Our State, Our Future

HOW TENNESSEE'S INCOME TAX SECRET HARMS RETIREES AND ENTREPRENEURS

By Lindsay Boyd

Faces of Freedom

Retiring to Tennessee

Jon and Linda Freeman are in their early 70s and have been married for over thirty years. Not long after meeting through their work at Boeing in Colorado, the young couple relocated to Alabama in 1965 with dreams of starting a family. Jon began planning for their retirement early, and Linda even enrolled in a "women in investing" course during a time when women were rarely active in this role. Both were dually committed to building a sound future for themselves and their children.

After Jon spent the better part of his career in the scientific field and Linda in the medical profession, they decided to retire in 2007 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. The couple began buying land in Coldwater during the 1990s, anticipating a welcoming rural retreat.

"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, enacted in 1929.

What is the Hall Income Tax? And if Tennessee is truly a state that rejects income taxes, why have we been levying one for over 80 years?

Tennessee's Income Tax

The Tennessee General Assembly instituted the Hall Income Tax in April 1929.[1] It is named for Sen. Frank S. Hall, who sponsored the legislation. The Tennessee Constitution empowers the General Assembly to "levy a tax on incomes derived from stocks and bonds that are not taxed ad valorem," or imposed at the time of the transaction.[2] The Hall Tax applies to interest and dividend income received by individuals who maintain their legal residence in Tennessee, including part-year residents who live in the state at least six months of the year.

The original Hall Tax rate was five percent, and all collected revenue was directed to the state government. However, just three years later, in 1931, the General Assembly amended the law to require that 45 percent of the revenue be distributed to local governments.[3] Effectively, this change resulted in nearly half of the proceeds being turned over to local governments, creating substantial lobbying interests—cities and counties across the state—in preserving the tax.

In 1937, the Hall Tax rate was increased to six percent, with three-eighths of Hall Tax collections apportioned back to the county or city where the individual income taxpayer resides.[4] Unfortunately, this tax is conveniently buried, often ignored, and therefore easy to miss by seniors like Jon and Linda looking for a tax-friendly retirement haven.

Since retiring and relocating, Jon and Linda have largely relied upon their income from investments to support their cost of living. Unfortunately, Tennessee's imposition of the Hall Tax negates the state's claims of being income tax-free. As a result, Jon and Linda are finding it difficult to sustain their retirement as Tennessee residents. If he had known about the Hall Tax, Jon suggests that he "would have had to seriously reconsider moving here. I might have considered Texas or Florida instead. I wish these harsh taxes had been more clear to us before we came here."

Facts on the Hall Tax:

- The Hall Tax is expected to bring in just $204 million in revenue during the 2013-2014 fiscal year, which is less than two percent of all state revenues, yet it has a tremendous impact on those who pay it.[5]
- The Hall Tax predominantly affects seniors, who are more likely to own stocks that pay dividends than other demographics of the population, with retirees that often rely on income from stock dividends.[6]
- In 2011, Governor Haslam and the General Assembly raised the Hall Tax exemption level in 2011 by $10,000 for single and joint filers, age 65 and above.[7]
- Single filers with a total annual income of $33,000 or less will be exempt from the Hall Tax,

which is well below a comfortable threshold for retiring seniors.[8]

• Joint filers, with either spouse 65 years or over and having total annual income of $59,000 or less, will also be exempt from the Hall Tax—essentially relegating a married couple to sustain future years of dual financial obligations on a modest income.[9]

• These income thresholds apply to all income, not just income from stocks and bonds, so it does not take much to become subject to the Hall Tax.[10]

The Impact on the Freemans

"We love living in this area. The people are incredible. We've never met nicer people. Jon and I have made wonderful friends and are fortunate with rock solid, trustworthy neighbors," says Linda Freeman. "Tennessee has a history of being a bulwark of the many freedoms that this nation prides itself on. In coming to the South in 1965, we became so appreciative of that."

Yet, despite both Jon and Linda qualifying from an exemption from the Hall Tax because they both are over the age of 65, their middle-class income means that much of their retirement income is subject to the tax. For a couple who initially set their sites on retirement in Tennessee thanks to its claims of being a tax-friendly state, this burden is one that Jon and Linda would have considered in their decision about where they would 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." 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."

So is the case with thousands of Tennessee seniors just trying to maintain a quality lifestyle and provide for their families.

Effects on Small Businesses

Families are not the only ones forced to make investment decisions based on this nonsensical tax. Small business owners and entrepreneurs are also leery of Tennessee due to the heavy penalties imposed by the Hall Tax.

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.

CentreSource and Populr.me were made possible through Nicholas' vision and willingness to undertake a tremendous personal financial burden to get these companies started. He is forced to think creatively about how to structure his businesses to adapt as they expand in scope and number of employees. Unfortunately, the Hall Tax has become a nemesis for Nicholas—an obstacle to growth that he hopes lawmakers will address.

“I founded CentreSource in 2003 and we’ve grown to about 40 employees. Now that the company is stable, I am launching a second company, which requires the majority of my time and energy,” explains Nicholas. “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.”

Nicholas, who was bestowed with the *Nashville Business Journal*’s “40 Under 40” award recognizing leading young professionals in 2012, wants to debunk the perception that the Hall Tax is only applicable to 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.

Yet, Nicholas also acknowledges that the Hall Tax will affect his decisions as he plans for his own retirement. As the Freeman’s indicated, Nicholas considers every financial investment today, both for his personal budget and for fiscal planning of his businesses, and whether they should be reengineered to avoid being penalized by the Hall Tax in the future.

