calendar year, and then sell its property on or after the anniversary date of the filing, free from the excise tax. Obviously, this poses some logistical difficulties, but with enough foresight and a willingness to delay the sale for a mere 12 months, this can save clients a substantial amount of tax.

Planning Tip: A FOE that plans to sell real property might pay less F&E taxes if it qualifies instead as an OME for the year of the sale, since an OME incurs an excise tax only on its gains and not on other income, whereas a big gain in a FOE can cause it to lose its F&E exemptions completely for the year of the sale. Better yet, a FOE can plan to avoid the tax completely by qualifying as an OME and waiting 12 months, under Planning Tip #1. Of course, such a change requires that the partners subject themselves to genuine risk by forgoing limited liability protection during the period of being an OME.

Unlike a FOE, an individual is not normally subject to the excise tax, nor is an individual subject to any Tennessee income tax on capital gains. Can a FOE avoid Tax Trap #1 by distributing to its partners (presumably family members) and let them sell instead?[13]

"So, sell if you must, but beware. Gains are not so easily free of F&E taxes without proper planning."

F&E Tax Trap #3 — The FOE 12-month lookback on sale by distributee

Any entity subject to excise tax, such as a taxable FLP, must include in its "net earnings" any gain on the sale of an asset distributed to one of the partners who then sells it within 12 months of the distribution (let's call this "12-month distributee gain").[14] The Tennessee Department of Revenue's unwritten but strongly held position, confirmed in a telephone conference, is that in any year's calculation of the FOE two-thirds passive investment income percentage, the denominator must include any 12-month distributee gain. This would prevent a FOE from avoiding loss of its exemption by its distribution of real property to the partners who in turn sell. Moreover, says the Department of Revenue, if the FOE terminates within those 12 months, the excise tax on such gain is an obligation of the partner rather than the FLP.[15]

Planning Tip: A reasonable statutory interpretation is that 12-month distributee gain, added to "net earnings" for purposes of a taxable entity, should have no relevance to an exempt entity such as a FOE.[16] The FOE exemption does not explicitly employ the concept of "net earnings." In determining exempt status, the FOE exemption measures only "passive investment income," defined as certain types of gross receipts, which for purposes of the two-thirds test is compared to all gross receipts, not "net earnings." The legislature could have created an explicit 12-month lookback on distributions by a FOE, as it did for taxable entities, but it did not. So why should it matter what an exempt FLP does or does not have to include in its "net earnings"? On the other hand, the two-thirds test is a regulatory definition,[17] not statutory, so perhaps the Department of Revenue is

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free to interpret and bend its regulations however it wishes not clearly inconsistent with the statute. One wishes for guidance where none now exists. Meanwhile, until there is more guidance by further regulation, case law, or statutory amendment, a partner in a FOE might well be advised to wait at least 12 months before selling real property distributed to him.

Can a FOE avoid all the Tax Traps #1, #2 and #3 by qualifying as an OME, then have the OME distribute real property to its partners, then let them sell instead, all within 12 months?

F&E Tax Trap #4 — The OME 'double' 12-month lookback

The Department of Revenue takes the position, again unwritten but strongly held, that if an OME 12-month lookback on qualification applies (Tax Trap #2), then a 12-month lookback on sales by distributees also exists.[18] That is, any sales by a distributee from the OME during the 12 months since qualification will be attributed back to the OME and therefore taxable. Since the statute purports to tax both individuals and entities, it is not clear in such case whether the partner or the OME would actually pay the tax, but a representative of the department indicates it doesn't really matter as long as the tax is paid.

Planning Tip: A reasonable statutory interpretation is that the OME 12-month lookback on qualification does not also contain a 12-month lookback on sales by distributees. One looks in vain in the statute for any such reference to the distributee lookback, explicit or implicit, although the department's logic that it should exist is sensible. Again, one wishes for guidance where none now exists. Until then, a prudent taxpayer receiving a distribution from an OME that qualified within the last 12 months might well be advised to wait until the 12 months had elapsed after qualification before selling real property distributed to him.

So, sell if you must, but beware. Gains are not so easily free of F&E taxes without proper planning.

