

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #96-07**

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 a partnership to be formed by members of the [TAXPAYER'S] family will be subject to the Tennessee Income Tax, better known as the Hall Income Tax.

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 his detriment.

FACTS

In order to unify, simplify, and control management of investments and savings of certain members of [THE TAXPAYER'S] family, [THE TAXPAYER] and his wife, [NAME] of [CITY], Tennessee, propose to form a partnership (Partnership). The proposed Partnership will be formed under the laws of [STATE A - NOT TENNESSEE]. The

resident Agent of the Partnership will be a law firm located in [CITY], [STATE A - NOT TENNESSEE]. The address of the Partnership will be that of the [CITY], [STATE A - NOT TENNESSEE] law firm for purposes of its [STATE A - NOT TENNESSEE] resident office and for the purpose of any legal communications. It is stated that the Partnership will be domiciled in [STATE A - NOT TENNESSEE] and will comply with [STATE A - NOT TENNESSEE] law in all of its organization and operations. It is also stated that the Partnership will be subject to [STATE A - NOT TENNESSEE] laws and will not be taxed by the [STATE A - NOT TENNESSEE], but [STATE A - NOT TENNESSEE] will tax its individual partners.

[THE TAXPAYER AND HIS WIFE] will hold both general and limited Partnership interests. As Trustee of the [NAME] Trust, a [STATE B - NOT TENNESSEE] Trust, [THE TAXPAYER] will also hold a limited Partnership interest. After formation of the Partnership, the daughters of [THE TAXPAYER AND HIS WIFE], [DAUGHTER 1] of [CITY], Tennessee and [DAUGHTER 2] of [CITY], [STATE C - NOT TENNESSEE] along with their son, [SON] of [CITY], [STATE B - NOT TENNESSEE] and their granddaughter, [GRANDDAUGHTER] of [CITY], [STATE A - NOT TENNESSEE] will become limited partners in the Partnership.

Partners, other than [THE TAXPAYER AND HIS WIFE], will have their initial and future contributions funded principally by gift transfers and by contributions they make in cash. Gift transfers will not be sham transactions, but will be real gifts with no strings attached.

In addition to his limited Partnership interest, [SON] will also be a general partner in the Partnership. He is described as an “associate general partner”, and will have only the following specified duties and limited powers to act on behalf of the Partnership:

1. He will have the principal power and duty to make periodic investments from a Partnership money market fund account to be opened under his authority for that purpose. This fund account will be opened in a money market fund located outside Tennessee and will utilize a bank located outside Tennessee. He will have the power to choose the timing of the investments. During the first year of the Partnership’s existence, he will invest \$20,000. For subsequent years, he will invest the lesser of \$20,000 per year, or one third of the amount that became available for investment by the Partnership the previous year. The amount that becomes available for investment by the Partnership is gross Partnership investment income and capital contributions less expenses, withdrawals and amounts reinvested under mutual fund reinvestment options. [THE TAXPAYER] estimates that, under normal circumstances, [SON] will invest \$20,000 each year on behalf of the Partnership with that amount being subject to increase, but not decrease, from time to time.
2. He will sign proxies on behalf of the Partnership.

3. He will be required to maintain, on behalf of the Partnership, copies of records with respect to every member of the Partnership to ensure that such records are protected and available when needed. Such records will include the Partnership Agreement, financial statements, tax returns and various reports.

4. He will have the right to veto the incurring of any debt except for inadvertent overdrafts.

In the event [THE TAXPAYER] ceases to serve as a general partner, another partner living outside Tennessee will be appointed to act in his place, or the partnership will open a principal office outside Tennessee for record keeping and investment correspondence. If this cannot be done, the partnership will be treated as subject to the Tennessee Income Tax.

No partner will be given any certificate evidencing any transferable interest in the Partnership or will receive any payment of interest from the Partnership evidenced by an instrument whereby the Partnership is the obligor.

