

**TENNESSEE DEPARTMENT OF REVENUE  
LETTER RULING # 11-55**

**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**

Whether entities formed for the purpose of securitizing trust preferred securities are exempt for purposes of the Tennessee individual income tax and the Tennessee franchise and excise taxes.

**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] is a [STATE OF ORGANIZATION] limited liability company that proposes to form one or more entities (each, the "Taxpayer Entity"), the sole purpose of which will be to securitize certain obligations that are treated as debt for federal income tax purposes (the "Instruments"). Each Taxpayer Entity will be an entity described in TENN. CODE ANN. §§ 67-2-104(e)(16)(A) (2011) and 67-4-2008(a)(10)(A) (2011).

The Instruments are commonly referred to as trust preferred securities. None of the Instruments will be obligations of natural persons. The Instruments will have a credit rating from a nationally

recognized statistical rating organization; the Taxpayer Entity's securities, which are sold to investors, will not have a credit rating. The Instruments include, but are not limited to, rated and unrated debt instruments and debentures issued by banks, other financial institutions, insurance companies, and real estate investment trusts (or their holding companies or subsidiaries thereof).

In carrying out its purpose, the Taxpayer Entity will engage in the following activities:

1. The issuance to investors in a private placement for cash one or more classes of interests evidencing ownership interests in the Taxpayer Entity.
2. The purchase of Instruments with investor funds, proceeds from payments on or proceeds from the sale of Instruments, or proceeds from funds borrowed by the Taxpayer Entity.
3. The holding of Instruments to maturity, or, at the discretion of the Taxpayer Entity, the sale of the Instruments prior to maturity if the fair market value of the Instruments increases or to avoid a loss or further loss in the investment in the Instruments.
4. The temporary investment in debt obligations with a high credit rating (except as provided below, in no event for a duration of more than six months) ("liquid investments") of either i) funds from investors until the funds are invested in Instruments, or ii) proceeds from the sale of or payments on the Instruments until a distribution is made to investors, either as a current distribution or as a redemption, or until invested in new Instruments.
5. Any other activities necessary or related to the foregoing.

The Taxpayer Entity may hold liquid investments longer than six months if an investor is redeemed in whole or in part and pursuant to the applicable formation documents of the entity. The Taxpayer Entity may hold a small percentage (but not more than ten percent of such redeemed interest) of such funds (i) as a reserve for contingent obligations until the amount of the contingency can be determined or (ii) if the fair market value of the redeemed interest cannot be determined at the time of redemption, until such time as the fair market can be determined, but in either case no later than the date of the issuance of the audited financial statements of the Taxpayer Entity for the period including the date of the redemption.

The Taxpayer Entity will not issue to investors any transferable certificate or other transferable evidence of the investor's interest in the Taxpayer Entity.

## **RULINGS**

1. Does the obligation of an obligor that (i) is issued by a person who is not a natural person and (ii) constitutes debt for federal income tax purposes qualify as a "debt obligation" within the meaning of TENN. CODE ANN. §§ 67-2-104(e)(16)(B) (2011) and 67-4-2008(a)(10)(B) (2011)?

**Ruling:** An obligation that (i) is issued by a person that is not a natural person and (ii) constitutes debt for federal income tax purposes will qualify as a "debt obligation" within the meaning of TENN. CODE ANN. §§ 67-2-104(e)(16)(B) (2011) and 67-4-2008(a)(10)(B) (2011) only if such obligation is a mortgage, home equity loan, trade receivable, obligation substituted for a trade receivable, credit card receivable, personal property

lease treated as debt for purposes of the Internal Revenue Code, automobile loan, or similar debt obligation.

2. If a Taxpayer Entity carries on only the activities described herein, is the sole purpose of the Taxpayer Entity properly characterized as the asset-backed securitization of debt obligations within the meaning of TENN. CODE ANN. §§ 67-2-104(e)(16)(B) (2011) and 67-4-2008(a)(10)(B) (2011)?

