

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 12-04**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

The application of the Tennessee individual income tax to the distribution of a deemed dividend by an S corporation making an election under Treas. Reg. § 1.1368-1(f)(3).

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and

(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER NAME] (the "Taxpayer") is a [STATE OF INCORPORATION] corporation formed in [YEAR]. The Taxpayer is currently taxed for federal income tax purposes as a Subchapter C corporation, but is considering electing Subchapter S status under I.R.C. §§ 1361-1363.

Because the Taxpayer has accumulated earnings and profits as a Subchapter C corporation, there is a possibility that the federal Subchapter S election would terminate in three years due to violation of Internal Revenue Code passive investment income restrictions. To avoid the potential termination of its Subchapter S election, the Taxpayer may make a distribution of a deemed dividend (the "Deemed Dividend") in accordance with Treas. Reg. § 1.1368-1(f) to eliminate its accumulated earnings and profits. In making the Deemed Dividend, the Taxpayer would make no actual distribution of money, stock, or other property to its shareholders.

RULING

Is the Deemed Dividend subject to the Tennessee individual income tax?

Ruling: Yes. The Deemed Dividend is a taxable dividend for purposes of the Tennessee individual income tax.

ANALYSIS

TENN. CODE ANN. § 67-2-102 (2011) imposes the Tennessee individual income tax at the rate of 6% on "incomes derived by way of dividends from stocks¹ or by way of interest on bonds of each person, partnership, association, trust and corporation in the state of Tennessee who received, or to whom accrued, or to whom was credited during any year" such dividend or interest income.

Federal Subchapter S election

I.R.C. § 1362(a) (West 2011) permits a corporation that was previously taxed under Subchapter C of the Internal Revenue Code to elect Subchapter S status, thereby permitting the corporation to be treated as a pass-through entity for federal income tax purposes. However, I.R.C. § 1362(d)(3)(A)(i) automatically terminates the corporation's Subchapter S status if the corporation has accumulated Subchapter C earnings and profits and the corporation's passive investment income exceeds 25% of its gross receipts for three consecutive taxable years. To avoid automatic termination, the corporation may distribute its accumulated Subchapter C earnings and profits in the form of a dividend.²

¹ TENN. CODE ANN. § 67-2-101(6) (2011) defines the term "stock" in pertinent part to mean "shares of stock issued by corporations chartered and organized under the laws of the state of Tennessee, or of any other state, or of the United States, or of any foreign government."

² I.R.C. § 316 (West 2011) defines a "dividend" for federal income tax purposes in pertinent part as "any distribution of property made by a corporation to its shareholders-- (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

Alternatively, the corporation may elect to distribute the accumulated earnings and profits through a “deemed dividend” as set forth in Treas. Reg. § 1.1368-1(f)(3) (West 2011).

The deemed dividend is treated as having been made by the corporation from its Subchapter C earnings and profits with respect to its stock on the last day of its taxable year, to all shareholders holding stock on that day.³ Treas. Reg. § 1.1368-1(f)(3). The amount of the deemed dividend is limited to the excess of the corporation’s C corporation earnings and profits on the last day of the taxable year, reduced by actual distributions of C corporation earnings and profits made during the taxable year. *Id.* For all purposes of federal income taxation, the deemed dividend is “treated as having been distributed in money to the shareholders in proportion to their stock ownership, actually received by the shareholders, and immediately contributed by them back to the corporation, all on the last day of the corporation’s taxable year.” *Id.*

The deemed dividend election allows the corporation to eliminate its accumulated Subchapter C earnings and profits without having to make an actual cash distribution; the effect of the deemed dividend is to convert retained earnings into paid-in capital, without reducing shareholder equity. *See* John Truskowski, *AJCA Changes to Subchapter S Broaden the Availability of the S Election*, 10 J. TAX. 327 (Dec. 2004). Because the deemed dividend is treated as having been contributed by the shareholder back to the corporation, the shareholder’s basis in his stock is increased accordingly.

Each shareholder must consent to the deemed dividend election, as set forth in Treas. Reg. § 1.1368-1(f)(5)(iii). Additionally, the corporation must attach to its federal income tax return a statement of election that includes the amount of deemed dividends distributed to each shareholder. *Id.* For federal income tax purposes, each shareholder must report the deemed dividend as a taxable dividend in the year the S corporation makes the election.

Tennessee individual income tax

As noted above, TENN. CODE ANN. § 67-2-102 imposes the Tennessee individual income tax at the rate of 6% on “incomes derived by way of dividends from stocks or by way of interest on bonds of each person, partnership, association, trust and corporation in the state of Tennessee who received, or to whom accrued, or to whom was credited during any year” such income.

Thus, for the Deemed Dividend to be taxable for purposes of the Tennessee individual income tax, the following requirements must be met: 1) the Deemed Dividend must be properly characterized as a dividend from stock;⁴ and 2) the Deemed Dividend must be received by, or accrued or credited to, the Taxpayer’s Tennessee shareholders during the taxable year at issue.

