

**TENNESSEE DEPARTMENT OF REVENUE  
LETTER RULING #94-03**

**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**

Application of the Tennessee Hall Income Tax (T.C.A. § 67-2-101 et seq.) to capital gain income distributed to Tennessee shareholders by qualified regulated investment companies known as the [X FUND] and the [Y FUND] (the Tennessee Funds" when such gains are attributable either directly to disposition of bonds exempt for income tax purposes or attributable to disposition of such bonds by a foreign Common Law Trust in which the Tennessee Funds have invested more than ninety percent (90%) of their assets.

**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, but applicable only to the individual taxpayers 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 his detriment.

## FACTS

The [TRUST] (the “Trust”) is a business trust organized under the laws of the Commonwealth of Massachusetts and registered with the Securities Exchange Commission as an open-end management investment company under the Investment Company Act of 1940. The Trust consists of a number of independently managed funds, each of which seeks to provide shareholders with income exempt from both federal income taxes and income taxes of the state to which the fund relates and in which its shareholders reside.

The funds for Tennessee (the “Tennessee Funds”) are the [X FUND] and the [Y FUND]. They, as well as other funds of the Trust, each have qualified or will qualify for treatment as a separate regulated investment company (“RIC”) under §§ 851-855 of the Internal Revenue Code. The Tennessee Funds invest substantially all (more than 90%) of their gross assets in the Tennessee Tax Free Portfolio (the “Hub”). The Hub is organized as a common law trust and invests primarily (at least 80% of its net assets) in bonds, the interest on which is exempt from both federal and Tennessee income taxation. Exempt investments of the Hub and the Tennessee Funds will include bonds issued by any of the following entities (collectively, “Exempt Bonds”):

- (a) Tennessee and its counties, municipalities, and political subdivisions, including any agency, board, authority, or commission of any of the foregoing;
- (b) The United States Government and any agency or instrumentality thereof;
- (c) Guam;
- (d) Puerto Rico; and
- (e) United States Virgin Islands.

The Hub and the Tennessee Funds are organized outside Tennessee, and none of them have a physical location in Tennessee. The Hub has not and will not issue a certificate to either Tennessee Fund representing its interest in the Hub. Such interest must be purchased from the Hub and is not transferable, but it may be redeemed by the Hub.

Neither Tennessee Fund ordinarily issues certificates to its shareholders representing their interests in the Fund. If a shareholder requests a certificate, however, it will be issued. Such certificate of interest would be transferable to a third party, but as a practical matter this would seldom, if ever, be done. The usual way for a shareholder to divest his interest

purchased from either Tennessee Fund would be for the fund to redeem the interest and also the certificate if the shareholder had a certificate.

Although the Hub is organized as a common law trust, it is recognized as a partnership for federal income tax purposes. Each Tennessee Fund is deemed to own a proportionate share of the assets and income of the Hub for purposes of determining whether it satisfies all the requirements of Internal Revenue Code §§ 851(b) and 852(b)(5). As a RIC, each Tennessee Fund has been or will be treated for federal income tax purposes as a “pass-through” entity as long as it meets, as it expects to do, certain tests. Thus, neither Tennessee Fund will be subject to federal income tax on its net investment or capital gain income recognized during any taxable year and distributed to its shareholders.

Tax exempt interest and capital gain income recognized by the Tennessee Funds either directly or through the Hub will, for federal income tax purposes, be treated as exempt interest or capital gain income, respectively, in the hands of shareholders receiving distributions of such interest or capital gain income from the funds as long as the funds meet, as they expect to do, certain tests.

In letter Ruling #93-01, the Tennessee Department of Revenue ruled that dividends paid by the Tennessee Fund to Tennessee resident shareholders and attributable either directly, or indirectly through the Hub, to the named exempt investments are not subject to the Tennessee Hall Income Tax under T.C.A. § 67-2-101 et seq.

