An Income Tax for Tennessee?

by Charles Trost

Among the group of states that includes Tennessee and its eight bordering states, Tennessee is unique in that it alone does not have a general tax on personal income. Although Tennessee’s sales tax is the highest of the group and its property tax is at the average, Tennessee’s average tax revenue is about 85 percent of the group average and $473 per individual below the national average. Tennessee ranks by far as the least taxed state of the group, near the bottom of all 50 states measured by state and local taxes collected on a per capita basis.

Opponents of an income tax assert there is waste and inefficiency in state government in Tennessee. The reality is that the administration of Tennessee is required to operate state government and provide the services its residents need and desire with significantly less revenue than the governments of all of its adjoining neighbors—substantially less than Virginia, North Carolina, and Georgia, whose per capita tax revenues are well above the regional average and are at or above the national average. There are no indications, however, that Tennesseans want and expect schools, highways, health and human services, police protection and other state services of any less quality or quantity than that demanded and expected by residents of our neighboring states.

State revenue systems are a three-legged stool, having three basic sources—sales tax, property tax, and income tax. Ideally these three revenue sources are in balance and complement each other in terms of growth, stability, and predictability. Sales and property taxes provide stability and predictability but fail to grow at a rate that matches the growth of income. The consequence of this inelastic system is that every five to seven years Tennessee experiences a shortfall in revenues that requires some type of tax increase.
The available options are limited. First there is the property tax. Presently this revenue source is reserved for local governments, although a form of state property tax is imposed on businesses through the franchise tax, which measures and taxes both tangible and intangible property. Opponents of a state property tax point out that, without a tax on intangibles owned by individuals, the burden would fall on one form of accumulated wealth—real property—but not on intangibles such as stocks, bonds, and cash. Other states have found intangibles to be easy to move and hard to find, presenting tax enforcement problems.

The sales tax already represents over three-fourths of state tax revenues. An increase in the rate would give Tennessee the highest sales tax in the country. Tennessee already suffers significant cross-border sales tax losses. This problem is exacerbated by the growth of mail order and Internet sales on which very little sales tax is collected. An expansion of the sales tax to previously untaxed professional and personal services is a solution that other states such as Florida have tried, found to be unworkable, and subsequently repealed. Further objections to increasing the sales tax are that it is a further burden on businesses, since up to 40 percent of the sales tax is collected from businesses, and that sales taxes paid by individuals are not deductible from federal taxable income.

Tennessee already imposes a 6 percent tax on income derived from stocks and bonds, meaning dividends and interest earned by individuals, and a 6 percent excise tax measured by the income earned by businesses from all sources. Two things that escape taxation in Tennessee are personal services income and income derived from sales of assets by individuals.

Broadening the tax base by taxing a small percentage of individuals’ or couples’ federal adjusted gross income less some reasonable exemption designed to exclude low income families, combined with reducing the rate of sales tax, would provide Tennessee with needed additional tax revenues, reduce the tax-incentive for cross-border shopping by Tennessee residents, and introduce an elastic source of tax revenue that would keep up with the growth of personal income over time without sacrificing stability and predictability.

There are those who oppose a personal income tax for various reasons—some principled and earnest, others more self-serving. Asking people whether they favor a personal income tax can elicit different responses depending on the concrete alternatives presented. In the abstract most people do not want to pay a Tennessee income tax because they work hard to earn money and would like to keep it for themselves.

However, life seldom offers abstract choices that do not involve tradeoffs, and the answer to this question is not one without consequences. The real-life choice the legislature and governor face is to increase taxes or curtail spending and services.

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Reduction in funding for higher education inevitably means a reduced level of services (the range of courses or the quality of instruction as professors leave for better opportunities) or increases in tuition and fees, which inevitably will limit the availability of higher education for less affluent families. A financial inability to attract and keep qualified elementary and secondary teachers will put the quality of education at risk. With a nationwide shortage of teachers, an inability to maintain competitive salary levels will result in erosion of the quality of our schools.

Across-the-board reductions in spending at the state level mean reduction in salaries and/or reduction in jobs and a concomitant reduction in the ability of state government to deliver timely and efficient state services. The citizens of Tennessee will not be well served by poorly funded state government when they can well afford and surely deserve better.

If curtailment of governmental services is not the answer, and an increase in the tax burden borne by individuals is not an option, the only solution is an increase in the tax burden borne by businesses. Tennessee is already the 12th highest state for overall state and local tax burden borne by businesses.

Tennessee is blessed by a favorable combination of natural resources, central location, good highways, and industrious, talented people. The consequence has been the location or expansion of businesses in Tennessee, providing good jobs and opportunities. But to remain viable a business must be profitable. Businesses compete nationally and globally, and all costs of doing business, tax costs included, affect the bottom line. Two things can drive or keep businesses away from Tennessee—an economic climate where the tax burden makes it hard to compete and employment of capital resources less profitable in Tennessee than elsewhere, or the inability to obtain educated, well prepared workers at competitive rates of pay.

If Tennessee’s ability to attract and retain good jobs is impeded or restrained by the state government’s failure to keep business taxes at or below the current relative level or by the state’s inability to provide a competitive infrastructure of roads, schools, and governmental services, the adverse consequences will be far-reaching.

Any state falling significantly behind in the ability to keep current with the rapidly changing business climate will find itself unable to keep up, let alone catch up with the competition. If we lose the race, the loss will fall upon the children and families of Tennessee, who may once again be faced, as was the generation of the 1920s and 1930s, with the harsh choice of accepting limited opportunities at home or having to leave the state to find better opportunities elsewhere.

To put the people of this state at risk in this way is irresponsible, regardless of how each of us may be personally affected in the short run. It is time for the people and leaders of Tennessee to face this challenge and bring our tax system and revenue base into the 21st century on a sound and fair footing which includes a broad-based income tax.

Some people, including some of my law partners, say the Tennessee constitution does not permit a personal income tax. But others, including the current Attorney General and two of his three predecessors who were asked to give their opinion, believe otherwise. In the final analysis no one will know until a specific tax act is enacted and our Supreme Court is called upon to adjudicate the issue of whether that act meets state constitutional muster. ■

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