³ Generally, S corporation distributions will first be treated as being sourced from the tax-free accumulated adjustments account, which represents the amount of income, deductions, and losses passed through to shareholders, less previous tax-free distributions to shareholders. *See* Treas. Reg. § 1.1368-2 (West 2011). Once the accumulated adjustments account is exhausted, S corporation distributions will then be treated as sourced from accumulated earnings and profits. IRC § 1368(c) (West 2011). However, the deemed dividend election treats the S corporation as first making a taxable distribution of accumulated earnings and profits, before any distribution from the tax-free accumulated adjustments account. Treas. Reg. § 1.1368-1(f)(3).

⁴ Because the Deemed Distribution clearly cannot be characterized as interest on a bond, this letter ruling will discuss only whether the distribution constitutes a dividend from stock.

The first requirement is satisfied because the Deemed Dividend is properly characterized as a dividend from stock. The second requirement is met because the Deemed Dividend is accrued or credited to the Taxpayer's Tennessee shareholders during the taxable year at issue.

The Tennessee individual income tax provisions do not define the term "dividend."⁵ However, the Tennessee Supreme Court has stated that, for purposes of the individual income tax, a dividend is a payment that is "distributed pro rata among the shares outstanding" and represents "the recurrent return upon stock" paid to stockholders, "which does not reduce their stock holdings and leaves them in a position to enjoy future returns upon the same stock." *Dobson v. Huddleston*, 863 S.W.2d 392, 396 (Tenn. 1993) (quoting *Gallagher v. Butler*, 378 S.W.2d 161, 167 (Tenn. 1964)).⁶

Accordingly, for the Deemed Dividend to be properly characterized as a dividend for Tennessee individual income tax purposes, the following requirements must be met: 1) the Deemed Dividend must represent a return upon stock paid to the shareholders of the Taxpayer on a pro rata basis; and 2) the Deemed Dividend must not reduce the shareholders' stock holdings, but rather must leave them in a position to enjoy future returns on the same holdings.

First, the Deemed Dividend is a pro rata return upon stock that is paid to the Taxpayer's shareholders.

The Deemed Dividend distribution is made on a pro rata basis. As explained above, Treas. Reg. § 1.1368-1(f)(3) permits the Taxpayer to elect to distribute its accumulated Subchapter C earnings and profits through a deemed dividend, which is treated as having been "distributed in money to the shareholders *in proportion to their stock ownership*." (Emphasis added.) Because a deemed dividend is distributed in proportion to the shareholders' stock ownership, the requirement that it be made on a pro rata basis is met.

The Deemed Dividend is also properly characterized as a return upon stock. The commonly understood meaning of the phrase "return on stock" is a return on one's investment in a corporation, *i.e.*, receipt of a proportionate share of the corporation's profits (as opposed to, for example, a return of contributed capital). *See, e.g.*, BLACK'S LAW DICTIONARY (9th ed. 2009) (defining "return" as "yield or profit (return on investment)"). Here, the Deemed Dividend is a distribution of the Taxpayer's accumulated Subchapter C earnings and profits to its shareholders. While the Internal Revenue Code does not define "earnings and profits" for federal income tax purposes, the term generally refers to the account that tracks the corporation's economic gains and losses. *See* Treas. Reg. § 1.312-6(b) (stating that earnings and profits must include all exempt gains as well as all gains includible in gross income). In other words, the funds distributed as the Deemed Dividend are profits realized by the Taxpayer. The distribution of such profits constitutes a return on the shareholders' investment in the Taxpayer with respect to their stock holdings.

⁵ Note that the federal income tax treatment of the transaction as a taxable dividend distribution is not controlling for state income tax purposes. The Tennessee Supreme Court has held, for example, that the revision of a federal tax law does not precipitate a revised interpretation of a corresponding but unaltered state tax law. *Tidwell v. Berke*, 532 S.W.2d 254, 261 (Tenn. 1975). Similarly, the Tennessee Court of Appeals has stated that "rulings of the federal courts in regard to federal tax laws are not binding on Tennessee courts when they are called upon to interpret Tennessee tax laws." *Little Six Corp. v. Johnson*, 1999 WL 336308 at 3 (Tenn. Ct. App. May 28, 1999).

⁶ Importantly, for purposes of the Tennessee individual income tax, the characterization of a distribution as a dividend does not depend on whether the distribution was made out of the corporation's earnings and profits. *Dobson v. Huddleston*, 863 S.W.2d at 397-98 (finding that dividends are not limited to distributions from earned surplus).

The Deemed Dividend is also a return that is paid to the Taxpayer's shareholders. One may argue that the Deemed Dividend is not paid or otherwise distributed to the shareholders because no cash, stock, or other property is actually transferred to them. However, each shareholder affirmatively consented to receive the distribution of a deemed dividend, as required by Treas. Reg. §1.1368-1(f)(5)(iii), in lieu of a direct cash distribution followed by a contribution of the cash back to the corporation. If the Taxpayer were to distribute its earnings and profits directly to the shareholders, there is no question that the distribution would constitute a dividend; the utilization of what is in essence a convenient shortcut to the same end result does not somehow alter the nature of the transaction.

