

MEMO# 1853

April 18, 1990

TENNESSEE TAX LEGISLATION DEFEATED

- 1 - April 18, 1990 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 UNIT INVESTMENT TRUST MEMBERS NO. 20-90 RE: TENNESSEE TAX LEGISLATION DEFEATED

Legislation was introduced in Tennessee earlier this year to amend the state tax provisions to retroactively repeal the exemptions from state income tax for dividends paid by mutual funds and interest paid by unit investment trusts that invest in Tennessee municipal obligations. The Commissioner of Revenue requested the legislation in response to an opinion issued by the Tennessee Attorney General's Office that concluded Tennessee tax law violates the U.S. Constitution because it exempts from taxation income from mutual funds and unit investment trusts that invest in municipal obligations but does not exempt income from funds and trusts that invest in federal obligations. The opinion stated that this situation could be remedied by repealing the exemptions for funds and trusts investing in Tennessee municipal obligations or by permitting an exemption for distributions from funds and trusts that invest in federal obligations. The Institute testified in opposition to the proposed repeal of the exemptions before the Tennessee Joint Business Tax Study Committee on March 12, 1990 and distributed an analysis of the constitutional issue to the Committee. The Institute testified that repeal of the exemptions would not cure the constitutional problem since federal law requires that Tennessee exempt from taxation mutual fund dividends derived from interest on federal obligations. Further, repeal of the exemptions would unfairly discriminate against less wealthy Tennessee investors who cannot afford to buy municipal obligations directly and would subject Tennessee investors to tax assessments for prior years. A copy of the Institute's testimony and analysis is attached. - 2 - The Committee voted not to repeal the current exemptions from state income tax for income paid by mutual funds and unit investment trusts that invest in Tennessee municipal obligations. The Tennessee Legislature adjourned for the year on April 13, 1990 without taking any action on the proposed legislation. We will keep you advised of further developments. Patricia Louie Assistant General Counsel Attachments