Each partner will maintain at his or her residence a file listing the names and addresses of each partner and certain information pertaining to the Partnership. Such information will include a copy of the current Articles of Partnership Agreement and Certificate issued by the [STATE A - NOT TENNESSEE], copies of the financial statements showing income, expenses, assets, liabilities, if any, records showing Partnership Capital Accounts and copies of all partnership tax returns and reports. The [CITY], Tennessee home address of [THE TAXPAYER] will be designated as the Partnership office where this information is maintained for the purpose of satisfying a [STATE A - NOT TENNESSEE] requirement that such information be maintained in a specified office location.

Partnership cash will be held in depositories outside the State of Tennessee. The Partnership will not do business with the public. Its business will consist of managing the savings and investments of its partners. Its investments will be maintained in brokerage accounts and in a number of regulated investment companies, none of which have offices in Tennessee.

Investments will be made in the name of the [FAMILY NAME] Partnership. General partners will send the investment payments by mail from their respective residences in [CITY], Tennessee and [CITY], [STATE B - NOT TENNESSEE] to the various offices of investment firms outside Tennessee where they will be received, recorded and invested. The investment firms will collect investment income and gains, credit them to the Partnership accounts and mail notices of such actions to [THE TAXPAYER] at his residence in [CITY], Tennessee or, with regard to the account for which he is responsible, to [SON] at his residence in [CITY], [STATE B - NOT TENNESSEE]. When investments are liquidated, the fund involved will either write a check to the Partnership or credit the amount to a Partnership money fund and mail the transaction notice to [THE

TAXPAYER] at his residence in [CITY], Tennessee or, [SON] at his residence in [CITY], [STATE B - NOT TENNESSEE], depending on the account or fund involved.

[THE TAXPAYER] will accumulate records of transactions and summarize them at his residence in Tennessee. In conference with all partners, [THE TAXPAYER] will then prepare reports to the partners and tax authorities. He will pay any bills of the partnership with checks drawn on out-of-state banks. Tennessee gift tax will be paid on the transfer of any funds or partnership interests by gift if such transactions are subject to the tax. He and [SON] will receive a small salary for the work they perform, as is required under the Federal Income Tax allocation rules.

The Partnership agreement will provide that [THE TAXPAYER AND HIS WIFE] will control critical Partnership decisions in proportion to their respective general partnership interests. General management of the Partnership will be done by telephone consultation among family members, by mail and during visits to their homes. It is stated that the limited partners will be given a substantial voice in Partnership affairs since the Partnership will be for their ultimate benefit. [THE TAXPAYER]'s daughter, [DAUGHTER 2] is a CPA in [CITY], [STATE C - NOT TENNESSEE] and her husband, [HUSBAND], is finishing his law studies. [HUSBAND] and [DAUGHTER 2] will both provide technical support and consultation for the Partnership. It is stated that it is intended that the partners of the [FAMILY NAME] Partnership will have control over their respective partnership interest shares.

ISSUE

Will the [FAMILY NAME] Partnership be subject to the Tennessee income tax?

RULING

Yes, to the extent taxable partnership dividend and interest income resulting from investments controlled by [THE TAXPAYER AND HIS WIFE] exceed the statutory \$1,250 exemption.

This ruling is based on the current facts presented. This Department does not have enough information to issue rulings with regard to the tax effect of possible future partnership structural changes mentioned.

ANALYSIS

A Partnership Is A Separate Legal Entity

The modern trend of both the courts and legislative bodies is to treat a partnership as a legal entity separate from its partners for certain purposes. *Tax Review Board v. Belmont Laboratories Company*, 141 A.2d 234 at 238 (1958). The Tennessee State Attorney General's Office has opined that a partnership should be treated as a separate legal entity

in Tennessee for purposes of taxation. Op. Att’y Gen. 83-340 (1983). Thus, a partnership is considered a legal entity separate from its partners for purposes of the Tennessee Income Tax.