Ruling: No. If a Taxpayer Entity carries on only the activities described herein, the sole purpose of the Taxpayer Entity is not properly characterized as the asset-backed securitization of “debt obligations” within the meaning of TENN. CODE ANN. §§ 67-2-104(e)(16) (2011) and 67-4-2008(a)(10) (2011).

3. Is the Taxpayer Entity exempt for purposes of the Tennessee individual income tax?

Ruling: No. The Taxpayer Entities are not exempt for purposes of the Tennessee individual income tax.

4. Is the Taxpayer Entity exempt for purposes of the Tennessee franchise and excise taxes?

Ruling: No. The Taxpayer Entities are not exempt for purposes of the Tennessee franchise and excise taxes.

5. Are distributions by the Taxpayer Entity subject to the Tennessee individual income tax?

Ruling: A distribution from a particular Taxpayer Entity will be subject to the Tennessee individual income tax to the extent that such distribution constitutes a dividend from stock or interest on a bond, as such terms are defined for Tennessee individual income tax purposes.

## ANALYSIS

TENN. CODE ANN. § 67-2-102 (2011) imposes the individual income tax at the rate of 6% on the “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 was credited, such income during the taxable year. TENN. CODE ANN. § 67-2-101(5) (2011) defines the term “person” in pertinent part as “every natural person, inhabitant, resident, beneficiary of every trust or estate, partnership, joint-stock company, business trust, corporation or any other form of organization” in receipt of taxable income.

Additionally, Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons, as the term is defined for franchise and excise tax purposes, that are doing business within Tennessee. TENN. CODE ANN. § 67-4-2007(a) (2011). Tennessee also imposes a franchise tax on all persons doing business within Tennessee, at the rate of \$0.25 per \$100, or major fraction thereof, of a taxpayer’s net worth.<sup>1</sup> TENN. CODE ANN. §§ 67-4-2105(a) (2011) and 67-4-

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<sup>1</sup> Note that, under TENN. CODE ANN. § 67-4-2108(a)(1) (2011), the franchise tax base “shall in no case be less than the actual value of the real or tangible property owned or used in Tennessee, excluding exempt inventory and exempt required capital investments.” For purposes of this section, “property” is to be “valued at cost less

2106(a) (2011). Persons subject to the Tennessee franchise and excise taxes include, but are not limited to, corporations, limited partnerships, limited liability partnerships, limited liability companies, and business trusts. TENN. CODE ANN. § 67-4-2004(37) (2011).

TENN. CODE ANN. § 67-2-104(e)(16) (2011) exempts from the Tennessee individual income tax certain entities whose sole purpose is the asset-backed securitization of debt obligations. TENN. CODE ANN. § 67-4-2008(a)(10) (2011) provides a similar exemption from the Tennessee franchise and excise taxes for such entities.<sup>2</sup>

To qualify for the exemption, the taxpayer first must (i) be classified as a partnership or trust for federal income tax purposes; (ii) have elected to be treated as a real estate mortgage investment conduit (REMIC) under I.R.C. § 860D; (iii) have elected to be treated as a financial asset securitization investment trust (FASIT) under I.R.C. § 860L; or (iv) be a business trust as defined in TENN. CODE ANN. § 48-101-202(a), or, when the commercial domicile of the trustee is not in Tennessee, be classified as a trust under the laws of the state in which it is created and be disregarded for federal income tax purposes. TENN. CODE ANN. §§ 67-2-104(e)(16)(A) and 67-4-2008(a)(10)(A).

Additionally, TENN. CODE ANN. §§ 67-2-104(e)(16)(B) and 67-4-2008(a)(10)(B) require that the “sole purpose of the entity, except for foreclosures and dispositions of the assets of foreclosures, is the asset-backed securitization of debt obligations, such as first or second mortgages, including home equity loans, trade receivables, whether an open account or evidenced by a note or installment or conditional sales contract, obligations substituted for trade receivables, credit card receivables, personal property leases treated as debt for purposes of the Internal Revenue Code of 1986, compiled in 26 U.S.C., home equity loans, automobile loans or similar debt obligations.”

