Beacon

CENTER OF TENNESSEE

A COMPREHENSIVE PACKAGE TO REPEALING THE HALL TAX

THE HALL TAX

The Hall Income Tax is a 6% tax on income derived from stocks and bonds.

More than 40% of those who pay the Hall Tax make less than $75,000 per year.

Revenues from the Hall Tax make up less than 1% of the total state budget.

THE SOLUTION

Reduce rate by 1% each year in revenue over-collection years until the tax is eliminated entirely.

SUMMARY

REPEALING TENNESSEE'S HALL INCOME TAX

The Hall Income Tax is a 6% tax on income derived from stocks and bonds. The Hall Tax is a punitive tax that penalizes sound financial planning, subjects individuals to double taxation, hamstrings retirees, and is a blight upon a state that has built a reputation as an income tax-free haven. That is not the Tennessee way.

Repealing the Hall Tax can be done gradually and responsibly:

- The Hall Income Tax rate can be reduced by 1% each year in years where there has been a surplus of revenue, until the tax is eliminated entirely.
- A portion of the Hall Tax is returned to cities and counties where the taxpayer resides. Beginning in the first year of the phase out, revenues from the Hall Tax can be shifted to these localities to prevent an immediate decline in local revenues, giving cities and counties more time to offset the revenue reduction.
- A provision can also be included that allows cities and counties to immediately eliminate the Hall Tax in their jurisdiction in an effort to remain competitive with their neighbors.

Why are these reforms necessary?

- The tax is a punitive tax on seniors, budding entrepreneurs, business owners, and the middle class, who pay a disproportionate percentage of their income on this tax. More than 40% of those who pay the Hall Tax make less than $75,000 per year.
- Revenues from the Hall Tax make up less than 1% of the total state budget and less than an average of 4% of local revenues. Thus, the harm to taxpayers and the economy is not justified by offsetting revenue collections.
- Tennessee must remain competitive with other states that have no income taxes on investments or otherwise, and are more inviting for business developers and retirees as a result.
- Eliminating this tax will remove the asterisk in Tennessee's claim to be an income tax-free state and a critical barrier to economic growth.
- Allowing cities and counties to opt out of the tax will create a competitive environment and incentives for neighboring localities to follow suit.
- Repealing the tax will provide meaningful and necessary tax relief to our seniors and job creators, and it will do so in a fiscally responsible and measured manner.

QUESTIONS TO ASK

Only the wealthy pay the tax, so why should I care?

The tax is actually a punitive tax on seniors, budding entrepreneurs, business owners, and the middle-class, who pay a disproportionate percentage of their income through the tax. Over 40% of those affected by the Hall Tax make less than $75,000 per year.

Doesn't our state government depend on the revenue generated from the Hall Tax?

In truth, Hall Tax revenue makes up less than 1% of the total state budget.

Won't our local government be forced to raise taxes in another area to compensate for the loss of revenue as a result of a repeal at the state level?

In the Beacon Center reform package, we will begin to transfer revenue from the state to the local governments the first year of the phase-out and every year thereafter, until localities receive 100% of the revenue generated from the tax. The phase-out also gives them at least six years, and likely a full decade, to revise their priorities to compensate for the eventual lost revenue.

Wouldn't there be less money for higher teacher pay and other important civic endeavors if we cut the tax?

Not only is this a misconception, but eliminating the Hall Tax could actually have the opposite effect. Repealing taxes like the Hall Tax will spur investment, having a net positive effect on the growth of our economy and possibly increase revenue from other taxes as a result.

DEBUNKING MYTHS BEHIND THE HALL TAX

By reducing and ultimately eliminating Tennessee's Hall Tax on investment income, we can empower Tennesseans to pursue their socio-economic dreams without worrying that their hard work would be penalized years later.

Here are some questions we suggest legislators ask those who support this unfair money grab:

- Why should we, as state lawmakers, continue to take from the savings of folks—especially our seniors living on fixed incomes—while at the same time touting that Tennessee does not have an income tax? Isn't that hypocritical?

- At a 6% rate, the Hall Income Tax puts Tennessee behind every other "no income tax" state in the nation for friendliness towards seniors and entrepreneurs. New Hampshire, the only other state in this class that taxes investment income, does so at a 5% rate. Why do we want to discourage these desirable residents from retiring in or relocating their business to Tennessee?

