

MEMO# 3580

March 10, 1992

TENNESSEE COMMISSIONER OF REVENUE DENIES PASS-THROUGH OF TENNESSEE MUNICIPAL BOND INTEREST AFTER APRIL 1, 1992

- 1 - March 11, 1992 TO: TAX COMMITTEE NO. 8-92 MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 3-92 RE: TENNESSEE COMMISSIONER OF REVENUE DENIES PASS-THROUGH OF TENNESSEE MUNICIPAL BOND INTEREST AFTER APRIL 1, 1992

As you know, Tennessee is one of the three remaining states that denies tax-exemption to mutual fund dividends or unit investment trust ("UIT") distributions derived from interest on federal obligations. Tennessee statutory law specifically provides, however, that the Hall Income Tax (the State's dividend and interest income tax) does not apply to mutual fund distributions or UIT distributions attributable to interest on Tennessee obligations, if the fund or UIT has at least 75 percent of its assets invested in Tennessee obligations. In 1990, the Tennessee Attorney General issued an opinion that allowing pass-through treatment for Tennessee obligations while denying it for federal obligations violated the United States Constitution by discriminating against federal obligations. At that time, the Tennessee Commissioner of Revenue asked the Tennessee legislature to repeal the exemption from tax for Tennessee obligation interest passed-through a mutual fund or UIT. The Institute strenuously opposed this legislation, which was defeated. (See Institute Memorandum to Board of Governors No. 28-90, Money Market Members - One Per Complex No. 5-90, SEC Rules Members No. 31-90, State Securities Members No. 9-90, Tax Members No. 17-90 and Unit Investment Trust Members No. 20-90, dated April 18, 1990.) In a letter dated February 24, 1992, the Tennessee Commissioner of Revenue has announced that because the Attorney General has reaffirmed his 1990 opinion that the state unconstitutionally discriminates against federal obligations, the Department of Revenue will disregard the statute, as of April 1, 1992, and no longer exempt mutual fund dividends or UIT distributions attributable to Tennessee obligation interest from tax. Recently, identical bills numbered House Bill 2603 and Senate Bill 2726 were introduced in the legislature. The bill - 2 - would resolve the discrimination problem by allowing the pass-through of federal interest on funds which meet a 75 percent threshold similar to that required under current law for Tennessee obligation pass-through. The Institute is currently working with local counsel and other interested parties in Tennessee to express support for this legislation and will testify at a hearing to be held on the legislation on March 23, 1992, before the Business Tax Study Committee. If that Committee votes favorably on the bill, it will be considered by the House and Senate Finance Ways and Means Committees, and then the two houses of the legislature. We are hopeful that the legislation, which may have a negative revenue impact,

will be adopted. We will keep you informed of developments regarding this legislation.
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