Thus, to qualify for the exemption, the Taxpayer Entity first must be described in TENN. CODE ANN. §§ 67-2-104(e)(16)(A) and 67-4-2008(a)(10)(A). Second, the Taxpayer Entity must have as its sole purpose, except for foreclosures and dispositions of the assets of foreclosures, the asset-backed securitization of debt obligations.

[REDACTED] has indicated that each Taxpayer Entity will be of a type described in TENN. CODE ANN. §§ 67-2-104(e)(16)(A) and 67-4-2008(a)(10)(A). Accordingly, this letter ruling will assume that each Taxpayer Entity meets the first requirement for exemption.

1. Debt obligations under TENN. CODE ANN. §§ 67-2-104(e)(16)(B) (Supp. 2010) and 67-4-2008(a)(10)(B) (Supp. 2010)

An obligation that (i) is issued by a person who is not a natural person and (ii) constitutes debt for federal income tax purposes will qualify as a “debt obligation” within the meaning of TENN. CODE ANN. §§ 67-2-104(e)(16)(B) and 67-4-2008(a)(10)(B), provided that such obligation is a mortgage, home equity loan, trade receivable, obligation substituted for a trade receivable, credit

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accumulated depreciation in accordance with generally accepted accounting principles.” TENN. CODE ANN. § 67-4-2108(a)(3).

<sup>2</sup> TENN. CODE ANN. § 67-4-2105(a) provides an exemption from the Tennessee franchise tax for any entity exempt from the excise tax under the provisions of TENN. CODE ANN. § 67-4-2008.

card receivable, personal property lease treated as debt for purposes of the Internal Revenue Code, automobile loan, or similar debt obligation.

There is no statutory requirement that the debt be of a natural person in order to qualify as a “debt obligation” for purposes of TENN. CODE ANN. §§ 67-2-104(e)(16)(B) and 67-4-2008(a)(10)(B). Accordingly, the fact that an obligation is issued by a person who is not a natural person will not preclude the obligation from qualifying as a “debt obligation” within the meaning of the exemptions at issue.

Note that the federal tax characterization of obligations as debt or equity is not controlling for purposes of the exemption found under TENN. CODE ANN. §§ 67-2-104(e)(16) and 67-4-2008(a)(10).<sup>3</sup> Rather, the obligation must be one of the types of obligations listed above or a similar type of obligation. Therefore, an obligation that is treated as debt for federal income tax purposes will not automatically qualify as a “debt obligation” for purposes of the exemption.

## 2. Characterization of Taxpayer Entity’s purpose.

If a Taxpayer Entity carries on only the activities described herein, the sole purpose of the Taxpayer Entity is not properly characterized as the asset-backed securitization of “debt obligations” within the meaning of TENN. CODE ANN. §§ 67-2-104(e)(16) and 67-4-2008(a)(10).

Neither the Tennessee Code nor the Tennessee courts have defined the term “debt obligation” for purposes of the Tennessee franchise and excise taxes or the Tennessee individual income tax. However, TENN. CODE ANN. §§ 67-2-104(e)(16)(B) and 67-4-2008(a)(10)(B) provide examples of what constitutes a “debt obligation” for purposes of the exemption at issue. In particular, an obligation will qualify if it is a mortgage, home equity loan, trade receivable, obligation substituted for a trade receivable, credit card receivable, personal property lease treated as debt for purposes of the Internal Revenue Code, automobile loan, or similar debt obligation.

In ascertaining the meaning of a statute, the Tennessee Supreme Court has stated that one must examine “the natural and ordinary meaning of the statutory language within the context of the entire statute without any forced or subtle construction that would extend or limit the statute’s meaning.” *Home Builders Ass’n of Middle Tennessee v. Williamson County*, 304 S.W.3d 812, 817 (Tenn. 2010). Thus, to constitute a debt obligation, an Instrument must be among the specific examples listed in the statute; similar to an obligation listed in the statute; or characterizable as a “debt obligation” in the ordinary sense of the word.

