

## Shop Talk: Court Finds Individual Not Entitled to Tennessee Resident Credit for Tax Paid to South Carolina

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In *Boone v. Chumley*, Tenn. Ct. App., Docket No. E2010-01692-COA-R3-CV, 11/30/11, 2011 WL 5967257, the Tennessee Court of Appeals has concluded that resident shareholders in two South Carolina S corporations were not entitled to a Hall Income Tax credit for taxes paid to South Carolina. Not only was there no express reciprocity agreement allowing a tax credit, but the court also rejected the taxpayer's arguments that a reciprocity agreement should be implied from the applicable state statutes. Accordingly, Tennessee residents holding S corporation shares in out-of-state companies can be subject to tax in multiple jurisdictions without any recourse through a tax credit.

**The tax scheme in question.** Tennessee's personal income tax is customarily referred to as the Hall Income Tax (Tenn. Code Ann., Title 67, Chapter 2). Rather than a general income tax, Tennessee is constitutionally and legislatively authorized to impose a personal income tax only on income derived from stocks and bonds (i.e., dividends and interest).

**The tax credit.** Under Tenn. Code Ann. §67-2-122, a Tennessee resident individual who is a shareholder of a Subchapter S corporation that is incorporated and doing business in another state may claim a credit against the Hall Income Tax for the tax paid to that other state "as a result of said income, distributions or dividends provided there exists a tax credit reciprocity agreement between Tennessee and the other state."

**The income in question.** In *Boone*, the husband-and-wife taxpayers were Tennessee residents who owned stock in two S corporations whose principal places of business are in South Carolina. In 2001, the taxpayers paid South Carolina income tax of around \$43,000 based on pass-through income from the S corporations of nearly \$624,000. The corporations also distributed dividends to them of about \$205,000. They reported the dividends on their 2001 Tennessee Hall Income Tax return, with a resulting tax of \$12,288, against which they claimed a credit for a like amount based on their payment of the South Carolina income tax.

The Tennessee Department of Revenue rejected the credit claim, and issued a notice of an outstanding tax liability for 2001 of about \$15,000, including penalties and interest. The taxpayers paid the assessment under protest and filed an action against the Department. The trial court in Grainger County upheld the Department's assessment and the taxpayers appealed.

**The appellate court's view.** The court noted that, with regard to the Hall Income Tax credit for taxes paid to other states on income or distributions from an S corporation, the requisite "tax credit reciprocity agreement" does not exist between Tennessee and South Carolina. South Carolina does, however, have a general credit for taxes paid to another state "on income from sources within that state which is taxed under both this chapter [the Income Tax Act] and the laws of that state regardless of the taxpayer's residence" (S.C. Code Ann. §12-6-3400(A)(1)).

On appeal, the taxpayers argued that there was an "implied tax reciprocity agreement" between Tennessee and South Carolina based on the existence of credit statutes in both states. The Department countered that any such agreement would be unworkable because the Hall Income Tax is very different in character from the general income tax imposed by South Carolina.

**No implied reciprocity.** The court of appeals found the differences in the two tax schemes to be dispositive, "not because there must be some similarity between the taxing statutes of the sister states, but rather because we do not believe the [Tennessee] General Assembly intended to enact a reciprocity agreement with a sister state *under which Tennessee could not receive a reciprocal benefit.*" (Emphasis in original.) According to the court, "[t]he core ingredient of a reciprocity agreement between taxing authorities of sister jurisdictions is an agreement by each jurisdiction to provide or forego certain benefits if the other jurisdiction will make similar concessions."

In that regard, the court considered a hypothetical situation in which the S corporations were domiciled in Tennessee and the stockholders were South Carolina residents. The court concluded that, in that instance, Tennessee would not tax the stockholder's share of the corporation's income (such income being nontaxable under Tennessee's tax scheme), nor would it tax the dividends because the stockholders were not Tennessee residents.

Accordingly, the court held that to imply an agreement in this case "does not make economic sense for the State of Tennessee." In short, the court said, "under the facts of the present case, there is no reciprocity in fact," and any such implied agreement "would never generate revenue for the State of Tennessee." Thus, the court rejected the taxpayers' argument that they are entitled to claim a credit based on an implied reciprocity agreement.

**No Commerce Clause violation.** The court also rejected the taxpayers claim that the absence of a credit results in double taxation in violation of the Commerce Clause of the U.S. Constitution. According to the court, "[i]t has long been accepted that income to a person from his or her intangible investments outside the state, such as dividends from stock in a foreign corporation, constitutes income from within the state of the person's residence." Thus, income earned in Tennessee from intangible dividend distributions did not involve interstate commerce.

Moreover, the court said, "[e]ven if there is some remote impact on interstate commerce in taxing dividends from earnings of a corporation that is engaged in interstate commerce, we believe that the nexus of the Taxpayers' residence here is sufficient to support a tax that is

'apportioned' according to dividends paid in Tennessee as opposed to total corporate earnings." Thus, the court concluded that the Commerce Clause did not apply to this "interstate" income.

**Practice pointer.** Due to the limited application of Tennessee's Hall Income Tax, it is common for S corporation shareholders to fall victim to this double-taxation trap. Although the Tennessee legislature has authorized the Department to enter into "reciprocity agreements" for Hall Tax credits, it is unclear whether any such agreements exist, leaving S corporation shareholders subject to the tax. Depending on the circumstances, a transition to limited liability company (LLC) form may allow the taxpayer to avoid the Hall Tax altogether. [ ]

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