Notes

1. In this column, the term FLP also includes any Limited Liability Company (LLC) used for estate planning, provided in either case that it is treated as a partnership for federal income tax purposes.

2. *Tenn. Code Ann.*§§67-4-2007(a) and 67-4-2106, respectively.

3. *Tenn. Code Ann.*§67-4-2006(a)(4).

4. A third exemption for farm or residential property is not often used with a FLP because personal use of the FLP assets can cause estate tax problems. *Tenn. Code Ann.*§67-4-2008(a)(6).

5. *Tenn. Code Ann.*§67-4-2008(a)(11). For an analysis of the 95-percent family-owned exemption, see Holbrook, "The 95-percent family-owned test for family limited partnerships," 37 *Tennessee Bar Journal* 31 (January 2001).

6. *Tenn. Code Ann.*§67-4-2008(a)(9).

7. Tennessee Department of Revenue Web site Frequently Asked Questions, Question 48. See *www.state.tn.us/revenue/misc/faefaq.htm*. Gross revenues are used except in the case of sale or exchange of stock, securities, or other capital assets, which use net revenues.

8. Viewed differently, if a FOE incurs gain on sale of real property that exceeds one-half of all its *other non-gain income*, it loses its exemption in total from the F&E taxes for that year.

9. *Tenn. Code Ann.*§67-4-2007(f)(1)(C).

10. Tennessee Department of Revenue Franchise and Excise Tax Guide, November 2005, page 16. The guide is available on the Department's Web site at *www.tennessee.gov/revenue/taxguides/feguide.pdf*.

11. Note that failure to report and pay the tax is subject to a penalty equal to 50 percent of the underpayment. *Tenn. Code Ann.*§67-4-2007(f)(3).

12. Tennessee Department of Revenue Franchise and Excise Tax Guide, November 2005, page 16.

13. Of course, distributions to partners might generate negative federal income tax consequences. See, e.g., Internal Revenue Code §§704(c)(1)(B), 707(a)(2)(B), and 737.

14. *Tenn. Code Ann.*§67-4-2006(b)(1)(I).

15. *Tenn. Code Ann.*§67-4-2006(b)(1)(I), last sentence, and *Tenn. Code Ann.*§67-4-2007(f)(1)(A).

16. Neither the *Tennessee Department of Revenue Franchise and Excise Tax Guide* nor the Department of Revenue Web site Frequently Asked Questions suggests that the 12-month lookback on sales by distributees under *Tenn. Code Ann.*§67-4-2006(b)(1)(I) applies to exempt entities. The F&E tax form for taxable entities includes a line to add gains on sales by partners on property distributed within the last 12 months. There is no form at all for exempt entities, much less a form on which to report sales by partners on property distributed within the last 12 months. *Tenn. Code Ann.*§67-4-2007(a), last sentence, reads: "Notwithstanding the fact that a person is otherwise exempted from the excise tax, such person shall be subject to excise tax on all of its Tennessee net earnings that are attributable to any activities unrelated to and outside the scope of the activities that give it an exemption status." This seems to apply only to nonprofits, not to other types of exempt organizations. On the other hand, since "passive investment income" for purposes of the FOE exemption does not include gain on sale or real property, the Department of Revenue may be able to argue that gains on sale of real property would be "unrelated to and outside the scope of the activities that give it an exemption status." Also, Frequently Asked Questions 52, 53 and 54 evidence a generally consistent intent by the Department of Revenue to use state modifications of federal earnings as its starting point for analysis of taxation, supporting its use of "net earnings" in the denominator of the two-thirds test.

17. See footnote 7.

18. *Tenn. Code Ann.*§67-4-2007(f)(1)(C). The OME 12-month lookback on sale by a distributee does not stem from *Tenn. Code Ann.*§67-4-2006(b)(1)(I), as in Tax Trap #3. Rather the Department of Revenue derives the existence of a 12-month OME lookback from the fact that *Tenn. Code Ann.*§67-4-2007(f)(1)(C) attempts to tax individuals as well as entities. How could an individual be taxable unless derivatively through a 12-month distributee lookback, even if not actually mentioned in the statute?