- Some claim that we need this revenue to meet our state and local budgetary obligations. But we know the Hall Income Tax accounts for less than 1% of our state budget. We also know that, according to the Beacon Center's latest *Pork Report* of government waste, fraud, and abuse, lawmakers, local officials, and bureaucrats squandered more than $700 million in taxpayer dollars in 2014 and 2015 alone. Meanwhile, the Hall Income Tax brought in just over $300 million during that same year. Can we really go back to our seniors and tell them we can't cut this tax because we can't afford it?

STORIES

THE FREEMANS

Jon and Linda Freeman have been married for over 30 years. In 2007, the couple decided to retire so they could spend more time with loved ones and finally enjoy a mountain home in their favorite alcove of Coldwater, nestled in the Tennessee hills. "It's beautiful. We love the outdoors," reflects Linda. "Huntsville (Alabama) was getting too big, with too much traffic. We wanted to get back to land, yet stay close enough to Huntsville to still go to church there and see friends. But this is home now." Yet, as much as Jon and Linda have embraced and relished their sunset years in Tennessee, they were met with a surprising and alarming tax that's been a harsh reality for Tennessee's retirees: the Hall Income Tax on investment income.

"We have to be a lot more careful about what we do with the structure of our income stream. Linda and I have to consider every investment we make, looking at whether it is taxable or not. Before knowing about this hefty tax, I made some investments that were prudent for our financial futures, but that I nevertheless would not have made, simply because they subject us to these heavy penalties. I might have considered Texas or Florida instead. I wish these harsh taxes had been more clear to us before we came here." – Jon Freeman

NICHOLAS HOLLAND

Meet Nicholas Holland, referred to as a "serial entrepreneur" by the *Nashville Business Journal*, whose latest venture is Populr.me, which helps clients create quick and effective one-page websites. Nicholas recently stepped down as CEO of CentreSource Interactive Agency to launch Populr.me, but continues to be active in the business, which he founded over eight years ago. To help support other local entrepreneurs, Nicholas also co-founded Jumpstart Foundry, Nashville's first microfund aimed at investing in startups.

"One of the reasons Tennessee is often touted as a good place to do business is because we supposedly don't impose an income tax. However, the Hall Tax is not only an income tax, but an income tax of the worst kind: it punitively punishes a segment of our population, namely the elderly, who have taken risks with their hard-earned dollars and hope to see their risks pay off."

– Nicholas Holland

ANALYSIS

INTRODUCTION

Tennesseans have a number of reasons to be proud of the direction our state has taken in recent years. We have the lowest government debt per capita,[1] have been ranked the third freest state in the nation,[2] and we remain on the short-list of states that provide an income tax-free haven.

But is the Volunteer State really income tax-free? Unfortunately, because of Tennessee's Hall Tax on investment income, our state cannot rightfully claim to compete against other states like Texas and Florida, which refrain from taxing income from any source. For over 85 years, our state has imposed an unfair and highly burdensome tax on investment income that poses a direct threat to thousands of Tennessee seniors and entrepreneurs who live on fixed incomes or depend on investments to grow their businesses. Taking crucial dollars from our parents and grandparents to provide the government with pocket change is not the Tennessee way.

WHAT IS THE HALL TAX?

The Tennessee General Assembly instituted the Hall Income Tax in April 1929.[3] It is named for Sen. Frank S. Hall and applies to interest and dividend income received by individuals who maintain their legal residence in Tennessee, including part-time residents who live in the state at least six months of the year.

> **This year should be the last year that Tennessee takes from the hands of our parents and grandparents to provide government with pocket change.**

The Hall Tax generated $262 million in revenue during the 2013-2014 fiscal year, and $302 million in the 2014-2015 fiscal year.[4] Not only does this show the volatility of this particular revenue stream, but it amounts to less than ***one percent*** of the entire state budget.[5] While it has a minimal impact on the state budget, it has a dramatic impact on seniors, who are more likely to own stocks that pay dividends as part of their retirement than other demographics of the population.

KICKING THE TAX CAN DOWN THE ROAD

Over the years, various small exemptions have been granted and expanded—with the first $1,250 earned per year for an individual and $2,500 for a couple remaining exempt from the tax. Most recently, in the 2015 legislative session, other exemptions were increased for single filers who are 65 or older with a total annual income of $37,000 or less, which is well below a comfortable income threshold for a retiring senior.[6] Joint filers, with either spouse 65 years or older and a total annual income of $68,000 or less, also became exempt from the Hall Tax.[7] While these changes are certainly steps in the right direction, they do not solve the underlying problem. Individuals are still forced to grapple with how to sustain future years of uncertain financial obligations on a modest income.

