

TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 16-11

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

The application of the Tennessee Hall income tax to corporate distributions.

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

[TENNESSEE REIT] (the "Tennessee REIT") is a Tennessee-based real estate investment trust ("REIT") that [CONDUCTS REDACTED ACTIVITIES]. The Tennessee REIT conducts business in Tennessee and other states through various affiliates, including [TAXPAYER] (the "Taxpayer"), a Tennessee-based limited partnership.

In [REDACTED – MONTH AND YEAR], the Taxpayer acquired 100% of the stock of [REIT SUBSIDIARY] (the “REIT Subsidiary”) as the result of a merger between the Tennessee REIT and [OUT-OF-STATE REIT]. In connection with the merger, the Tennessee REIT elected to treat the REIT Subsidiary as a taxable REIT subsidiary for federal income tax purposes.¹ As a separate entity for federal income tax purposes, the REIT Subsidiary retained certain income tax attributes, such as [REDACTED].

Prior to the Merger, the REIT Subsidiary operated various commercial business enterprises through a number of [REDACTED – ENTITIES]. These commercial activities included [REDACTED ACTIVITIES]. After the merger, the REIT Subsidiary expanded its commercial lines of business by [REDACTED].

Thereafter, the Tennessee REIT adopted a primary business model focusing on [REDACTED – ACTIVITIES]. Consequently, the REIT Subsidiary discontinued its commercial business enterprises that did not fit in with the Tennessee REIT’s business model and disposed of all such commercial property except for [REDACTED],² each of which the REIT Subsidiary owns through separate, wholly-owned LLCs. The remaining assets that the REIT Subsidiary owns through its LLC interests are as follows in millions of dollars:

Distributed Assets	Net tax value	Estimated FMV
[REDACTED]	[REDACTED]	[REDACTED]
Total Assets	[DOLLAR AMOUNT]	[LESSER DOLLAR AMOUNT]

The Tennessee REIT adopted a business plan whereby it distributed to the Taxpayer the remaining assets held by the REIT Subsidiary that correspond with the Tennessee REIT’s primary business model whereby it would distribute all of the income-producing properties held by the REIT Subsidiary (the “Distribution”). After the Distribution, the REIT Subsidiary’s sole assets will consist of [REDACTED]. The assets to be distributed represent [REDACTED – PERCENTAGE] of the fair value of all assets of the REIT Subsidiary and constitute all of the current income-producing assets owned by the REIT Subsidiary. The REIT Subsidiary plans to continue to hold the remaining [ASSETS] for sale.

Through [DATE], the REIT Subsidiary has [REDACTED - DOLLAR AMOUNT] paid-in capital and an accumulated deficit of [REDACTED – DOLLAR AMOUNT]. The Taxpayer projects that the REIT Subsidiary will continue to maintain a negative retained earnings account after the distribution. The Taxpayer plans to record the Distribution as a reduction in paid-in capital.

RULING

Is the Distribution taxable income for purposes of the Tennessee Hall income tax?

Ruling: No, the Distribution constitutes a nontaxable return of capital.

ANALYSIS

The Distribution is not taxable income for purposes of the Tennessee Hall income tax.

¹ See generally I.R.C. § 856(l) (West 2016) (defining “taxable REIT subsidiary”).

² [REDACTED].

TENN. CODE ANN. § 67-2-102 (Supp. 2016) imposes the Tennessee Hall income tax at a rate of five percent on “incomes derived by way of dividends from stocks³ 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.⁴

While the Tennessee Hall income tax provisions do not define the term “dividend,”⁵ the Tennessee Supreme Court has stated that for purposes of the Hall income tax, such term must be given its “ordinary meaning”⁶ and has repeatedly stated that, for purposes of the Hall income tax, the term dividend “refers to the recurrent return upon stock paid to stockholders by a going corporation in the ordinary course of business which does not reduce their stock holdings and leaves them in a position to enjoy future returns upon the same stock.”⁷ In reaching this definition, the Tennessee Supreme Court considered the context the Hall income tax with respect to Article 2, Section 28, of the Tennessee Constitution, enabling the Legislature to levy a tax on “incomes derived from stock.”⁸ The Court found that “income,” as intended by the Legislature, constitutes “profits set apart for division among shareholders,”⁹ and that a dividend is a “distribution of such profits to the shareholder.”¹⁰ In a subsequent decision, the Tennessee Supreme Court clarified that the term “dividend” does not necessarily require earned surplus be the source of the distribution.¹¹ On the contrary, the source of funds has no bearing on whether a distribution is a dividend for Hall income tax purposes—provided that the source is not capital.¹²

³ TENN. CODE ANN. § 67-2-101(6) (2013) 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.”

⁴ The General Assembly reduced the rate of the Tennessee Hall income tax from six percent to five percent for all tax years beginning on or after January 1, 2016, and repealed the tax effective for tax years beginning on or after January 1, 2022. See 2016 Tenn. Pub. Acts Ch. 1064, §§ 1, 3 (codified at TENN. CODE ANN. §§ 67-2-102, -124 (Supp. 2016)). Additionally, the General Assembly expressed its intent to reduce the Tennessee Hall income tax “by one percent (1%) annually through enactments of general bills beginning with the first annual session of the 110th General Assembly.” *Id.* § 3 (codified at TENN. CODE ANN. § 67-2-124 (Supp. 2016)).