*The Tennessee Income Tax Is Imposed
On Partnerships Having Tennessee Domicile or Residence*

T.C.A. § 67-2-102 imposes the 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 or by way of interest on bonds of each person, partnership . . . 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 . . .”

It has frequently been held that domicile or residence, more substantial than mere presence in transit or sojourn, is an adequate basis for taxation, including income taxation. *Miller Bros. Co. v. State of Maryland*, 74 S.Ct. 535 (1954). Under T.C.A. § 67-2-101 (5) quoted below, the term “person” can also mean a partnership, and a partnership is subject to the Hall Income Tax if it is domiciled in Tennessee, or maintains a residence in Tennessee for more than six months.

“ ‘Person,’ ‘it,’ or any other singular pronoun means . . . [a] partnership, . . . in receipt of dividends from corporate stocks and/or interest on bonds as herein defined, regardless of the sources from which such income is derived, . . . Any person who has a legal domicile in Tennessee shall be subject to the tax hereby imposed; every person who maintains a place of residence in Tennessee for more than six (6) months in the tax year shall be subject to the tax herein imposed, regardless of what place such a person may claim as a legal domicile;”

Domicile or residence within a state is a valid basis for the imposition of an income tax by such state. 85 C.J.S. *Taxation* § 1090(b). Whether the proposed Partnership will be subject to the Hall Income Tax depends on whether it can be said to have a Tennessee domicile, or a residence in Tennessee for more than six months of a tax year. It is well established that a person, or in this case the Partnership, may establish several residences, but can have only one domicile. *Svoboda v. Svoboda*, 454 S.W.2d 722 (Tenn. App. 1969), Cert. Den. Oct. 6, 1969.

*The Partnership Will Have a Tennessee Residence
And Will Be Domiciled In Tennessee*

For Tennessee corporate tax purposes, “commercial domicile” is defined by T.C.A. § 67-4-804(a)(3) as the principal place from which the trade or business is conducted. This is the definition derived from the Uniform Division of Income for Tax Purposes Act (UDITPA), a model act prepared by the National Conference of Commissioners on

Uniform State Laws. *Associated Partnership I, Inc. v. Huddleston*, 889 S.W. 2d 190 (1994). Where a partnership is considered to be an entity, it has domicile for tax purposes at the place where its business is conducted. 84 C.J.S. *Taxation* § 328; *In Re Svoboda and Hannah*, 142 N.W.2d 328 at 334 (1966). Accordingly, a partnership's domicile is defined in the same way as the domicile of a corporation and the same basic criteria for determining domicile apply.

Commercial domicile is the place from which the business is managed or directed, rather than the place where the assets of the business are located and operate. *Associated Partnership I, Inc. v. Huddleston*, supra at 198. A partnership interest is regarded as having situs at the place where the business of the partnership is carried on. *McKinney v. Nacogdoches Independent School Dist.*, 489 S.W.2d 161 at 169 (Tex. Civ. App. 1972), citing 51 Am. Jur., *Taxation* § 486.

[THE TAXPAYER AND HIS WIFE] are the only general partners who have full unlimited authority to manage the Partnership, and they will be doing that from [CITY], Tennessee. The Partnership Agreement will provide that they will control critical Partnership business decisions in proportion to their respective general partnership interests. Although [SON] is also a general partner, he will not have the usual general powers of a general partner. His actual powers and management responsibilities are to be limited by the partnership agreement to the fund account for which he is responsible plus certain other specified powers and duties. [THE TAXPAYER] will manage all Partnership investments and activities except those connected with the fund account for which [SON] is responsible. Records of transactions will be accumulated and summarized and [THE TAXPAYER] will prepare reports to the partners and tax authorities. [THE TAXPAYER] will also authorize payment of certain Partnership bills and will make payment of such bills on behalf of the Partnership.

