State of Arkansas
Tax Relief and Reform
Legislative Task Force
Corporate Income Tax

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Discussion Topics

- Overview and History
- Corporate Income Tax Revenues
- Corporate Income Tax Characteristics and Benchmarking
- Corporate Tax Avoidance and State Responses
- Corporate Income Tax Expenditures
- Key Issues
Overview and History
Overview

- States Generally Assess a Corporate Income Tax
  - 44 states
  - Includes states without a broad-based individual income tax (Alaska, Florida, New Hampshire, Tennessee)

- Primary Alternative is a Gross Receipts Tax
  - Four states levy (Nevada, Ohio, Texas, Washington)
  - Two states do not levy either a corporate income or gross receipts tax (South Dakota, Wyoming)

- Makes Up a Comparatively Small Portion of Overall State Tax Revenue
  - Totals 5.4 percent of FY2014 state tax revenue (U.S. Census Bureau)
  - Trend is downward in share of state revenue
  - Factors include changes in how states apportion income and other tax changes, how businesses are structured

- Economic Efficiency, Equity Concerns
  - Income taxed twice – at corporate level when earned and shareholder level when distributed
  - Higher income less ‘ability to pay’ connection than on individual income tax
History of State Corporate Income Taxes

- Form of corporate income tax dates to colonial times
  - Earliest forms of ‘faculty’ (or ability) taxes used property as the sole proxy
  - Continued to evolve to include ‘artists and tradesmen’ and their ‘returns and gains’
  - First enacted in Massachusetts (1643), spread to other colonies, such as Connecticut (1650), Rhode Island (1673), New Jersey (1684)
  - Expanded and enhanced in other locales (such as Southern states) in the 1700s

- Modern state corporate income taxes:
  - Hawaii Territory (prior to statehood) in 1901
  - Wisconsin 1911 – with reliance on state rather than local collection
  - Virginia 1916, New Mexico and North Dakota 1919, Mississippi and North and South Carolina 1921, Tennessee 1923

- Similar rise/expansion as with individual income taxes
  - Replacement for existing property-based and excise taxes
  - Need for new revenue replacement during the Great Depression era
  - Oklahoma 1931, Alabama and Kansas 1933, Iowa and Louisiana 1934
Corporate Income Taxes vs. Business Taxes in General

- Corporate income taxes only apply to c-corporations
  - Vast majority of businesses are not organized as c-corporations
  - Of 26 million businesses, 5 percent organized as c-corporations (U.S Department of Treasury, tax year 2014)
  - Rest are pass through entities, where owners are taxed via the individual income tax
  - Nationally, these businesses make up a majority of business income

- Businesses also pay other taxes
  - Property tax, sales and use tax, severance, excise and other taxes
  - According to the Council on State Taxation (COST), In FY2016, businesses accounted for $724.1 billion (approximately 44 percent) of all state and local tax revenue
  - For Arkansas, COST estimates the amount at $4.8 billion, 40.3 percent of all state and local taxes

Ernst &Young, STRI, COST, “Total State and Local Business Taxes, FY2016,” August 2017
Corporate Income Tax in Arkansas

- Enacted in 1929 as a 2 percent tax on net income

- Major changes from the original tax:
  - 1941 introduced five brackets with rates ranging from 1 percent to 5 percent
  - 1969 rates were increased by 1 percentage point for top two brackets
  - 1991 introduced 6.5 percent tax rate on all corporate net income if income is over $100,000
Corporate Income Tax Revenues

State General Revenues by Share (1977-2014)

Arkansas Corporate Income Tax Revenue (1977 to 2015 in millions)

Source: Tax Policy Center, State & Local Government Finance Data Query, 2017
Corporate Income Tax Characteristics and Benchmarking
Share of Overall Tax Collections

- Arkansas corporate income tax revenue slightly below national average (5.4 percent) and around the middle of benchmark states

