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Reduction in Tennessee State Budget Outlook and Tackling the Franchise Tax Problem

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Lower-than-expected growth in the Tennessee economy has resulted in a slight decline in tax revenues thus far this fiscal year. Further complicating matters, state officials also recently disclosed a potential legal problem with the state's franchise taxes that will even further depress the state budget outlook, the combination of which is likely to leave little room in the state budget for new programs or initiatives this upcoming fiscal year, which starts July 1, 2024.

Fortunately, the state has been managed by fiscal conservatives, and as a result, Tennessee remains in a solid financial position. The rainy-day fund exceeds $2 billion, and the state has an ongoing cushion of up to $1.3 billion in annual funds received that have not been recognized as recurring funds for budgeting purposes, with that figure projected at $2.6 billion in the next fiscal year.

Revenue growth generally comes in around three percent annually in Tennessee (and has been as high as ten percent in recent years due to federal COVID-19 spending), but state revenues are predicted to flatline this year. According to the Commissioner of Finance and Administration Jim Bryson's testimony in Senate Finance, Ways and Means Committee on January 9, 2024, we should not expect any meaningful growth in revenues in the foreseeable future. Indeed, the State Funding Board recently assigned growth of the General Fund of only -0.50 to 0 percent going forward.

Making things even more difficult are the recently disclosed flaws in the state's franchise tax regime. For scale, approximately 13.5 percent of the state's revenue is generated by Franchise & Excise (F&E) taxes, with one-third of that amount generated by the Franchise tax. Based on the flaws in the tax system, F&E projections were revised downward to a staggering -7.9 percent.

According to Commissioner of Revenue, David Gerregano, who testified alongside Commissioner Bryson in the Senate committee meeting, "The pending legal challenge is…currently in the form of refund claims, but it puts the state at risk of litigation." Although the fiscal impact has not been publicly shared by the Department of Revenue, some have projected the franchise tax will cost the state between $1.2 and $1.5 billion in one-time funds (to cover refunds for three fiscal years of liability for improper taxes collected), plus an annual, recurring reduction in revenues of approximately $400 million.

Commissioner Bryson added, "Tennessee is well prepared to address this issue even in a slow growth year." For the past few years, the state has intentionally used recurring revenue for nonrecurring expenses, and the recurring revenue flexibility that has been created can be used to address the balanced budget challenges caused by, among other things, the franchise tax shortfall. For fiscal year 23-24, the state anticipates collecting approximately $1.3 billion in recurring revenue which it has not obligated.

As the legislative session progresses and the Governor's proposed budget is released, we will have a clearer picture of the budget and the effects on programmatic opportunities for clients. Upcoming Baker Donelson alerts will address subsequent information as it becomes available.

Our attorneys and our dedicated State Public Policy Advocacy Group will be closely monitoring developments. Please do not hesitate to contact Jacob Baggett with budget or policy questions, or to seek assistance engaging in the legislative process.