In fact, these income exemptions do not take into consideration the "flat tax" function of the Hall Tax, meaning that even a small amount of income over and above the exempted levels then subjects ***all*** income—not just the amount earned above the exemption—to the six percent penalty. For example, a retired couple with stock and bond earnings of $68,000 a year would be wholly exempt from the tax. Yet, if in subsequent years, they make a single dollar more in income, they are taxed on $65,501 after the $2,500 exemption. This means that just ***one*** more dollar earned will actually ***cost*** this couple more than $3,900.

THE PRICE OF THE HALL TAX

In 2004, the Tennessee Advisory Commission on Intergovernmental Relations determined "the state and most local governments in Tennessee are not to any significant degree dependent on [Hall Tax] revenue for funding general government operations." Moreover, the same study found that, as evidenced in earlier data, the revenue generated from the Hall Tax is one of the most volatile revenue streams in the state's revenue portfolio.

The Hall Tax does have a significant and harmful effect upon those who pay it.

Yet, the Hall Tax does have a significant and harmful effect upon those who pay it. In "Our State, Our Future," the Beacon Center featured two stories of Tennesseans detrimentally affected by the tax as part of our 2014 Faces of Freedom series.[8]

Jon and Linda Freeman's middle-class income precludes them from the aforementioned age exemption and means that much of their retirement income is subject to the Hall Tax. The couple began planning for their future settlement in Coldwater, Tennessee years ago due largely to its claims of being a tax-friendly state. Had the known about the Hall Tax, this burden is one that Jon and Linda would have considered in their decision about where they would ultimately hang their hats.

"We very carefully planned our retirement," says Jon. "We made sure to save throughout our careers and were very proactive with our investments. We were never so 'well-to-do' that we didn't have to be concerned about our future, or our children's futures."[9]

When asked how the Hall Tax has impacted their quality of living, Jon responds, "We have to be a lot more careful about what we do with the structure of our income stream. Linda and I have to consider every investment we make, looking at whether it is taxable or not. Before knowing about this hefty tax, I made some investments that were prudent for our financial futures, but that I nevertheless would not have made, simply because they subject us to these heavy penalties."[10]

> **"Linda and I have to consider every investment we make, looking at whether it is taxable or not."**
> **-Jon Freeman**

The impact upon small business owners and entrepreneurs is also important when analyzing the more far-reaching consequences of the tax. Nicholas Holland, referred to as a "serial entrepreneur" by the *Nashville Business Journal*, is also leery of expanding his businesses because of the penalties he would incur from the Hall Tax. Nicholas recently stepped down as CEO of CentreSource Interactive Agency to launch Populr.me, but continues to be active in the company, which he founded over nine years ago. To help support other local entrepreneurs, Nicholas also co-founded JumpStart Foundry, Nashville's first microfund aimed at investing in startups.[11]

Despite his tremendous success, Nicholas' decision to found another company has been made more complicated with the Hall Tax. "Rather than continue to draw a salary as CEO of CentreSource, I would like to shift that position and begin drawing a moderate income from my shares, or stock in the company. However, I am reluctant to do so because of the impositions of the Hall Tax, which subject me to heavy penalties if I begin to draw income from my shares. Effectively, this deters and tremendously hinders me in my goals to expand," notes Nicholas.[12]

As a 2012 recipient of the *Nashville Business Journal*'s "40 Under 40" award recognizing leading young professionals, Nicolas' story is also a reminder that the Hall Tax reaches well beyond retirees or the wealthy. "I would first say that no one, or at least no small business entrepreneur I know, goes into business for themselves with the intent to get rich. In fact, often times—as was the case for me—small business entrepreneurs leave well paying jobs with lots of built in security to risk going out on their own and often make less than they did when they were with their previous employers," he notes.[13]

The time has come for Tennessee to finally take the bold and necessary action required to rid our state of this punitive tax.

Not only does this successful small business owner face current challenges from the Hall Tax for his burgeoning companies and his own future retirement, but he must also now grapple with the issue when considering his mother's financial well being.