## ISSUE

Are dividend distributions from either Tennessee fund that are attributable to fund or Hub capital gain income from the sale, exchange, redemption, payment at maturity or other disposition of exempt bonds subject to Tennessee Hall Income Taxation?

## RULING

No.

## ANALYSIS

### ***CAPITAL GAINS DISTRIBUTED TO SHAREHOLDERS OF A REGULATED INVESTMENT COMPANY ARE DIVIDENDS FOR PURPOSES OF THE TENNESSEE HALL INCOME TAX***

T.C.A. § 67-2-102 imposes the Tennessee Hall Income Tax as follows:

“An income tax in the amount of six percent (6%) per annum shall be levied and collected on incomes derived by way of dividends from stocks .

. . . of each person . . . in the State of Tennessee who received, or to whom accrued, or to whom was credited during any year income from the sources above enumerated, except as hereafter provided.”

Stocks are defined by T.C.A. § 67-2-101(6) as follows:

“Stocks” means shares of stock issued by corporations . . . and all interests in partnerships, associations, or trusts represented by transferable evidence of such interest”.

The Tennessee Supreme Court has held that the word “dividends” must be given its ordinary meaning and that profit made by a corporation becomes income to a stockholder only when distributed to him in the form of dividends. According to the Supreme Court, pro rata distributions of gains realized by an investment company upon disposition of securities held in its investment portfolio are dividends for purposes of the Tennessee Hall Income Tax. *Gallagher v. Butler*, 378 S.W.2d 161 at 165 (Tenn. 1964) citing *Lawrence v. MacFarland*, 354 S.W.2d 78 (Tenn. 1962).

The distributions by the Tennessee Funds to their Tennessee shareholders are dividends for Tennessee Hall Income Tax purposes regardless of whether they are attributable to dividend, interest, or capital gain income earned by the funds or the Hub. Such dividends are subject to the Tennessee Hall Income Tax in the hands of Tennessee shareholders unless otherwise exempted by law.

***DIVIDENDS ATTRIBUTABLE DIRECTLY TO INVESTMENTS BY THE TENNESSEE FUNDS IN EXEMPT SECURITIES OR INDIRECTLY TO INVESTMENTS BY THE HUB IN EXEMPT SECURITIES ARE EXEMPT FROM TENNESSEE HALL INCOME TAXATION***

Prior to the enactment of Chapter 347 of the Public Acts of 1977, all dividend distributions from a regulated investment company were subject to the Tennessee Hall Income Tax in the hands of a Tennessee shareholder without regard to the type of investments held by the investment company or whether money used to pay the dividends was earned from interest on bonds, dividends on stocks, capital gains from disposition of stocks or bonds, or from some other source. See: *Lawrence v. MacFarland*, 354 S.W.2d 78 (Tenn. 1962). The enactment of Public Chapter 347 (T.C.A. § 67-2-104(f)) made the tax inapplicable to dividend distributions regardless of how they were earned, if the investment fund had at least 75% of the value of its investments in Tennessee state or local bonds.

In 1992 the Tennessee legislature passed Chapter 931 of the Public Acts of 1992 which amended T.C.A. § 67-2-104(f) to its present language a follows:

“Nothing contained in this chapter shall be construed or held to authorize the levy of an income tax on dividends from a regulated investment company qualified as such under subchapter M, chapter 1, subtitle A of

the Internal Revenue Code (26 U.S.C. §§ 851-860G); provided, that a part of the value of the investments of such regulated investment company shall be in any combination of bonds or securities of the United States Government or any agency or instrumentality thereof or in bonds of the State of Tennessee, or any county or any municipality or political subdivision thereof, including any agency, board, authority or commission of any of the above. Such dividends shall be exempt from the levy of an income tax only in proportion to the income of the regulated investment company attributable to interest on bonds or securities of the United States government or any agency or instrumentality thereof or on bonds of the State of Tennessee, or any county or any municipality or political subdivision thereof, including any agency, board, authority or commission of any of the above”.