<table>
<thead>
<tr>
<th>State</th>
<th>Percent of Total Tax Collections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tennessee</td>
<td>11.5%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>6.0%</td>
</tr>
<tr>
<td>Nebraska</td>
<td>6.0%</td>
</tr>
<tr>
<td>Indiana</td>
<td>5.9%</td>
</tr>
<tr>
<td>Kansas</td>
<td>4.9%</td>
</tr>
<tr>
<td>Arkansas</td>
<td>4.8%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>4.1%</td>
</tr>
<tr>
<td>Iowa</td>
<td>3.9%</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>3.9%</td>
</tr>
<tr>
<td>Alabama</td>
<td>3.8%</td>
</tr>
<tr>
<td>Missouri</td>
<td>2.7%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>1.8%</td>
</tr>
<tr>
<td>Texas</td>
<td>--</td>
</tr>
</tbody>
</table>

Source: Federation of Tax Administrators
State Corporate Income Tax Comparisons

- Most states have a flat rate (31 states)
  - Range is from low of 3.0 percent (North Carolina) to high of 9.99 percent (Pennsylvania)
  - Average rate is 6.76 percent, median rate is 6.5 percent, most common rates are 6 and 6.5 percent (four states each)

- Remaining states have a progressive tax with income brackets
  - Most remaining states have either 2 or 3 brackets, with one state each having 5, 6 and 10 brackets
  - A few states have compressed brackets, such as Mississippi ($5,000 to $10,001), North Dakota ($25,000 to $50,001), Vermont $10,000 to $25,000)
  - Four states allow a deduction for federal taxes paid (Alabama, Iowa, Louisiana, Missouri)
Federal Starting Point

- Most states start from taxable or net taxable income. The primary difference is net operating losses are subtracted from taxable income.
- Arkansas starting point is gross sales.

<table>
<thead>
<tr>
<th>State</th>
<th>Federal Starting Point</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>---</td>
</tr>
<tr>
<td>Arkansas</td>
<td>---</td>
</tr>
<tr>
<td>Indiana</td>
<td>Taxable Income</td>
</tr>
<tr>
<td>Iowa</td>
<td>Net Taxable Income</td>
</tr>
<tr>
<td>Kansas</td>
<td>Net Taxable Income</td>
</tr>
<tr>
<td>Louisiana</td>
<td>Taxable Income</td>
</tr>
<tr>
<td>Mississippi</td>
<td>---</td>
</tr>
<tr>
<td>Missouri</td>
<td>Net Taxable Income</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Net Taxable Income</td>
</tr>
<tr>
<td>North Carolina</td>
<td>Taxable Income</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>Taxable Income</td>
</tr>
<tr>
<td>Tennessee</td>
<td>Taxable Income</td>
</tr>
<tr>
<td>Texas</td>
<td>Gross Income</td>
</tr>
</tbody>
</table>

Source: Federation of Tax Administrators
State Conformance with the Federal Tax Code

- Arkansas is one of three states that does not conform to either taxable or net taxable income

Source: Tax Foundation, Federation of Tax Administrators
## State Corporate Income Taxes, Benchmark States

