The Tennessee Advisory Commission on Intergovernmental Relations

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MEMORANDUM

TO: Commission Members

FROM: Cliff Lippard
Executive Director

DATE: 6 September 2018

SUBJECT: House Bill 971/Senate Bill 1075 (Local Revenue and Service)—Update

The Commission's local government members met on June 14 and August 10, 2018, to discuss revenue and services of local governments in Tennessee as part of the Commission's study pursuant to a request by the House Finance Ways and Means Committee. That committee, during discussion of House Bill 971 by Sargent, asked the Commission to study the duties of cities and counties mandated by law and the funds from the state to each group to comply with the law. The original version of House Bill 971 and its companion, Senate Bill 1075 by Watson, would have revised the distribution of local government revenue generated by the 2.25 percent local sales tax imposed on sales made in this state by dealers with no location in Tennessee. The Commission directed staff to conduct a comprehensive study of local government revenue and services, with the revenue including but not limited to out-of-state sales tax collections and state-shared taxes, with a goal of completing an interim or final report by January 2019.

Consistent with the guidance of the overall Commission, the local members took a holistic view of local government revenue and services during the two meetings. The first meeting included a review of current and trend data on the various revenue sources available to local government as well as information on required and authorized local services, while the second focused primarily on out-of-state sales tax collection and distribution. The second meeting featured a discussion between the members and Tennessee Department of Revenue Commissioner David Gerregano about the potential effect on the state and its local governments of the recent Supreme Court decision in *South Dakota v. Wayfair, Inc.* The second meeting also included a review of updated information on overall local government revenue and expenditure trends. The minutes of both meetings are included as attachment A. Following the two meetings, the local government members agreed that staff should prepare this summary memorandum for the full Commission and that it should include "big picture" trend information drawing on the revenue and expenditure material reviewed during the meetings, as well as a summary of the discussion with Commissioner Gerregano and a recommendation for next steps. The local government members also agreed on three principles they believe should guide the Commission's study:

- The report should provide a comprehensive review of trends in local government revenue and services.
- Because of the complexity of the overall revenue system and the potential for unintended consequences, the report should not propose shifting existing sources of revenue among cities and counties.
- The report should explore whether the state should or could do more to financially support local governments.

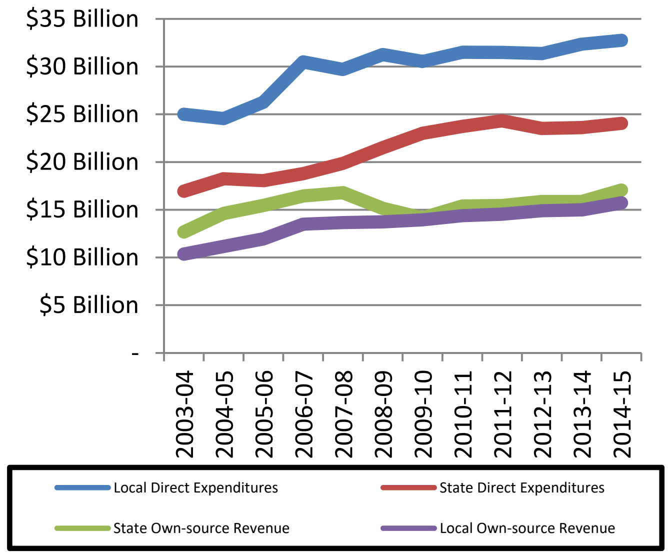
An additional point of agreement among local members was that one of the most effective ways for the state to help local governments address local budget issues would be for the state to use some of the likely increase in out of state collections of the state's 7% sales and use tax to increase its Basic Education Program (BEP) funding. They discussed that the easiest way to increase BEP revenue for local governments would probably be to increase teacher salary and benefits or to change teacher-student ratios, as teacher funding makes up one of the largest portions of the formula.