Importantly, TENN. CODE ANN. § 67-2-102 does not require that cash, stock, or other property actually be transferred to the shareholders for taxable income to arise. On the contrary, TENN. CODE ANN. § 67-2-102 expressly imposes the individual income tax on persons "who received, or to whom accrued, *or to whom was credited*" taxable dividend or interest income during the taxable year (emphasis added). Thus, it is sufficient that the Taxpayer credit its shareholders with the amount of the Deemed Distribution.

Moreover, there is no general requirement that money or other property be transferred directly to a shareholder for a dividend or other type of distribution to occur. Rather, it is sufficient that a direct or indirect transfer of money or other property be made for the benefit of the shareholders. The Tennessee Business Corporation Act defines a "distribution" in pertinent part as "a **direct or indirect transfer** of money or other property (except its own shares) ... by a corporation **to or for the benefit of** its shareholders in respect of any of its shares." TENN. CODE ANN. § 48-11-201(9) (Supp. 2011) (emphasis added). Thus, under Tennessee law, as long as the Taxpayer's shareholders receive the benefit of a transfer of money in respect of their shares, a distribution has occurred. In the case of a deemed dividend election, the corporation makes a transfer of its profits for the benefit of the corporation's shareholders. In accordance with Treas. Reg. § 1.1368-1(f)(3), the deemed dividend is treated as having been distributed in money to the shareholders; as a result, each shareholder recognizes a return on his or her investment. This return is then reinvested, thereby allowing the shareholders to receive the benefit of an increase in the basis of their stock holdings. Additionally, downward adjustments to the corporation's accumulated earnings and profits account made as a result of the dividend confer a benefit on the shareholders, because such adjustments cause future distributions to not be taxed as dividends for federal income tax purposes.

Second, the Deemed Dividend does not reduce the shareholders' stock holdings, and leaves them in a position to enjoy future returns on the same stock. As discussed above, the effect of the deemed dividend is to convert retained earnings into paid-in capital, without reducing shareholder equity. Importantly, the Taxpayer's shareholders retain the same stock holdings in the same ownership percentages both before and after the Deemed Dividend. Because the shareholders retain the same stock before and after the transaction, the Deemed Dividend leaves the Taxpayer's shareholders in a position to enjoy future returns on the same stock.

Finally, the Deemed Dividend is accrued or credited to the Taxpayer's Tennessee shareholders during the taxable year at issue.

Note that no portion of the Deemed Dividend will be exempt from the Tennessee individual income tax under TENN. CODE ANN. § 67-2-104(e)(7) (2011), which provides in pertinent part that "[n]o distribution of capital shall be taxed as income under [the individual income tax laws], and no distribution of surplus by way of stock dividend shall be taxable in the year such distribution is made; but all other distributions out of earned surplus shall be taxed as income when and in whatever

manner made, regardless of when such surplus was earned.” The accounting terminology used in this exemption is fairly antiquated;⁷ in fact, the Committee on Terminology of the American Institute of Certified Public Accountants recommended the discontinuance of the term “surplus” in corporate accounting in 1949. *See* D. Edward Martin, ATTORNEY’S HANDBOOK OF ACCOUNTING, AUDITING AND FINANCIAL REPORTING § 11.02[1] (1994). Instead of the term “earned surplus,” the committee recommended “retained earnings” or “accumulated earnings,” which are in fact the terms commonly used today. *Id.* As used in TENN. CODE ANN. § 67-2-104(e)(7), the term “distribution of surplus” refers to a distribution of capital in excess of what is required for the corporation’s operations. However, distributions out of “earned surplus” (now commonly known as “accumulated earnings”) are subject to taxation. Because Treas. Reg. §1.1368-1(f)(3) requires that the Deemed Dividend be made entirely out of the Taxpayer’s accumulated earnings and profits, it follows that no portion of this distribution will be characterized as an exempt return of capital under TENN. CODE ANN. § 67-2-104(e)(7).⁸

Accordingly, the Deemed Dividend is a taxable dividend for purposes of the Tennessee individual income tax.

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General Counsel

APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: May 18, 2012

⁷ The predecessor to TENN. CODE ANN. § 67-2-104 was originally enacted in 1931.

⁸ Importantly, for purposes of the Tennessee individual income tax, the characterization of a distribution as a dividend does not depend on the source of the distribution. *See Dobson v. Huddleston*, 863 S.W.2d at 397-98 (holding that a distribution of borrowed funds constituted a taxable dividend). In contrast with the federal income tax laws, which require that a “dividend” be made out of earnings and profits (*see* I.R.C. § 316), the characterization of a distribution as a dividend for Tennessee individual income tax purposes does not depend on whether the distribution is from earnings and profits.