<table>
<thead>
<tr>
<th>State</th>
<th>Tax Rate Lowest</th>
<th>Tax Rate Highest</th>
<th>Number of Brackets</th>
<th>Income Bracket Lowest</th>
<th>Income Bracket Highest</th>
<th>Federal Taxes Deductible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>1.0%</td>
<td>6.5%</td>
<td>6</td>
<td>$3,000</td>
<td>$100,001</td>
<td>No</td>
</tr>
<tr>
<td>Alabama</td>
<td>6.5%</td>
<td>6.5%</td>
<td>1</td>
<td>Flat Rate</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Iowa</td>
<td>6.0%</td>
<td>12.0%</td>
<td>4</td>
<td>$25,000</td>
<td>$250,001</td>
<td>Yes</td>
</tr>
<tr>
<td>Kansas</td>
<td>4.0%</td>
<td>4.0%</td>
<td>1</td>
<td>Flat Rate</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Louisiana</td>
<td>4.0%</td>
<td>8.0%</td>
<td>5</td>
<td>$25,000</td>
<td>$200,001</td>
<td>Yes</td>
</tr>
<tr>
<td>Mississippi</td>
<td>3.0%</td>
<td>5.0%</td>
<td>3</td>
<td>$5,000</td>
<td>$10,001</td>
<td>No</td>
</tr>
<tr>
<td>Missouri</td>
<td>6.25%</td>
<td>6.25%</td>
<td>1</td>
<td>Flat Rate</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Nebraska</td>
<td>5.58%</td>
<td>7.81%</td>
<td>2</td>
<td>$100,000</td>
<td>$100,000</td>
<td>No</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>6.0%</td>
<td>6.0%</td>
<td>1</td>
<td>Flat Rate</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Tennessee</td>
<td>6.5%</td>
<td>6.5%</td>
<td>1</td>
<td>Flat Rate</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Texas</td>
<td>Franchise tax imposed on various entities at differing rates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Net Operating Loss Carry Forward/Carry Back

- Federal IRC allows 20 years of losses to be carried forward and for 2 years to be carried back
- ‘Levels the playing field’ for cyclical industries or unusual events

<table>
<thead>
<tr>
<th>State</th>
<th>Carry Forward</th>
<th>Carry Back</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>15</td>
<td>2</td>
</tr>
<tr>
<td>Arkansas</td>
<td>5</td>
<td>-</td>
</tr>
<tr>
<td>Indiana</td>
<td>20</td>
<td>-</td>
</tr>
<tr>
<td>Iowa</td>
<td>20</td>
<td>-</td>
</tr>
<tr>
<td>Kansas</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>Louisiana</td>
<td>20</td>
<td>-</td>
</tr>
<tr>
<td>Mississippi</td>
<td>20</td>
<td>2</td>
</tr>
<tr>
<td>Missouri</td>
<td>20</td>
<td>2</td>
</tr>
<tr>
<td>Nebraska</td>
<td>20</td>
<td>-</td>
</tr>
<tr>
<td>North Carolina</td>
<td>15</td>
<td>-</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>20</td>
<td>2</td>
</tr>
<tr>
<td>Tennessee</td>
<td>15</td>
<td>-</td>
</tr>
<tr>
<td>Texas</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Federation of Tax Administrators
Apportionment of State Corporate Income

- Apportionment is the process of assigning to a particular state that portion of a multistate corporation’s income that the state may tax.
- Traditional method (sales, property and payroll equally weighted) is now only used in eight states.
- Most common method is to apportion solely on the sales factor (20 states).
- Arkansas is one of nine states that double weight sales while also using property and payroll in its formula.
- Other formulas are also used:
  - Choice between single sales factor or double weighted sales (four states)
  - Triple weighted sales (one state), quadruple weighted sales (one state)
  - 80 percent sales, 10 percent each of property and payroll (one state)
## Apportionment Formula of Benchmark States

<table>
<thead>
<tr>
<th>State</th>
<th>Apportionment Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Double weighted sales</td>
</tr>
<tr>
<td><strong>Arkansas</strong></td>
<td><strong>Double weighted sales</strong></td>
</tr>
<tr>
<td>Indiana</td>
<td>Sales</td>
</tr>
<tr>
<td>Iowa</td>
<td>Sales</td>
</tr>
<tr>
<td>Kansas</td>
<td>3 Factor</td>
</tr>
<tr>
<td>Louisiana</td>
<td>3 Factor</td>
</tr>
<tr>
<td>Mississippi</td>
<td>Sales/Other</td>
</tr>
<tr>
<td>Missouri</td>
<td>3 Factor</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Sales</td>
</tr>
<tr>
<td>North Carolina</td>
<td>Quadruple weighted sales</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>3 Factor</td>
</tr>
<tr>
<td>Tennessee</td>
<td>Triple weighted sales</td>
</tr>
<tr>
<td>Texas</td>
<td>Sales (Gross Receipts Tax)</td>
</tr>
</tbody>
</table>