Under the facts given, it is clear that the [FAMILY NAME] Partnership will be domiciled in Tennessee and that it will have a permanent residence here. The Partnership's Tennessee domicile will subject it to our Hall Income Tax under T.C.A. §§ 67-2-102 and 67-2-101(5). However, since the Partnership will be conducting business from [CITY], Tennessee on an ongoing basis and will have physical presence there, it will also have a permanent Tennessee residence which would subject it to the Hall Income Tax even if it were domiciled in another state.

The Partnership Will Be Subject To Tennessee Income Taxes On Taxable Investment Income From Business Transacted by [THE TAXPAYER AND HIS WIFE].

The Tennessee Income Tax is not a tax on the privilege of doing business in Tennessee. In enacting the Hall Income Tax, it was the intent of the Legislature to provide for the assessment and collection of taxes upon property that paid no ad valorem tax. The Legislature chose not to tax the income from the purchase and sale of stocks and bonds, but only the dividends and interest accruing on stocks and bonds. The object of the Hall Income Tax statute was to raise revenue, not by taxing the value of the bond, the value of

stocks, or “income” derived from dealing in such securities, but to tax the interest and dividend income produced by the stocks and bonds on which no ad valorem tax had been paid. *First National Bank of Memphis v. McCanless*, 207 S.W.2d 1007 at 1009 and 1010 (Tenn. 1948)

Under T.C.A. § 67-2-102 and 67-2-101(5) the tax is applicable to “persons”, which includes partnerships, having Tennessee domicile or Tennessee residence and having dividend income on stocks or interest income on bonds. As has been explained, the [FAMILY NAME] Partnership meets this criteria. Our law will subject the [FAMILY NAME] Partnership to the Tennessee Hall Income Tax on its dividend and interest income of a taxable nature to the extent such income exceeds the \$1,250 exemption granted by T.C.A. § 67-2-104(a) and to the extent Tennessee has jurisdiction to tax such income.

However, Tennessee can not impose any tax in such a way that it violates the United States Constitution. Generally, the due process and commerce clauses of the United States Constitution prohibit states from imposing an income-based tax on values earned outside their borders. However, states may tax income from interstate operations if a fair apportionment formula is provided. 71 Am. Jur., *Taxation* §§ 574-576; *Luhr Bros., Inc. v. Director of Revenue*, 780 S.W.2d 55 at 57 (Mo.banc 1989). *Complete Auto Transit, Inc. v. Brady*, 97 S.Ct. 1076 (1977) sets forth a four prong test that may be applied in considering whether a state can impose a tax without constitutional violations. To meet constitutional muster under *Complete Auto Transit*, the activity of the taxpayer must be sufficiently connected to the taxing state to justify the tax, the tax must be fairly related to benefits provided the taxpayer, the tax must not discriminate against interstate commerce and the tax must be fairly apportioned.

A state may constitutionally tax income fairly attributable to events or transactions occurring within the state and subject to state regulation and protection. 71 Am. Jur., *Taxation* § 574. The enjoyment of the privileges of domicile or residence within a state and the attendant right to invoke the protection of its laws are inseparable from the responsibility for sharing the costs of government. A tax measured by the net income of residents is an equitable method of distributing the burden of government among those privileged to enjoy its benefits. Such a tax is founded on the protection afforded by the state to the income recipient, the recipient’s right to receive, enjoy and control the income, and the economic advantage the income recipient enjoys. *Herndon v. West*, 393 P.2d 35 (Idaho 1964) citing 85 C.J.S. *Taxation* § 1090(b).

A close examination of the [FAMILY NAME] Partnership’s relationship with Tennessee and our imposition of the Hall Income Tax reveals no constitutional violations as long as only income from the Partnership’s Tennessee activities is subjected to the tax.

