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The Real Story on Tennessee's Revenue Shortages

by Brett R. Carter

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In this article, Carter writes that Tennessee's budget shortfalls are probably not as attributable to loopholes as state leaders might have taxpayers believe. He suggests that taxpayers examine how the shortfall compares with lost franchise and excise tax revenue caused by companies relocating to other states.

Republican leadership in Tennessee recently closed the 2014 legislative session with major unanswered questions regarding the decline in state revenue collections. Tennessee franchise and excise tax collections are lagging approximately $130 million behind projections as of March, a shortfall of more than 10 percent. Although no reasons have been offered for the state's budget woes, Gov. Bill Haslam (R) took a page out of former Gov. Phil Bredesen's playbook in the final weeks of the legislative session, suggesting that the shortfall may be the product of taxpayers taking advantage of loopholes.

That is important to Tennessee taxpayers because the mention of loopholes during the Bredesen administration was a precursor to proposals to raise taxes — proposals that were generally met with approval from lawmakers on both sides of the aisle. The most memorable was the partial repeal of the exemption for some family-owned noncorporate entities in 2009.

Despite Haslam's speculation that loopholes are to blame for Tennessee's budget shortfall, the administration has made no effort to identify any loopholes that may exist, nor has it attempted to quantify how much of the shortfall is attributable to those hypothetical loopholes. The governor's comments, however, have left observers wondering what to expect.

Budget Debate Raises Questions

During the budget debate on the House floor in the final weeks of the session, Rep. Charles Sargent (R), chair of the House Ways and Means Committee, claimed that the Department of Revenue and other state finance departments have been unable to determine the reason why franchise and excise tax collections have been consistently below projections. Sargent avoided questions from Rep. Mike Stewart (D) when pressed about the administration's inability to offer any answers, saying only that the shortfall would be studied over the summer. That response was lacking for Democrats, who were challenging the administration's decision to forgo raises that were planned for state employees, including teachers.

Stewart said it "ought to be pretty easy" to look at the top 50 companies and see what they're doing, adding, "We should be able to figure it out in a few days." Stewart correctly pointed out that a large percentage of the franchise and excise tax collections come from relatively few taxpayers. It is believed that approximately 100 companies pay more than 80 percent of those taxes. Stewart said he was surprised the administration has not been able to provide more clarity.

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It is strange that state officials cannot provide the General Assembly with guidance on what industries or sectors have reported less tax due from 2012 to 2013. But the problem with Haslam's comments and Sargent's response to the budget shortfall question is that the reasons for that shortfall may not be that big of a mystery.

Possible Cause of Budget Shortages

A likely answer to questions related to the budget shortfall may be found by reviewing events related to company relocations in recent years. In 2012 Tennessee was unable to retain San Francisco-based pharmaceutical giant McKesson Corp., which moved its Memphis distribution operations across the border to Olive Branch, Mississippi.

While the loss of one company would hardly seem significant enough to cause the current shortfall in franchise and excise tax collections, publicly available court documents reveal that McKesson's facility served as the primary distribution channel for pharmaceutical companies throughout the United States and resulted in millions of dollars in franchise and excise tax revenue in Tennessee.

In 2011 and 2012, several lawsuits were filed seeking millions in refunds of franchise and excise tax paid. The lawsuits were based on the state's position that all pharmaceuticals sold through the McKesson facility in Memphis were Tennessee sales and the companies' position that this unfairly increased the franchise and excise tax liability of the various pharmaceutical companies using McKesson as a distributor. The state's position ignored the fact that a significant percentage of the pharmaceuticals were delivered to customer locations outside Tennessee.

As set forth in court documents, Allergan Inc. sought refunds of $1.2 million for 2009 and $1.5 million for 2010. Allergan had requested relief from the state for what it described as a tax position that resulted in a "gross distortion" of its Tennessee tax. That request was initially denied in the waning days of the Bredesen administration, and in 2011, the Haslam administration again denied Allergan's requested relief.

Allergan's cases are still pending, but in 2012, the McKesson distribution center moved to its new location across the border in Mississippi. It is likely no coincidence that the decline in Tennessee's tax revenue comes in the year following what appears to have been a major economic and community development loss for Tennessee.

Data compiled by the IMS Institute for Healthcare Informatics reveal that U.S. pharmaceutical sales in 2010 exceeded $300 billion in revenue. Of that total, Allergan reported approximately $4 billion in pharmaceutical sales.

If Allergan's $1.5 million refund claim is compared with total pharmaceutical sales in 2010, pharmaceutical companies may have been paying more than $150 million in Tennessee franchise and excise taxes in 2010 that is attributable to the state's position that is being challenged by Allergan. That amount is in line with the projected shortfall in the current fiscal year now that McKesson has moved its facility to Mississippi.

Mississippi Outmaneuvers Tennessee Legislature

Not surprisingly, a review of Mississippi tax laws that have been enacted in recent years reveals that the Mississippi Legislature has apparently outmaneuvered Tennessee, enacting tax incentives that exempt pharmaceutical distribution centers from the Mississippi franchise tax. In April Mississippi passed additional legislation to reduce Mississippi tax on pharmaceutical companies.

It seems obvious that at least some of the franchise and excise tax shortfall in Tennessee is attributable to the state's failure to retain key components of the pharmaceutical industry. While Tennessee grapples with the fallout of that relocation, it serves as a case study in the financial consequences to a state government that loses when a company relocates.

What Should Tennessee Taxpayers Expect Next?

Based on the administration and General Assembly's failure to answer questions related to the revenue shortage, it calls into question how transparent state officials are being on the issue. It is unclear why the governor would claim that tax loopholes are to blame when there is apparently an obvious answer to why franchise and excise tax collections are down.

The state's woes could also be the product of poor administration of the budgeting process, which raises questions about how thoroughly the state is vetting the assumptions on which the budget is based. State leaders should have at least considered the McKesson situation when preparing the budget rather than putting the state in a position to speculate about why there is a shortage.

Taxpayers should monitor this topic and scrutinize the state's explanation when it eventually studies the question and offers solutions to the revenue shortfalls. History has shown that when tax loopholes are to blame, government officials (Republicans included) do not hesitate to raise taxes. Just ask owners of family-owned noncorporate entities that now pay the franchise and excise taxes in Tennessee.

It will be interesting to see whether an increase in the franchise and excise taxes will be a palatable solution for a Republican administration and General Assembly that have in recent years repealed other taxes and never hesitated to promise lower taxes and less government. Less government this year meant that state workers, including teachers, were paid less than expected. ✰