“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,” espouses Nicholas.

Not only does this successful small business owner face current challenges from the Hall Tax for his burgeoning companies and his own 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 impact 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.

Ultimately, Nicholas and the Freemans are joining the call for state lawmakers to alleviate this punitive tax that deters entrepreneurs from building for the future and retirees from living out their lifelong dreams in Tennessee.

Economic Impact of the Hall Tax

In March 2013, Governor Haslam passed a bill to raise the exemption level of the Hall Tax to single filers that are 65 years or older with an income of less than $33,000, and to joint filers with one spouse at least 65 years old and an income of less than $59,000. In his statement, Governor Haslam espoused, "By managing the state budget conservatively and focusing on making state government more efficient and effective, we've been able to cut taxes while continuing to make strategic investments and balancing the budget" and he thanked the General Assembly "for passing this sensible legislation that makes Tennessee an even more attractive state to live."[11]

Indeed this is a great step in the right direction. Yet, as exhibited in the stories of the Freemans and of Nicholas Holland, Tennessee has still not achieved an environment that welcomes investors, entrepreneurs, and retirees. Rather, the Hall Tax still ensures that these individuals are charged for their risk-taking and responsible planning, and at a rate that makes it difficult for them to remain confident in their future provisions.

Tennessee companies also suffer under the antiquated Hall Tax code—which taxes income, regardless of whether that income may have already been subjected to other taxes. We see these consequences demonstrated at the federal level. In 2003, companies increased dividend payments—meaning that individuals could receive larger rewards for their investments—when the tax on dividends declined. In other words, when the tax burden on dividends was alleviated, companies were able to reciprocate with higher payments to investors. In 1993, however, the top marginal tax rates were higher and resulted in the long-term trend of declining dividend payments—meaning that individuals were getting less in return for their investments. In simple terms, the tax code on income from stocks and dividends has a direct impact—providing for more or fewer dollars in the pocketbooks of those who are depending upon these investments for financial security.

Several studies suggest that a dividend becomes less valuable when more of it is taxed, so taxpaying investors only buy the stocks at lower prices, since they are getting less of a yield in dividends from the investment. Another consequence of imposing the Hall Tax is that it encourages more people to sell stocks rather than begin to draw income from the investments. Investors sell to avoid paying taxes that they would have to pay if they collected the dividend, which impacts the financial planning of the investor and has negative economic consequences for the companies.

Yet, perhaps the most compelling argument comes from our senior citizens, who own a disproportionate percentage of dividend-paying stocks, which means that many retirees have to live on smaller incomes as a direct result of the tax.[12] These seniors will have diminished financial security and consume less due to lower payouts as a result of the Hall Tax. As a state that claims to be retirement-friendly, we owe it to our seniors to expose the punitive undercurrent of the Hall Tax and work to alleviate its burden, particularly on the elderly.

Becoming Truly Income Tax-Free

In early January of this year, *Business Insider* released a report documenting the migration of individuals from one state to another and rating each state for their retirement-friendly economic climates. Surprisingly, Tennessee still rates in the middle of the pack, despite being touted as one of a few income-tax free states that would seem ripe for business development and retiring seniors. The Hall Tax, an antiquated tax law from a bygone era, still rears its ugly head and wrecks havoc upon the financial livelihoods of vulnerable Tennesseans, even as lawmakers have moved to reduce its impact.

Jon and Linda Freeman are just one family among thousands that unknowingly set their retirement dreams on Tennessee, only to realize that this little known tax will become a big problem for them. And Nicholas Holland is exactly the type of engaged citizen that Tennessee should be cultivating—a young, energetic entrepreneur interested in giving back to his community and proactively planning for his future. As their stories show, the Hall Tax drives retirees, investors, and entrepreneurs alike out of our state, or places stringent burdens on them for staying here.

Rather than continue to kick the can down the road by slowly increasing the exemption levels from this punitive tax, lawmakers should bring an end to this unjust law and finally make Tennessee a truly, all-encompassing income-tax free state.

1. Tenn. Const. Art. 2, Sec. 28.
2. T.O. Trotter, "The Tennessee Income Tax Law of 1929." 8 Tenn. L. Rev. 106 (1929-1930).
3. Stanley Chervin and Harry A. Green, "Hall Income Tax Distributions and Local Government Finances." Tennessee Advisory Commission on Intergovernmental Relations. 2004.
4. Ibid.
5. Tennessee State Budget: FY 2013-2014. p. A-202.
6. "Tax Relief for Seniors." 2013. http://www.tn.gov/governor/legislation/hall-tax.shtml.
7. Ibid.
8. "Individual Income Tax." Tennessee Department of Revenue. 2013. http://www.tn.gov/revenue/tntaxes/indinc.shtml.
9. Ibid.
10. Ibid.
11. "Haslam signs Hall Income Tax reduction in Crossville." Newsroom and Media Center. 2013. http://news.tn.gov/node/10783.
12. Gary B. Gray, "Stock-holding seniors, retirees see benefits from Tennessee tax law change, but cities seek relief as losses loom." *Johnson City Press*. December 9, 2013. http://johnsoncitypress.com/article/113157/stock-holding-seniors-retirees-see-benefits-but-changes-could-be-made#sthash.xZZikeEw.dpuf.

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"Faces of Freedom" is a Beacon Center series to educate Tennesseans about the barriers to prosperity brought about by poor public policy. By providing real-life stories of real-life citizens, Tennesseans can better understand the impact public policy has on their lives.

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