For the reasons explained below, the Instruments are not properly characterized as debt obligations for purposes of the exemptions at issue.

The facts state that the Instruments are trust preferred securities and include rated and unrated debt instruments and debentures issued by banks, other financial institutions, insurance

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<sup>3</sup> 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); *See also Tidwell v. Berke*, 532 S.W.2d 254, 261 (Tenn. 1975) (finding that the revision of a federal tax law does not precipitate a revised interpretation of a corresponding but unaltered state tax law). Therefore, federal income tax laws are not controlling with respect to the interpretation of what constitutes a debt obligation for Tennessee tax purposes.

companies, and real estate investment trusts. Trust preferred securities are hybrid securities that have debt characteristics that provide preferential treatment as debt for federal income tax purposes. However, trust preferred securities also have equity characteristics that allow bank holding companies to count the securities as capital for regulatory purposes. Angelee J. Harris, Trust Preferred Securities Still Eligible for Tier 1 Capital Treatment; New Rules Are A Compromise, 121 BANKING L.J. 688, 689 (2004). Such instruments are essentially mechanisms for the raising of capital by a business enterprise; for regulatory purposes, trust preferred securities count as Tier 1 Capital<sup>4</sup> at the holding company level, provided that certain requirements are met. Katherine M. Koops, Robert D. Klingler, Financing Growth, 121 BANKING L.J. 675, 677 (2004).

First, the Instruments purchased and held by the Taxpayer Entities are not among the specific examples provided under TENN. CODE ANN. §§ 67-2-104(e)(16)(B) and 67-4-2008(a)(10)(B).<sup>5</sup>

Second, the Instruments are not sufficiently similar to the debt obligations listed under TENN. CODE ANN. §§ 67-2-104(e)(16)(B) and § 67-4-2008(a)(10)(B) so as to bring them within the scope of the exemptions. The types of obligations provided as examples in these subsections generally arise out of commerce from the sale of goods or services or the extension of consumer credit. In contrast, the Instruments are trust preferred securities, which are essentially mechanisms for the raising of capital by a business enterprise. The Instruments do not represent receivables, loans, extensions of consumer credit, or similar obligations.

For the same reason, the Instruments cannot generally be characterized as “debt obligations” for purposes of the exemptions. As noted above, the Instruments are essentially mechanisms for the raising of capital by a business enterprise. Trust preferred securities such as the Instruments are hybrid securities that do in fact have debt characteristics; however, trust preferred securities also have equity characteristics.

The burden is on the taxpayer to establish entitlement to an exemption from taxation. The Tennessee Supreme Court has stated that “[a]lthough the rule is well-established that taxing legislation should be liberally construed in favor of the taxpayer and strictly construed against the taxing authority, it is an equally important principle of Tennessee tax law that ‘exemptions from taxation are construed against the taxpayer who must shoulder the heavy and exacting burden of proving the exemption.’” *Am. Airlines, Inc. v. Johnson*, 56 S.W.3d 502, 506 (Tenn. Ct. App. 2000) (quoting *Rogers Group, Inc. v. Huddleston*, 900 S.W.2d 34, 36 (Tenn. Ct. App. 1995)). The Tennessee Supreme Court has also stated that the burden is on the taxpayer to

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<sup>4</sup> Tier 1 capital is the core measure of a bank’s financial strength from a regulator’s point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include non-redeemable non-cumulative preferred stock.

