

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 14-09**

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 individual 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

The Taxpayer is a Tennessee resident and has been since [YEAR ONE]. In late [YEAR SIX], the Taxpayer accepted an offer of employment at [CORPORATION] (the "Corporation"). As part of the employment agreement, the Corporation provided the Taxpayer with options, vesting over five years, on [NUMBER] shares of the Corporation's common stock. On [DATE, YEAR TEN], the Taxpayer exercised his vested options to acquire [NUMBER] shares of common stock in the Corporation at [\$ AMOUNT] per share.

In January [YEAR ELEVEN], the Corporation formed a subsidiary limited liability company, [SUBSIDIARY] (the “Subsidiary”). The Corporation subsequently sold twenty-five percent (25%) of the Subsidiary to a third party. Contemporaneous with or shortly after this sale, the Corporation made a cash distribution to its shareholders (the “January Distribution”), which the Corporation depicted as a distribution of proceeds from the partial sale of the Subsidiary. Over the course of [YEAR ELEVEN], the Corporation made four additional cash distributions to its shareholders (the “Additional Distributions”).

The Taxpayer received [\$ AMOUNT] from the January Distribution and another [\$ AMOUNT] from the four other distributions made in the same year. None of the distributions reduced the number of the Taxpayer’s shares or the Taxpayer’s proportionate interest in the Corporation. The Corporation remains a going concern following the distributions.

RULINGS

1. Are the January Distribution and the Additional Distributions properly characterized as dividends for purposes of the Tennessee individual income tax?

Ruling: Yes. The January Distribution and the Additional Distributions are dividends for purposes of the Tennessee individual income tax.

2. Is any portion of the January Distribution or the Additional Distributions properly considered a return of capital, which is exempt from the Tennessee individual income tax under TENN. CODE ANN. § 67-2-104(e)(7) (2013)?

Ruling: No. No portion of the January Distribution or the Additional Distributions is a return of capital that is exempt from the Tennessee individual income tax.

ANALYSIS

1. DEFINITION OF A “DIVIDEND” FOR TENNESSEE INDIVIDUAL INCOME TAX PURPOSES

The January Distribution and Additional Distributions are dividends for purposes of the Tennessee individual income tax.

TENN. CODE ANN. § 67-2-102 (2013) imposes the Tennessee individual income tax at a 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.

¹ 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.”

While the Tennessee individual income tax provisions do not define the term “dividend,”² the Tennessee Supreme Court has repeatedly stated that, for purposes of the individual 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.”³

Distributions to shareholders are presumed to represent the recurrent return upon stock made in the ordinary course of business when (1) the distributing corporation is a “going concern” after the distribution, (2) the distribution does not reduce the recipients’ proportionate share of stock, and (3) the distribution does not alter the recipients’ position to enjoy future returns upon their stock.⁴

Each of the five distributions that the Taxpayer received falls within the definition of a “dividend” as established by the Tennessee courts. The Taxpayer has indicated that his proportionate share of stock and his position to enjoy future returns have not changed after each distribution and that the Corporation has remained a going concern after each of the distributions. Accordingly, the January Distribution and the Additional Distributions satisfy the three elements that are sufficient to characterize each distribution as a dividend.

As a general matter, the source of funds for a corporate distribution has no bearing on whether a distribution is a dividend for individual income tax purposes.⁵ The Tennessee Supreme Court has held “that it was the intention of the Legislature . . . to tax the total amount of revenue produced by stocks and bonds and that in passing the law the Legislature clearly did not intend in the administration of the law that the administrators thereof have the burden of tracing dividends to the source – the contrary is true.”⁶ To that end, distinctions made by bookkeeping methods or methods of federal income tax reporting, such as whether a distribution exceeds earnings and profits, are not determinative of whether a distribution is a dividend for purposes of the individual income tax.⁷ Thus, whether or not the January Distribution was funded by proceeds from the Corporation’s partial sale of the Subsidiary is not relevant when determining whether the distribution is a dividend for Tennessee individual income tax purposes.