Big Picture Local Government Expenditure and Revenue Trends

Although state and local government expenditures and revenues have increased from 2000-01 to 2016-17 (see Figure 1), intergovernmental revenue from the state to local governments has not necessarily kept pace. Total revenues and total tax revenues both grew at 4.0% per year on average, faster than the 2.9% growth in state-shared tax revenue. State-shared tax revenue (excluding business and beer wholesale tax revenue because of data limitations) increased from $681.1 million to $1.1 billion, slower than the growth in total state revenue, which grew from $16.7 billion to $31.1 billion and the growth in state total tax revenue, which grew from $8.1 billion to $15.1 billion. In dollar terms, state-shared tax revenue increased $392.6 million; however, adjusting for inflation, the increase was only $154.1 million, while state total revenue increased by $8.6 billion, and state total tax revenue increased $4.2 billion.

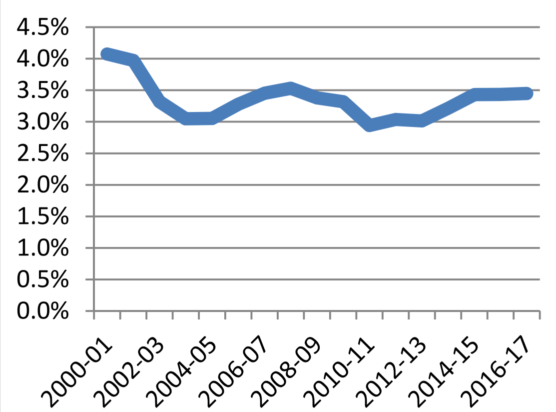
Local governments' state-shared tax revenue, as a percentage of both total revenue and tax revenue, has decreased from fiscal year 2000-01 to 2016-17 (See Figures 2 and 3). One reason for the decrease is that the last two times the state increased its sales tax rate, from 5.5% to 6% in fiscal year 1992-93, and from 6% to 7% in fiscal year 2002-03,[1] it did not increase the statutory percentage for the state-shared sales tax (See Figures 4).[2] The state-shared sales tax was established when Tennessee's sales tax began in 1947.[3] At the time, 12.5% of the state's 2% sales tax went to cities, or 0.250%, not much different than today's 4.603% of 5.5%, or 0.253%. Although almost all of the state-shared sales tax goes to cities, most state-shared gas tax revenue goes to counties. Other than $3,485,258 (fiscal year 2016-17) for river resort districts, counties receive no state-shared sales tax.

Figure 1. TennesseeState and Local Government Direct Expenditures,[1] Fiscal Years 2003-04 to 2014-15.



For fiscal year 2016-17, the overall county share of $1.35 billion in state-shared tax revenue, which included business and beer wholesale tax revenue, is $508.1 million (37.5%), and the overall city share is $845.5 million (62.5%); however the increases in the gasoline and motor fuel taxes, and the phase out of the Hall income tax, will decrease the percentage of state-shared taxes that cities

Figure 2. State of Tennesee's Percentage of Total Revenue[1] Shared with Local Governments, Fiscal Years 2000-01 to 2016-17.



Source: State of Tennessee Comprehensive Annual Financial Reports. [1]Total revenue includes taxes, intergovernmental revenue, fees, and other charges.

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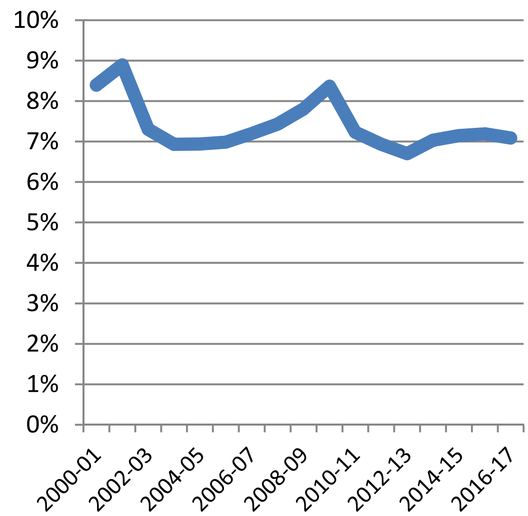
[1] Public Chapter 856, Acts of 2002.

[2] Tennessee Department of Revenue.