⁵ Note that the federal income tax treatment of the transaction as a taxable dividend distribution is not controlling for state income tax purposes. For example, distributions reported as “non-dividend distributions” on a Federal Form 1099 nonetheless may be dividends for purposes of Tennessee’s Hall income tax. Furthermore, the Tennessee Supreme Court has held 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*, No. 01-A-01-9806-CH00285, 1999 WL 336308, at *3 (Tenn. Ct. App. May 28, 1999).

⁶ *Lawrence v. MacFarland*, 354 S.W.2d 78, 81 (Tenn. 1962).

⁷ *Gallagher v. Butler*, 378 S.W.2d 161, 167 (Tenn. 1964); *Dobson v. Huddleston*, 863 S.W.2d 392, 396 (Tenn. 1993).

⁸ *Gallagher*, 378 S.W.2d at 167.

⁹ *Id.*

¹⁰ *Lawrence*, 354 S.W.2d 78, 83 (Tenn. 1962) (The income tax seeks to tax “gains realized in the field in which the tax operates over and above the taxpayers’ original investment.”); see also *Dobson*, 863 S.W.2d at 395 (“[P]roperty earned by the corporation, as distinguished from property invested therein by the shareholders, and distributed to a shareholder is subject to taxation.”).

¹¹ *Dobson*, 863 S.W.2d at 397.

¹² See *id.* at 398 (providing that a distribution of borrowed funds, which are not past earned surplus, constitutes a taxable dividend); *Lawrence*, 354 S.W.2d at 81 (“The only matter as far as the statute is concerned ‘is that complainants received

Distributions that are returns of capital are not subject to the Hall income tax.¹³ In pertinent part, TENN. CODE ANN. § 67-2-104(e)(7) states that “[n]o distribution of capital shall be taxed as income under this chapter, 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 term “capital” is not defined by statute. The Tennessee Supreme Court, however, has defined the term to mean the original amount “invested in the corporation by the stockholder.”¹⁴ The Court contrasted capital with “earned surplus,” which it defined as “property earned by the corporation as distinguished from property invested therein by the shareholders.”¹⁵ The Court found that, based on the language of TENN. CODE ANN. § 67-2-104(e)(7), the Legislature sought to tax “everything else above the original capital of the corporation as earned surplus and make it taxable.”¹⁶ Likewise, Tennessee’s appellate courts have repeatedly demonstrated that capital must, without reasonable doubt, be the only remaining value of the corporation to be distributed to shareholders,¹⁷ leading to the principle that, for purposes of the Tennessee Hall income tax, capital is returned last, and a distribution is an exempt return of capital only to the extent that it reduces the true value of the corporation below the value of property contributed by shareholders.

Whether a dividend is paid out of capital is a question of fact to be determined under the facts of the case.¹⁸ Courts have found that a corporation’s bookkeeping methods are immaterial, and instead look to the actual condition of the corporation’s assets and liabilities, as well as the “substantial and practical effect rather than to the form in which” the distributions were made.¹⁹ To establish that a distribution is a return of capital, the Tennessee Supreme Court has stated that a taxpayer must provide proof of (1) the value of “property invested therein by the shareholders,” and (2) “the actual condition of the corporation’s assets and liabilities” showing that the distribution had the “substantial and practical effect” of divesting the corporation of the contributed capital.²⁰

certain payments on account of their ownership of shares in a business concern, and that complainants’ right to such payments did not represent to complainants a return of capital originally invested by complainants in such shares.”).

¹³ TENN. CODE ANN. § 67-2-104(e)(7) (Supp. 2016)).

¹⁴ *Lawrence*, 354 S.W.2d at 83.

¹⁵ *Id.*

¹⁶ *Id.* at 82.

¹⁷ See, e.g., *Cherry v. Farr*, No. M2013-01823-COA-R3-CV, 2014 WL 1512811, at *3, *5 (Tenn. Ct. App. April 15, 2014) (The taxpayer presented evidence suggesting that a “Special Dividend” was intended to distribute “excess under-utilized capital,” that the distribution was made from a corporation with an “accumulated deficit,” and that the distribution was recorded on the corporation’s audited financial statements as reducing “paid-in capital. Nevertheless, the Tennessee Court of Appeals found this evidence did not prove that the distribution was in substance “a return of capital as distinguished from being funded by some other source or sources.”); *Dobson*, 863 S.W.2d at 397-98 (In *Dobson*, the Tennessee Supreme Court determined that the taxpayer had failed to prove a return of capital after presenting evidence that nearly two-thirds of the distribution exceeded the distributing corporation’s “earned surplus account,” because the corporation also had appreciated assets and debt secured by future earnings to fund a distribution.).

¹⁸ *Lawrence*, 354 S.W.2d at 81.

¹⁹ *Id.* at 80-81; see also *Dobson*, 863 S.W.2d at 395; *Cherry*, 2014 WL 1512811, at *3.

²⁰ *Dobson*, 863 S.W.2d at 395.

Here, the REIT Subsidiary is ending its business operations by making an extraordinary, one-time distribution to shareholders, and it is not making recurrent returns of earnings to its shareholders. Furthermore, it is clear that the source of the Distribution is capital, because the REIT Subsidiary's shareholder capital of [DOLLAR AMOUNT] is greater than the combined value of its assets prior to the distribution of [LESSER DOLLAR AMOUNT]. In other words, all that remains prior to the Distribution is shareholder capital, and the Distribution constitutes a nontaxable return of such capital for purposes of the Tennessee Hall income tax.

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APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: November 14, 2016