² 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 individual 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).

³ *Dobson v. Huddleston*, 863 S.W.2d 392, 396 (Tenn. 1993) (quoting *Gallagher v. Butler*, 378 S.W.2d 161, 167 (Tenn. 1964)).

⁴ See *Cherry v. Farr*, No. M2013-01823-COA-R3-CV, 2014 WL 1512811, at *4 (Tenn. Ct. App. April 15, 2014), cert. denied, No. M2013-01823-SC-R11-CV (Tenn. Aug. 26, 2014).

⁵ An exception to this general rule is exempt distributions from capital, which are discussed in the second part of this ruling. See TENN. CODE ANN. § 67-2-104(e)(7).

⁶ *Lawrence v. MacFarland*, 354 S.W.2d 78, 80 (Tenn. 1962). See also *Dobson*, 863 S.W.2d at 397-98.

⁷ *Id.* at 81-82.

Accordingly, because the Corporation continues as a “going concern,” nothing has impaired the Taxpayer’s position to enjoy future distributions from the Corporation, and the Taxpayer’s proportionate right to future distributions remains undiminished. Therefore, the January Distribution and the Additional Distributions are properly characterized as dividends for purposes of the individual income tax.

2. EXEMPT RETURNS OF CAPITAL

The facts presented do not establish that any portion of the January Distribution or the Additional Distributions is a return of capital exempt from the Tennessee individual income tax under TENN. CODE ANN. § 67-2-104(e)(7).

Distributions that are properly characterized as returns of capital are exempt from the Tennessee individual income tax.⁸ 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.”

Distributions qualify as exempt returns of capital only when the value of property invested by shareholders is the sole remaining value in the corporation. As a tax exemption, TENN. CODE ANN. § 67-2-104(e)(7) is “strictly construed against the taxpayer and the burden is on the taxpayer to establish his exemption. Furthermore, every presumption is against the exemption and a well-founded doubt is fatal to the claim.”⁹ Accordingly, to establish a right to the exemption, 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) “proof of 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.¹⁰

Tennessee’s appellate courts have repeatedly demonstrated that this burden cannot be met unless capital is, without reasonable doubt, the only remaining value of the corporation to be distributed to shareholders. In *Cherry v. Farr*, for example, 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.”¹¹ 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.”¹² Similarly, the Tennessee Supreme Court in *Dobson v. Huddleston* 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

⁸ TENN. CODE ANN. § 67-2-104(e)(7) (2013).

⁹ *Cherry*, 2014 WL 1512811, at *3 (citations omitted) (internal quotation marks omitted).

¹⁰ *Dobson*, 863 S.W.2d at 395.

¹¹ *Cherry*, at *3.

¹² *Id.* at *5.

account,” because the corporation also had appreciated assets and debt secured by future earnings to fund a distribution.¹³

All of this precedent can be condensed into the simple principle that, for purposes of the Tennessee individual income tax, capital is returned last. To the extent that the distributing entity can continue to conduct business and has sufficient funds or sufficiently valuable assets to finance a distribution without returning capital, a well-founded doubt must exist as to whether “capital was in fact *the source* of the funds.”¹⁴ For a distribution to be an exempt return of capital, the distribution must reduce the true value of the corporation below the value of property contributed by shareholders.

The asserted fact that the January Distribution was made out of the proceeds of selling a capital asset is insufficient to show a return of capital for purposes of the Tennessee individual income tax. To qualify for the return of capital exemption, at least some portion of the January Distribution or the Additional Distributions must have reduced the true value of the Corporation below the amount of capital actually contributed by shareholders. Without evidence of (1) the amount of capital actually contributed by shareholders and (2) the true value of the Corporation after the distributions, the Taxpayer cannot establish a right to the return of capital exemption.

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APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: October 6, 2014

¹³ *Dobson*, 863 S.W.2d at 397-98.

¹⁴ *Cherry*, 2014 WL 1512811, at *5 (emphasis in original).