[3] Public Chapter 3, Acts of 1947.

receive and increase counties' share. Of the $1.35 billion state-shared tax revenue total, $350.8 million is restricted in its use; it's earmarked mostly for roads (gasoline and motor fuel taxes) and education (mixed drink tax).

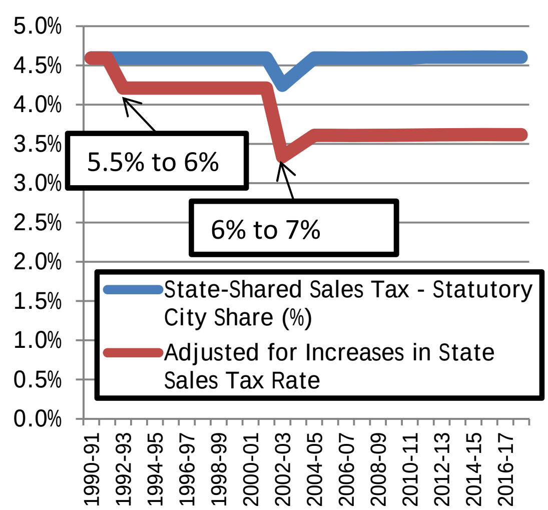
Figure 3. State of Tennessee's Percentage of Tax Revenue Shared with Local Governments, Fiscal Years 2000-01 to 2016-17.



Source: State of Tennessee Comprehensive Annual Financial Reports.

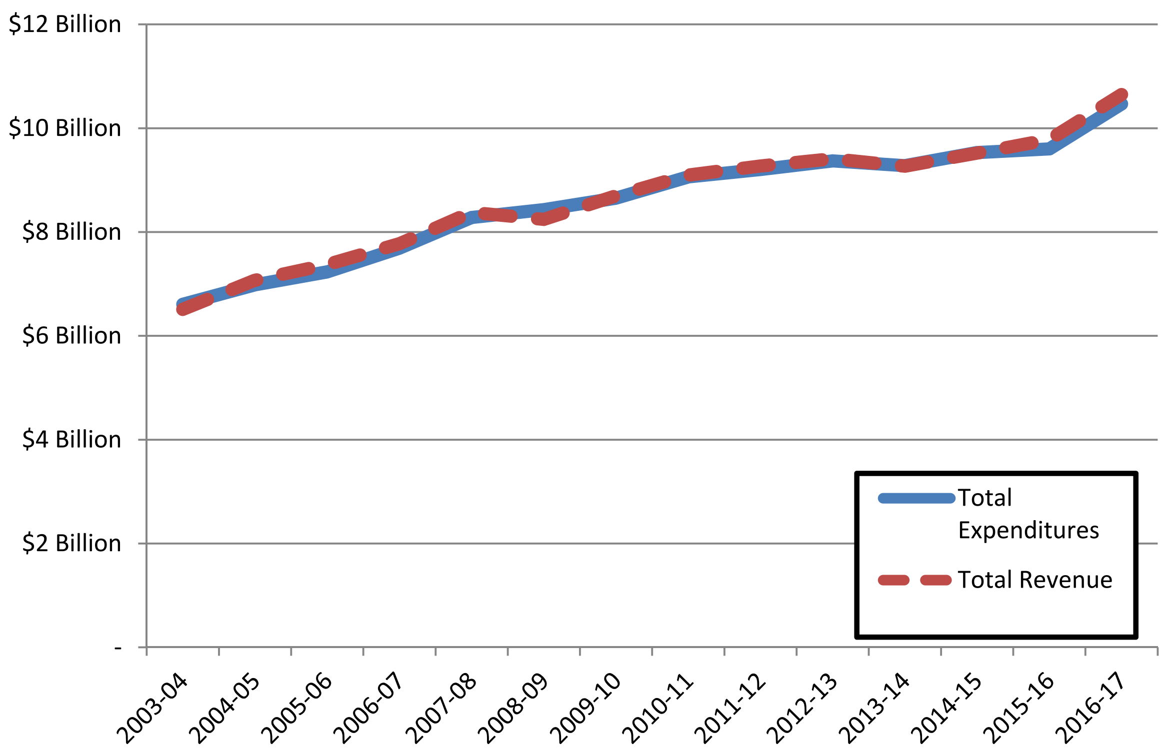
State government direct expenditures, which do not include revenue shared with local governments to avoid double-counting, increased faster than state-shared revenues, from $16.9 billion in 2003-04 to $24.0 billion in 2014-15, for an average annual increase of 3.2%, but all of that increase occurred before it peaked at $24.3 billion in 2011-12 and then declined over the following three years. Local government direct expenditures increased from $25.0 billion in fiscal year 2003-04 to $32.7 billion in fiscal year 2014-15 for an average annual increase of only 2.5%. Education expenditures are arguably one of the largest expenditures for local governments, increasing at an average annual rate of 3.6%, from $6.6 billion in fiscal year 2003-04 to $10.5 billion in 2016-17, while total education revenue averaged increases of 3.9% per year (see Figure 5). Education revenue coming from the state increased at an average annual rate of 4.1%, from $2.7 billion in 2003-04 to $4.6 billion in 2016-17, versus rates of 3.0% for local and 4.0% for federal revenue (see Figure 6). Staff will continue to look into state and local governments' costs of delivering services, starting with Census of Governments data and possibly supplemented by surveying local governments.