"My father recently passed away and my mother—who would be considered very middle class—received some financial assistance through my father's insurance. We have discussed placing those funds into stocks that would give her a fixed income necessary for her retirement. However, the Hall Tax makes this an unlikely option for us. Lawmakers should remember that seniors are among the most vulnerable of our population and the impacts this tax has is not just limited to those individuals, but also to their families, who face the burden of assisting or providing for their loved ones," Nicholas reminds.[14]

REPEALING THE HALL TAX IN 2016

The time has come for Tennessee to finally take the bold and necessary action required to rid our state of this punitive tax and return to Tennesseans our inherent prerogative of responsibly planning for our futures and those of our loved ones.

The Tennessee General Assembly can repeal the Hall Tax at the state level, while also affording local city and county governments the ability to accommodate for the minimal revenue changes over time.

The Beacon Center has worked with lawmakers to develop a comprehensive solution that reduces the tax rate by one percentage point at a time in years when revenues meet three percent growth or more, until the tax is ultimately eliminated.

The following framework details the incremental steps of this responsible solution:

- Reduce the Hall Tax rate by a percentage point each year that meets the revenue contingencies until the tax is phased out entirely at the state level;
- Hold local city and county governments harmless during the phase out period by shifting existing revenue to those local governments;
- Consider a local option to continue the city or county portion at local taxpayers' discretion;
- Consider fiscal triggers that base a rate cut on the consistency of revenue growth.

In doing so, a repeal would address both state and local concerns of revenue disruption caused by the elimination of the tax—mitigating the impact while remaining committed to retiring the tax accordingly.

By repealing the Hall Tax, our state can restore its status as the most friendly environment to grow a business, build a family, and plan for a future, uninhibited by government and unencumbered by any consequences but the choices of empowered Tennesseans.

ENDNOTES

1 Richard Borean, "Monday Map: State Debt Per Capita." Tax Foundation. June 3, 2013. http://taxfoundation.org/blog/monday-map-state-debt-capita.

2 "Freedom in the 50 States." Mercatus Center. 2013. http://freedominthe50states.org/overall/tennessee.

3 Tenn. Const. Art. 2, Sec. 28.

4 "Comparative Statement of Collected Revenues." Tennessee Department of Revenue. July 2014-June 2015. http://www.tn.gov/revenue/tntaxes.

5 "Comparative Statement of Collected Revenues." Tennessee Department of Revenue. July 2013-May 2014. http://www.tn.gov/revenue/tntaxes.

6 "Individual Income Tax." Tennessee Department of Revenue. 2013. http://www.tn.gov/revenue/tntaxes/indinc.shtml.

7 Dave Boucher, "Hall income tax change: More for seniors, less for Tenn." *The Tennessean*. May 2, 2015. http://www.tennessean.com/story/news/politics/2015/05/02/hall-income-tax-change-seniors-less-tenn/26711673.

8 Lindsay Boyd, "Our State, Our Future: How Tennessee's Income Tax Secret Harms Retirees and Entrepreneurs." Beacon Center of Tennessee. February 2014. http://www.beacontn.org/wp-content/uploads/Our-State-Our-Future.pdf.

9 *Id*, at 4.

10 Ibid.

11 Ibid.

12 *Id*, at 5.

13 Ibid.

14 *Id*, at 5-6.

ABOUT THE BEACON CENTER OF TENNESSEE

The Beacon Center empowers Tennesseans to reclaim control of their lives, so that they can freely pursue their version of the American Dream. The Center is an independent, nonprofit, and nonpartisan research organization dedicated to providing expert empirical research and timely free market solutions to public policy issues in Tennessee.

GUARANTEE OF QUALITY SCHOLARSHIP

The Beacon Center of Tennessee is committed to delivering the highest quality and most reliable research on Tennessee policy issues. The Center guarantees that all original factual data are true and correct and that information attributed to other sources is accurately represented. The Center encourages rigorous critique of its research. If an error ever exists in the accuracy of any material fact or reference to an independent source, please bring the mistake to the Center's attention with supporting evidence. The Center will respond in writing and correct the mistake in an errata sheet accompanying all subsequent distribution of the publication, which constitutes the complete and final remedy under this guarantee.

For additional information or questions, feel free to contact us:

Justin Owen
President & CEO
(615) 383-6431
justin@beacontn.org

Lindsay Boyd
Director of Policy
(615) 383-6431
lindsay@beacontn.org

Patrick Gleason
Senior Fellow for Fiscal Policy
(202) 785-0266
pgleason@atr.org