STATE INCOME TAX

Opportunities and Perspective as the Arkansas Tax Reform Task Force Nears Conclusion

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Arkansas Became a Red State—Now What?

Arkansas is one of an echelon of Upper South states that recently turned very "red." With Republican control of the governorship and both chambers of the legislature, politicians in recent years have been grappling with how to transform a complex, populist tax system into something that will encourage economic growth and reduce tax burdens.

Progress to date has been limited: Arkansas is a poor state in terms of per capita income, and it combines rock-bottom property taxes (3rd lowest in the nation), a progressive income tax with high marginal rates (6.9% individual and 6.5% corporate), and a high sales tax that taxes several business inputs while exempting many consumer purchases. It is a great place to own a modest home and live on a small fixed income. These same policy choices, however, make the state relatively less attractive to high earners and to geographically flexible manufacturing or service businesses.

With the support of Governor Hutchinson, the General Assembly has made some incremental progress in cutting and simplifying taxes: There was a $100 million middle class income tax rate cut in the 2015 legislative session,[2] which was followed by a $50 million lower income rate cut in the 2017 session.[3] And 2017 also saw a sales tax package that phased out the InvestArk investment credit while phasing in an exemption for manufacturing repair parts and services.[4] The good news is that these tax cuts and reform have brought real relief to many Arkansans. The fundamental problems of the state's tax structure remain: high top marginal income tax rates and significant overall complexity.

The Tax Reform and Relief Legislative Task Force came out of the 2017 legislative session as part of the low-income tax cut package. Many legislators desired larger tax cuts than what was proposed and to pursue broader reform in general. The Task Force is comprised of 16 legislators, including many leading state senators and representatives. The stated purposes of the Task Force are to:

- Modernize and simplify the Arkansas tax code;
- Make the Arkansas tax laws competitive with other states to attract businesses to the state;
- Create jobs for Arkansans; and
- Ensure fairness to all individuals and entities impacted by Arkansas tax laws.

The Task Force first convened in May 2017. Typically, the Task Force met monthly with hearings stretched over two days.[5] The first nine months were solely educational, with presentations from various stakeholders. The Task Force has narrowed down policy proposals in recent months for further study. The Task Force will provide its final report by September 1, 2018. It is anticipated that the Task Force's proposals will be considered in the 2019 legislative session.

Income Tax Reform as Low-Hanging Fruit

Of the three major tax types, income tax seems likely to see the most substantial reform proposed.[6] Clearly, rate cuts will be a part of this. The governor has suggested an individual rate cut from 6.9% to 6.0% for the 2019 legislative session,

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2 Act 22 of the 2015 General Assembly.

3 Acts 78 and 79 of the 2017 General Assembly.

4 Act 465 of the 2017 General Assembly. InvestArk stopped taking new applications after June 30, 2017. The manufacturing repair parts and services exemption phases in with a reduced rate refund mechanism until complete exemption is achieved in July 2022.

5 We cover Task Force meetings on our Arkansas Tax and Incentives Updates blog (http://www.doverdixonhorne.com/ARTaxandIncentivesUpdate). Please email me or subscribe on the website if you would like to receive these updates via email.

6 This article was written in mid-May of 2018.

and even deeper cuts are being considered by the Task Force. The long-term goal is to get rates under 5%, a level that is generally perceived as being low enough to not drive away high-income individuals. Corporate rate cuts are also under consideration.

State income taxes are much more than rates alone. The Task Force has an opportunity to educate legislators on these nonintuitive, but vital issues. For example, Arkansas's old-school apportionment system is under review. Currently, it is a three-factor, double-weighted sales formula. The sales factor calculation applies a throwback rule and uses a proportional costs-of-performance approach to sourcing services and intangibles. The net effect is an apportionment formula that weighs heavily on in-state businesses, many of which effectively face double taxation when selling into single sales factor, market-sourcing jurisdictions. And compared with other proposals, apportionment reform at least partially offsets the lost revenue from in-state tax relief with revenue raised from out-of-state businesses.

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Net operating losses (NOLs) are another issue ripe for reform. The state's five-year NOL carryforward stands out as the most restrictive in the nation (together with that of Rhode Island). The result is to expose cyclical businesses to substantial risk of double taxation, if they cannot use NOLs within the carryforward period. Reforming NOLs is potentially an important part of making the state more attractive to capital investment.

Federal conformity is another area to watch. Arkansas's income tax framework is as independent as you can get, with a freestanding definition of income and only specific chapters and sections of the Internal Revenue Code adopted as of various effective dates. While the Task Force heard testimony this past winter about the impact of federal tax reform, there have been few requests for follow-up. But as news of other states' experiences filter into the state, do not be surprised to see the Task Force revisit adopting portions of the recent federal tax reform bill, particularly to the extent the Task Force seeks to raise revenue. The Task Force is also considering adopting some of the more pro-growth aspects of federal tax reform, such as accelerated depreciation and expensing.