Figure 4. State-Shared Sales Tax: City Share (%).



Source: Tennessee Code Annotated, Section 67-6-603 (Archived Versions).

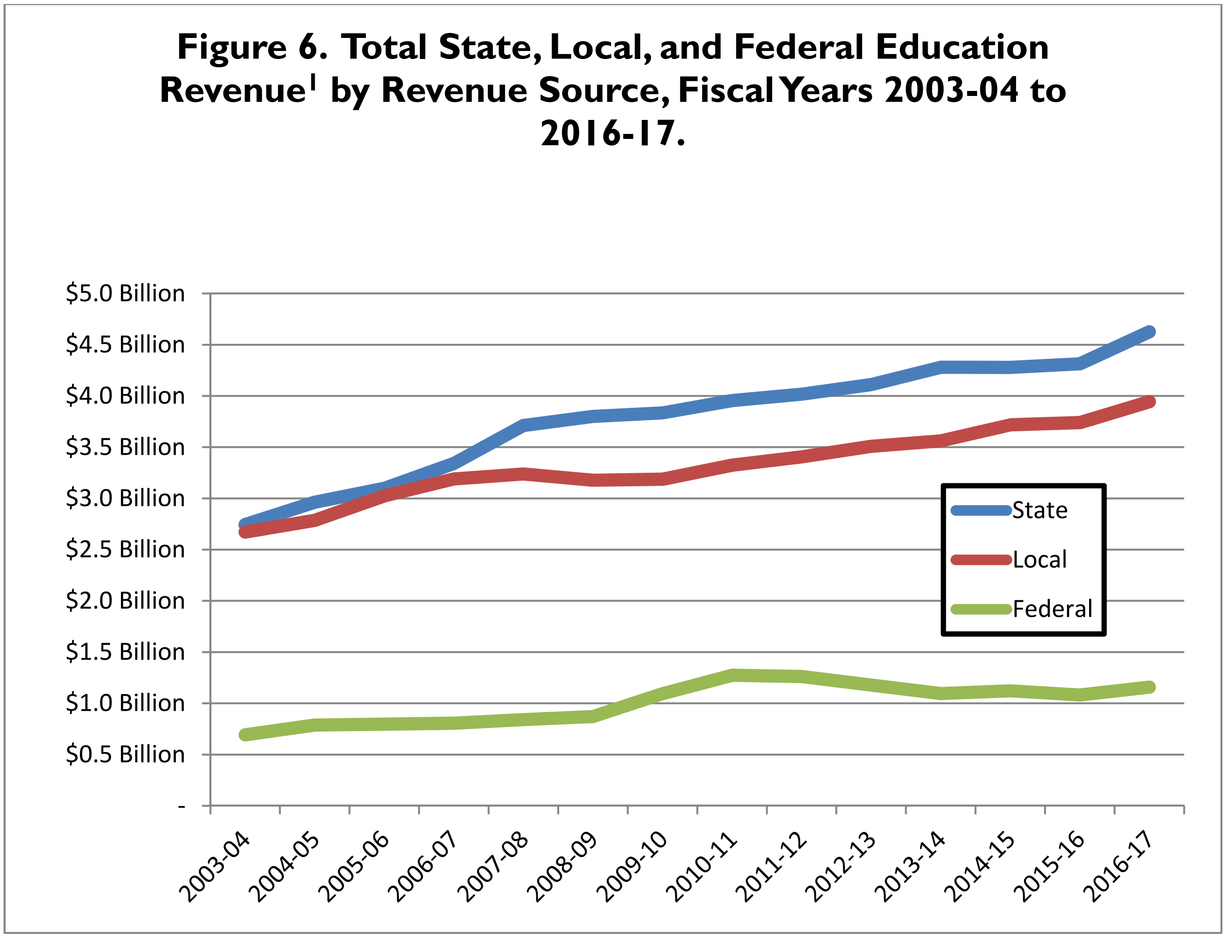
Figure 5. Total Education Expenditures[1] and Revenue,[2] Fiscal Years 2003-04 to 2016-17.



