TENNESSEE'S INCOME TAX ASTERISK

REPEALING THE HALL TAX IS GOOD FOR TENNESSEANS AND OUR ECONOMY

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INTRODUCTION

As the national economy staggers through another year of uncertainty, joblessness, and skyrocketing debt, numerous states have proven that responsible governance can actually create an incubator of growth and become an insulator against the waste and taxpayer abuse we see in Washington. Tennesseans have a number of reasons to be proud of the direction our state has taken in recent years to assert a commitment to free market principles. In fact, our state owns the least amount of government debt per capita,[1] has been ranked the third freest state in the nation,[2] and remains 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, such as Texas and Florida, which refrain from taxing income from any source. Instead, thousands of Tennessee seniors and entrepreneurs struggle to sustain a livelihood or further contribute to our state's growth and economic prosperity. And it is because they are disproportionately affected by this *asterisk* on our otherwise laudable income tax reputation.

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, 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.[4] The Hall Tax 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.

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.[5] Effectively, this change redirected nearly half the total proceeds to local governments, creating substantial lobbying interests—cities and counties across the state—in preserving the tax. The legislature again adjusted the tax in 1985, bringing the rate to its current levy of six percent and removing special rates for the amount of assessable property and company location.

The Hall Tax generated nearly $262 million in revenue during the 2013-2014 fiscal year. This amounts to less than two percent of all state revenues, yet it has a tremendous impact on those who pay it.[6] The tax predominantly affects seniors, who are more likely to own stocks that pay dividends than other demographics of the population, with retirement benefits that often derive from stock dividends.

EVOLUTION OF TENNESSEE'S INCOME TAX ON INVESTMENTS

Over the years, various small exemptions were granted to Tennessee residents who received less than $25 in income from investments—enacted in 1949—and less than $4,800 and $6,000 for single and joint filers respectively—passed in 1976. These exemptions were later raised in 1978, 1985, and 1998. More recently, in 2011, Gov. Bill Haslam and the General Assembly raised the Hall Tax exemption level by $10,000 for single and joint filers who are age 65 and above.[7] Then again, in 2013, the exemptions were increased for single filers with a total annual income of $33,000 or less, which is well below a comfortable income threshold for retiring seniors.[8] Joint filers, with either spouse 65 years or older and a total annual income of $59,000 or less, also became exempt from the Hall Tax. 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 Gov. Haslam's March 2013 statement regarding the latest increase in exemption levels, he 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." The governor also thanked the General Assembly "for passing this sensible legislation that makes Tennessee an even more attractive state to live."[9] Yet, despite these good intentions, 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 $59,000 a year would be wholly exempt from the tax. Yet, if in the subsequent year, they make a single dollar more in income, $56,501 of their entire $59,001 would be taxable at six percent. This means that just one more dollar earned will actually cost the couple almost $3,400, even after the $2,500 exemption provided by the law.

CONSEQUENCES OF TAXING INVESTMENT INCOME

Economists know that when the *price* of investing increases, the *amount* of investing decreases. In short, when fewer people are willing to pay the prices associated with potential investments, the economic wheel generated by job creators and wealth suppliers must continue to turn on diminished resources. In a report produced by the Tax Foundation, the authors conclude that:

"When fewer people are willing to invest, two things happen. First, the capital stock (i.e., the amount of computers, factories, equipment) shrinks over time, which makes workers less productive and decreases future wages. Second, because there is less capital available the available capital is more valuable, which causes the return to capital to rise. The effect of this over time is that wage earners make less…and current tax code exacerbates this problem significantly through its non-neutral bias towards consumption over future consumption (i.e., saving)."[10]

When considered on the national and global economic stages, the numbers are startling. Consumption comprises 72 percent of our country's Gross Domestic Product (GDP), eclipsed in ranking of developed nations only by Greece at 75 percent. In contrast, our rate of investment is second to last behind the United Kingdom at just 16 percent.[11] The consequences of these reversed priorities are evident in the economic decline since 2008 and the persistent struggle for greater job creation.

The rippling effects are not coincidental, nor are they isolated, and they have a direct impact on the actions of both investors and publicly traded companies. For example, in 2003, companies increased dividend payments—meaning that individuals could receive larger rewards for their investments—when the tax on dividends declined.[12] 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 increased and resulted in the long-term trend of declining dividend payments—meaning that individuals were receiving less in return for their investments. In simple terms, tax rates on income from stocks and dividends have a direct impact, providing for more or less dollars in the pocketbooks of those who are depending upon these investments for financial security.[13]

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 taxes such as the Hall Tax is that they encourage more people to sell stocks rather than begin to draw income from their 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.

IMPACT OF THE HALL TAX ON TENNESSEANS

Just as saving and investing help to propel a national economy forward, the same principles apply at the state, local, and even household levels. As previously established, penalizing responsible citizens for forward-thinking investments harms economic growth and inhibits an individual's accommodations for the future. It also becomes an obstacle to business growth. Furthermore, the Hall Tax is effectively a "double tax" because corporate taxes—the source of interest and dividend income—are already taxed in the corporate tax code.[14] The effect is a system that punishes Tennesseans for their risk-taking and responsible planning, and at a rate that makes it difficult for them to remain confident in their future provisions.

Despite claims to the contrary, the reduction or elimination of the Hall Tax will not have a notable impact upon state and local budgets. 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."[15] Moreover, the same study found that revenue generated from the Hall Tax is one of the most volatile revenue streams in the state's revenue portfolio.

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.[16]

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 they 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."[17]

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."[18]

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 eight years ago. To help support other local entrepreneurs, Nicholas also co-founded JumpStart Foundry, Nashville's first microfund aimed at investing in startups.[19]

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.[20]

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.[21]

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.[22]

REPEALING THE HALL TAX IN 2015

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 of Tennessee, Americans for Tax Reform, and the Tax Foundation—in close collaboration with members of the Tennessee legislature—have developed a comprehensive solution that reduces the tax rate by one percent each year until it is ultimately eliminated.

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

- Reduce the Hall Tax rate by one percent each year until the tax is phased out entirely in six years;
- Hold local city and county governments harmless during the phase out period;
- Consider a local option for a referendum proposed by local governments to immediately end the tax locally or continue the city or county portion at local taxpayers' discretion;
- Consider fiscal triggers for years with substantial state revenue shortfalls, freezing the phase out in years where revenue falls substantially short of projections.

By utilizing these pillars as a foundation for reform efforts, the legislature would reduce and ultimately eliminate the impact the Hall Tax currently has on low and middle-income seniors and job-creating entrepreneurs. Furthermore, reform should also address local concerns of revenue disruption caused by changes to the Hall Tax at the state level—mitigating the impact while remaining committed to eliminating the tax accordingly.

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

ENDNOTES

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17 *Id*, at 4.

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20 *Id*, at 5.

21 Ibid.

22 *Id*, at 5-6.

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