Direct Business Input Needed and Valued

Testimony at the Task Force to date has been dominated by economists, tax administrators, legislative staff, policy wonks, and industry associations. Little has been heard from the experiences of actual business taxpayers as to how Arkansas compares with other states. Part of this may be a disinclination by various business taxpayers to come forward and invite attention to their companies. However, it also leaves those with firsthand knowledge of how tax policies affect business location and expansion decisions unable to share those insights with the Task Force. While policy professionals can address macro issues of tax rates, exemptions, etc., they do not capture the micro-level issues of ambiguities and cumbersome compliance mechanisms that cause headaches for taxpayers.

The notable exception has been a presentation in by Leisa Cagle, Vice President and Controller of McKee Foods. In April 2018, April walked the Task Force through a sophisticated presentation about how her company experiences the Arkansas tax and incentives environment. Arkansas stood out for having higher sales/use, income, and ad valorem personal property tax burdens compared to the company's locations in Tennessee and Virginia. The Task Force legislators were appreciative, as the testimony provided insight as to how the state's tax policy choices affect business decision-making and perceptions of the state's competitiveness.

Businesses should not underestimate the importance of providing input. These business leaders can credibly explain the interplay between state tax policy and business location and expansion decisions. This can be done through some combination of public testimony like that of McKee Foods, private discussions with legislators, and input to third-party industry organizations and business groups. Doing so effectively requires collaboration between the technical expertise of the tax function and the knowledge of the political landscape provided by government relations. For smaller enterprises without a dedicated government relations function, consider leveraging local chambers of commerce, industry associations, or the Arkansas State Chamber of Commerce for guidance in navigating the political landscape.

Good Ideas—Now How to Pay for Them?

Perhaps part of the reason for businesses' reticence in the Arkansas tax reform process to-date is that it is not obvious how to pay for the reform needed to make the state more competitive. Once you are stuck in a populist tax system, it is hard to get out. The state's low property tax rates and relative poverty—especially in rural areas—mean that local governments rely heavily on sales taxes and state-

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level funding. Arkansas state-level income taxes and sales taxes need to pay for not only state government, but also for much of local government. These taxes, as currently structured, weigh heavily on the business communities and high-income individuals. This means that there is not that much room for pro-growth tax reform that has any sort of revenue impact.

A few months ago, it seemed that the reinstatement of the full general sales tax on groceries could be the source of significant revenue to pay for substantial reform. There was a consensus among both conservative[7] and liberal[8] policy groups that it would be better policy to restore the sales tax on groceries. In addition, a targeted "groceries" income tax credit would be offered to make it up to poor families. After all, a general groceries exemption is an imprecise policy tool because you are exempting not only necessities like rice, beans, and milk, but also luxury consumption items like caviar, prime rib, and wild salmon. This good policy idea ran into the buzz saw of political reality. Questions arose whether such a reform could ever have passed the General Assembly. In any event, Arkansas is in an election year. Amidst a conservative grassroots outcry, the grocery tax was seized on by conservative primary challengers, including a challenger to Governor Hutchinson in the gubernatorial primary. A letter from Governor Hutchinson to the Task Force stating his opposition to sales tax on groceries seems to have stopped the grassroots outcry and foreclosed the grocery tax idea for the time being. This leaves the Task Force searching for ways to raise revenue.

The Task Force stands in contrast to more behind-the-scenes efforts in other states. This has been good in terms of educating legislators on complex tax issues. At the same time, it becomes more difficult to make policy choices. A long, drawn out process does not lend itself to political courage, particularly when there is not much going on at the Capitol. At the end of the day, it would not be surprising if the Task Force's final report does not offer a comprehensive reform package including necessary provisions to raise revenue. Perhaps it will be just a list of good policies that the legislature should try to implement in the years ahead, to the extent state revenue allows.

Whatever the contents of the Task Force's final report turn out to be, it will be too soon to tell whether the Task Force was a success. Perhaps most of the Task Force's value will have been educating a generation of part-time, generalist legislators on Arkansas tax policy issues. The test then will be the legislative outcomes in 2019 and the next few sessions thereafter. Tax bills will be coming in front of Task Force legislators who have been educated on the issues and who have ideas about where the state should go. Tax reform ideas that were not considered by the Task Force may face an especially skeptical audience. As such, business taxpayer involvement during the final months of the Task Force process is crucial. A once-in-a-generation opportunity to educate generally pro-business, pro-growth legislators about beneficial tax policy ideas should be embraced, not avoided.

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7 The Tax Foundation and the Arkansas Center for Research in Economics (ACRE).

8 Arkansas Advocates for Children and Families (AACF) and the Institute on Taxation and Economic Policy (ITEP).