Source: Tennessee Department of Education Annual Statistical Reports.

[1]Includes current operating expenditures, community services, early childhood education, capital outlay, debt service, operating transfers, and capital projects.

[2]Includes revenue for current operations and capital outlay and from sales of bonds, notes, lease proceeds, insurance recovery, and transfers.



Source: Tennessee Department of Education, Annual Statistical Reports.

[1]Does not include revenue from sale of bonds, notes, lease proceeds, insurance recovery, and transfers.

At the second meeting on August 10, 2018, local members discussed the effect of the *Wayfair* decision on internet and other out-of-state sales tax collections in Tennessee with Commissioner David Gerregano of the Tennessee Department of Revenue. Commissioner Gerregano said the internet sales tax is both a fiscal issue and a fairness issue, and while many out-of-state sellers already collect and remit sales tax a large population of out-of-state sellers without a physical presence in Tennessee do not. The Department of Revenue has since released a sales and use tax notice discussing the Wayfair ruling (see attachment B). And TACIR staff has also prepared an analysis of the *Wayfair* ruling (see attachment C).

Commissioner Gerregano explained the legal history of out-of-state sales tax collection to the local members. He said the US Congress has not passed a law addressing internet sales tax, but US Supreme Court Justice Anthony Kennedy invited states to challenge *Quill*[4] and *Bellas Hess*[5], which prohibited states from requiring an out-of-state seller to collect sales tax unless the seller has a physical presence in the state.[6] Commissioner Gerregano said Tennessee, Alabama, and South Dakota created test cases to challenge that physical presence rule, and South Dakota's case (*Wayfair*) made it to the Supreme Court first.

In 2016, the Tennessee Department of Revenue implemented a rule[7] that required out-of-state dealers exceeding $500,000 in sales in the previous twelve months to register by March 1, 2017, and begin collecting sales taxes by July 1, 2017. This rule was challenged in the Chancery Court for Davidson County,[8] and the parties to the case agreed to delay enforcement of the rule and await the response of the Supreme Court to the test cases. Commissioner Gerregano said the lawsuit in the Davidson County Chancery Court challenging the rule won't drive the timing of enforcement because of the legislative aspect. The General Assembly prohibited enforcement of the rule until further review (see attachment D).[9]

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[4] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[5] *National Bellas Hess v. Department of Revenue of Ill.*, 386 U.S. 753 (1967).

[6] See Justice Kennedy's concurring opinion in *Direct Marketing Association v. Brohl*, 575 US _ (2015).

[7] Rule 1320-05-01-.129(2).

[8] American Catalog Mailers Ass'n v. Tennessee Department of Revenue.

[9] Public Chapter 452, Acts of 2017.