The Partnership will have an office in the [CITY], Tennessee home of [THE TAXPAYER AND HIS WIFE]. Both [THE TAXPAYER AND HIS WIFE] will be general partners in the Partnership and [THE TAXPAYER] will also be a paid employee

of the partnership. The Partnership will be domiciled in Tennessee and will have a permanent Tennessee residence. From the Partnership's Tennessee office, [THE TAXPAYER] will manage the Partnership business, create and maintain partnership records, pay partnership bills, make and control partnership investments, and receive on behalf of the partnership, or have accrued or credited to the partnership, income resulting from such investments. This satisfies the Due Process requirement that the Partnership have sufficient connection with Tennessee to justify taxation.

The State of Tennessee will provide benefits and protections, such as fire and police protection, and will provide an orderly society which will enable the Partnership, through its general partner and employee [THE TAXPAYER], to conduct business from the office it maintains in Tennessee. Investment decisions made from the Partnership's Tennessee office will result in income being earned by the Partnership. This meets the Due Process requirement that the tax be fairly related to the benefits provided by the state.

The Commerce Clause requires that a tax not discriminate against interstate commerce. In taxing the Partnership, Tennessee will not undertake to tax any interstate activity carried on outside its borders. Only income from stocks, bonds and mutual funds purchased, held, managed, and controlled from Tennessee will be taxed. Although the Partnership will conduct business in other states, none of the Partnership activities that directly result in the earning of the dividend and interest income being taxed by Tennessee are conducted in another state.

The fact that other businesses that the partnership may do business with, such as banks and brokers, may be located in other states and may conduct their business activities in other states does not change the fact that, with regard to the dividend and interest income to be taxed, the Partnership will conduct all of its business in Tennessee. The mere fact that a business located in a state has a bank account in another state or that it does business with brokers located in other states, gives those states no right to tax the Partnership. If another state in which the Partnership does business should tax the partnership's income, that state would either have to fairly apportion the income taxed, or tax only the income resulting from Partnership activities in that state. Thus, there is no danger of multiple taxation.

In addition to the Partnership investment activities to be conducted from its [CITY], Tennessee domicile and residence, [SON] will also be conducting investment activities on behalf of the Partnership from a Partnership residence in [CITY], [STATE B - NOT TENNESSEE]. However, the Tennessee Income Tax statutes contained in T.C.A. § 67-2-101 et seq. make no provision for apportionment of taxable dividend and interest income earned by a multistate partnership.

Without apportionment provisions, a state does not have the power to impose a tax on income derived outside the state. 71 Am. Jur., *Taxation* §§ 575-576. Thus, dividend and interest income that will be earned by the [FAMILY NAME] Partnership as a result of

investments made on its behalf by [SON] in [CITY], [STATE B - NOT TENNESSEE] can not be subjected to the Tennessee Hall Income Tax.

Tennessee can apply the Tennessee Hall Income Tax to taxable dividend and interest income earned within its borders. The [FAMILY NAME] Partnership will be subject to the Tennessee Hall Income Tax on its dividend and interest income of a taxable nature earned as a result of investments made on its behalf by [THE TAXPAYER AND HIS WIFE] and controlled from its [CITY], Tennessee office.

*The Department Does Not Have Enough Information
To Issue Rulings With Regard To The Tax Effect Of
Possible Future Partnership Structural Changes*

This ruling is based on the current facts presented. The facts also mention certain options the [FAMILY NAME] Partnership may have if [SON] ceases to serve as a general partner and restructuring of the Partnership becomes necessary. However, we do not have enough information to issue rulings as to how the Tennessee income tax would apply under the restructuring options mentioned. Specific details are not given as to how the Partnership would operate under the various restructuring options mentioned and the persons that would be involved and their responsibilities are not outlined. If detailed information is submitted with regard to the facts that will exist in the event the Partnership adopts certain restructuring options, this Department will issue another Letter Ruling based on new facts presented.

Arnold B. Clapp, Tax Counsel

APPROVED: _____

Ruth E. Johnson

DATE:

2-8-96