Resolution of the issue presented by the taxpayer’s factual situation is dependent upon the construction of the above quoted statute. The basic rule of statutory construction in Tennessee is to ascertain the legislative purpose and intent as expressed in the statute itself. Such intent and purpose is derived primarily from the natural and ordinary meaning of the language contained therein when read in context with the whole statute. *James Cable Partners v. Jamestown*, 818 S.W.2d 338 at 341 (Tenn. App. 1991) citing *Metropolitan Government of Nashville and Davidson County v. Motel Systems, Inc.*, 525 S.W.2d 840 (Tenn. 1975) and *Worrall v. Kroger Co.*, 545 S.W.2d 836 (Tenn. 1977). It is also appropriate to consider the caption of a bill when seeking its legislative intent. *Hyatt v. Taylor*, 788 S.W.2d 554 at 556 (Tenn. 1990) citing *Dorrier v. Dark*, 537 S.W.2d 888, 892 (Tenn. 1976). A statute is passed as a whole and not in parts and is animated by one general purpose and intent. Consequently, each part or section should be construed in connection with every other part or section so as to produce a harmonious whole. Effect must be given to all provisions of a statute so that no part will be inoperative or superfluous, void or insignificant, and so that one section will not destroy another unless the provision is the result of an obvious mistake or error. Sutherland, *Statutory Construction*, Literal Interpretation, §§ 46.05 and 46.06 (4th Ed). A statute should be given construction which promotes the purpose and object of the act. *Carter v. Jett*, 370 S.W.2d 576 (Tenn. 1963).

When considered as a whole, the object and purpose of Chapter 971 of the Public Acts of 1992 is to exempt from the income tax all distributions from regulated investment companies attributable to investments in U.S. and Tennessee obligations. The first sentence of the above quoted statute prohibits income taxation of dividends from a regulated investment company whose investments are in any combination of bonds or securities of the United States government or its instrumentalities or bonds of the State of Tennessee or its counties, municipalities or political subdivisions. The second sentence of the statute is designed and functions to determine the amount of dividend distributions exempt when part of the investment company’s investments are in non-exempt securities. In such cases the amount exempt is proportional to the company’s income attributable to the exempt investments.

The bill's caption describes it as "AN ACT to amend Tennessee Code Annotated, Title 67, Chapter 2, relative to the taxation of *income* from stocks and bonds." (Emphasis Added). The legislature has made no effort, either by the caption or by the language of the act itself, to divide the "income" earned from stocks and bonds into parts except as it is attributable to exempt or non-exempt investments.

The word "interest" in the second sentence of the Act does not limit the first sentence exemption of regulated investment company dividend distributions attributable to exempt securities. It only explains that the amount of dividend distributions exempt will be proportional to income, such as interest, earned from the exempt securities when the investment company earns a part of its income from investment in non-exempt securities. To interpret the second sentence of the Act containing the word "interest" in any other way would defeat the legislative intent and purpose of the Act and the exemption granted in the first sentence for dividend distributions attributable to income from exempt securities.

In Letter Ruling #93-01 the Tennessee Department of Revenue ruled that dividends paid by a regulated investment company [X FUND] to Tennessee resident shareholders and attributable either directly, or indirectly through the Hub, to the named exempt investments fall within the exemption set forth in T.C.A. § 67-2-104(f) and are not subject to the Tennessee Hall Income Tax. Having found that the capital gains earned by the Tennessee Funds, or by the Hub, from disposition of the exempt securities in question are, for Tennessee Hall Income Tax purposes, "Dividends" when distributed by the Tennessee Funds to Tennessee Shareholders, it follows that they are exempt from the Tennessee Hall Income Tax under T.C.A. § 67-2-104(f) to the extent they are attributable to any type of income from exempt securities, including capital gain income from their disposition.

Arnold B. Clapp, Special Counsel

APPROVED: Joe Huddleston

DATE: March 16, 1994