Commissioner Gerregano noted the justices in *Wayfair* agreed that the physical presence rule was inconsistent with the Supreme Court's interpretation of the Commerce Clause, but the justices disagreed on whether the Court should overrule *Quill* and *Bellas Hess.* Commissioner Gerregano said courts are reluctant to overturn precedent (the principle of stare decisis), especially if that precedent has been relied upon. On June 21, 2018, the Supreme Court overruled *Quill*, invalidating the physical presence rule and opening the way for states to require out-of-state sellers—including internet sellers—without a physical presence in the state to collect sales tax. In Tennessee, that would amount to $160.5 million per year for the state government and $59.4 million per year for local governments if the Department of Revenue's rule were enforced.

Commissioner Gerregano said states cannot place an undue burden on interstate commerce and cannot discriminate against out-of-state sellers. The Supreme Court left open the question of whether South Dakota's law is unconstitutional. However, the Supreme Court's opinion in *Wayfair* outlined factors that weigh in favor of the South Dakota law's constitutionality:

- Sellers who transact only limit business in the state are exempt.
- Retroactive enforcement is prohibited.
- Several features of the Streamlined Sales and Use Tax Agreement, of which South Dakota is a member, reduce the burden on out-of-state sellers.

Similarly, if Tennessee were to require out-of-state sales and use tax collection using the method already in statute but not yet enabled, it would likely be upheld against a constitutional challenge (see attachment C).

One way Tennessee reduces the burden on out-of-state sellers with no physical presence in the state is by giving them the option of paying a uniform 2.25% rate instead of paying the local option sales tax rate of the local jurisdiction where the sale was delivered. This amounted to $1.6 billion for the state government and $368.2 million for local governments in fiscal year 2017-18. The optional 2.25% rate would expire on July, 1, 2019, but every two years since this provision and other streamlined sales tax provisions were first put into state law, the effective date has been extended two years into the future. Tennessee is the only state with a uniform rate option for local option sales tax, and Commissioner Gerregano said the trend is that more out-of-state sellers, currently about 37% of them, are paying local jurisdictions' local option sales tax rates, not the uniform rate. Many out-of-state sellers that pay local jurisdictions' rates in other states find it easier to do so in Tennessee as well.

For out-of-state sellers that do not opt for the uniform 2.25% local rate, the local jurisdiction that receives local option sales tax revenue is based on the destination (delivery) of the sale,[10] not its origin. Deputy Commissioner Barbara Sampson said the destination is based on the entire address, not just the ZIP code. Commissioner Gerregano said Tennessee is a destination-based state for out-of-state sales and an origin-based state for sales within the state (intrastate sales), including deliveries, but streamlined sales tax provisions in Tennessee state law[11] would make Tennessee a destination-based state for all sales if those provisions become effective July 1, 2019.

Another streamlined sales tax provision requires the removal of the single article cap on sales tax. Commissioner Gerregano said, if the streamlined sales tax provision removing the single article cap became effective on July 1, 2019, exceptions would still be made for big ticket items like cars, but not for jewelry.[12] He said there are three paths for Tennessee to consider: becoming a full member of the streamlined sales tax agreement, staying an associate member, and giving up membership.

Next Steps:

Because of the urgency of providing information to support potential legislation modifying or postponing the state's streamlined sales tax provisions set to become effective on July 1, 2019, the local government members recommend that the Commission's initial focus be on analyzing out-of-state sales tax collections and distributions. Ideally, the January 2019 Commission report will be a final report including that analysis as well as comprehensive information on services and other revenue. If it is not possible to complete the full report by January 1, 2019, the interim report should include that out-of-state sales tax analysis and supporting trend data at a minimum, and a final report with the comprehensive service and revenue data would be completed by May 2019.

The local government members also recommend that a representative from the Department of Revenue be included in a discussion panel at the Commission's December 2018 meeting to answer questions and provide updates on the status of the state's response to the *Wayfair* decision.

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[10] For sellers who have no location in the state and choose the uniform 2.25% rate option, it's based jurisdictions share of situs-based sales. See Tennessee Code Annotated, Section 67-6-710.
[11] Public Chapter 357, Acts of 2003, Section 74.
[12] Public Chapter 357, Acts of 2003, Section 64.