<sup>5</sup> The taxpayer has suggested that the Instruments should be considered trade receivables because debt obligations held for investment or sale by a bank can be treated as inventory under generally accepted accounting principles (“GAAP”). TENN. CODE ANN. §§ 67-2-104(e)(16)(B)(ii) and 67-4-2008(a)(10)(B)(ii) define the term “trade receivables” as “obligations arising from the sale of inventory in the ordinary course of business.” While the Instruments are issued in the ordinary course of business, they do not arise from the sale of “inventory” in the ordinary sense of the word. Here, the ordinary meaning of the term “inventory,” as used in the context of the exemption provision, refers to inventories of goods held for sale. Characterizing a bank’s debt obligations as inventory on the basis that GAAP permits it would constitute a forced or subtle construction that would extend or limit the statute’s meaning. *See Home Builders Ass’n of Middle Tennessee*, 304 S.W.3d at 318.

establish the exemption, and any well-founded doubt is sufficient to defeat a claimed exemption from taxation. *Am. Airlines*, 56 S.W.3d at 506 (citing *Tibbals Flooring Co. v. Huddleston*, 891 S.W.2d 196, 198 (Tenn. 1994); *United Cannery, Inc. v. King*, 696 S.W.2d 525, 527 (Tenn. 1985)).

Here, sufficient doubt exists as to the characterization of the Instruments as debt obligations, as the term is used under TENN. CODE ANN. §§ 67-2-104(e)(16)(B) and 67-4-2008(a)(10)(B).

Accordingly, if a Taxpayer Entity carries on only the activities described herein, the sole purpose of the Taxpayer Entity is not properly characterized as the asset-backed securitization of “debt obligations” within the meaning of TENN. CODE ANN. §§ 67-2-104(e)(16) and 67-4-2008(a)(10).

### 3. Exemption from Tennessee individual income tax

The Taxpayer Entities are not exempt for purposes of the Tennessee individual income tax under TENN. CODE ANN. § 67-2-104(e)(16).

For the reasons set forth in the response to Question #2, above, the Instruments do not qualify as debt obligations for purposes of the exemption under TENN. CODE ANN. § 67-2-104(e)(16). Because the Instruments do not qualify as debt obligations, the Taxpayer Entities do not meet the requirement under TENN. CODE ANN. § 67-2-104(e)(16) that the “sole purpose of the entity, except for foreclosures and dispositions of the assets of foreclosures, is the asset-backed securitization of debt obligations.” As a result, the Taxpayer Entities do not qualify for this exemption.

### 4. Exemption from Tennessee franchise and excise taxes

The Taxpayer Entities are not exempt for purposes of the Tennessee franchise and excise taxes under TENN. CODE ANN. § 67-4-2008(a)(10).

For the reasons set forth in the response to Question #2, above, the Instruments do not qualify as debt obligations for purposes of the exemption under TENN. CODE ANN. § 67-4-2008(a)(10). Because the Instruments do not qualify as debt obligations, the Taxpayer Entities do not meet the requirement under TENN. CODE ANN. § 67-4-2008(a)(10) that the “sole purpose of the entity, except for foreclosures and dispositions of the assets of foreclosures, is the asset-backed securitization of debt obligations.” As a result, the Taxpayer Entities do not qualify for this exemption.

### 5. Distributions

A distribution from a particular Taxpayer Entity will be subject to the Tennessee individual income tax to the extent that such distribution constitutes a dividend from stock or interest on a bond, as such terms are defined for Tennessee individual income tax purposes.

As noted above, TENN. CODE ANN. § 67-2-102 imposes the individual income tax at the rate of six percent on the “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 was credited, such income during the taxable year. Thus, to

be subject to the individual income tax, a distribution must be characterized as either a dividend from stock or interest on a bond.

With certain exceptions, TENN. CODE ANN. § 67-2-101(1) defines the term “bonds” in pertinent part as “all obligations issued by any person ... evidenced by an instrument whereby the obligor is bound to pay interest to the obligee.” TENN. CODE ANN. § 67-2-101(6) defines the term “stock” to include “shares of stock issued by corporations” and “all interests in partnerships, associations, or trusts represented by transferable evidence of such interest.”

[REDACTED] has not provided details regarding choice of entity with respect to the Taxpayer Entities. However, distributions from a Taxpayer Entity will be subject to the Tennessee individual income tax to the extent that such distributions are properly characterized under TENN. CODE ANN. §§ 67-2-101(1) or (6) as dividends from stock or interest on a bond.

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Commissioner of Revenue

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