*Source: Federation of Tax Administrators*
Corporate Tax Avoidance and State Responses
Overview

- Corporate tax revenue decline as a share of revenue has been the norm

Share of State Tax Revenue

- Corporate tax planning has impacted on corporate tax collections
- States have devised various strategies to combat that
- Generally opposed by business groups as onerous or overly complicated
Combined Reporting

- Corporations can use passive investment companies (PICs) located in states without corporate taxes to offset income in other states.
- Combined reporting treats corporations as a unit for purposes of allocating profits for tax purposes – 25 states have adopted.

<table>
<thead>
<tr>
<th>State</th>
<th>Throwback Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>No</td>
</tr>
<tr>
<td>Arkansas</td>
<td>No</td>
</tr>
<tr>
<td>Indiana</td>
<td>No</td>
</tr>
<tr>
<td>Iowa</td>
<td>No</td>
</tr>
<tr>
<td>Kansas</td>
<td>Yes</td>
</tr>
<tr>
<td>Louisiana</td>
<td>No</td>
</tr>
<tr>
<td>Mississippi</td>
<td>No</td>
</tr>
<tr>
<td>Missouri</td>
<td>No</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Yes</td>
</tr>
<tr>
<td>North Carolina</td>
<td>No</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>No</td>
</tr>
<tr>
<td>Tennessee</td>
<td>No</td>
</tr>
<tr>
<td>Texas</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Institute on Taxation and Economic Policy, February 2017
Corporate Income Tax Expenditures
Significant Corporate Income Tax Expenditures

- The State offers a variety of credits, deductions and exemptions that reduce corporate income tax liability

- Deductions reduce taxable income by a given amount, while credits are a subtraction against liability

- In 2016, the State provided 18 corporate income tax credits, 7 of which were in excess of $1 million

<table>
<thead>
<tr>
<th>Program Name</th>
<th>Amount Claimed in 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Waste Reduction and Recycling Equipment Credit</td>
<td>$11,907,856</td>
</tr>
<tr>
<td>Create Rebate Program (Payroll Rebate)</td>
<td>$11,378,089</td>
</tr>
<tr>
<td>ArkPlus Income Tax Credit</td>
<td>$9,776,510</td>
</tr>
<tr>
<td>Equity Investment Incentive Act of 2007</td>
<td>$3,226,267</td>
</tr>
<tr>
<td>Research and Development Credits</td>
<td>$4,169,960</td>
</tr>
<tr>
<td>Advantage Arkansas Income Credit</td>
<td>$3,540,409</td>
</tr>
<tr>
<td>Historic Rehabilitation Income Tax Credit</td>
<td>$2,450,722</td>
</tr>
</tbody>
</table>

Source: DFA – Business Incentives and Tax Credit Program Costs Through December 31, 2016
Significant Corporate Income Tax Expenditures

- **Deduction for Business Expenses**: Allows a deduction for trade or business expenses ($8.7 billion in 2014)

- **Interest Deduction**: Allows a deduction for interest expense pursuant to IRC § 163 ($352 million in 2014)

- **Depreciation Deduction**: Allows a deduction for depreciation and the expensing of property pursuant to IRC § 167, 168(a)-(j), 179 and 179A ($318 million in 2014)

- **Worthless Debts Deduction**: Allows a deduction for debts ascertained to be worthless and charged off the books ($225 million in 2014)

- **Taxes Deduction**: Allows a deduction for certain taxes ($188 million in 2014)

*Source: DFA Income Tax Section – IIT and CIT – Tax Expenditures*
Key Issues
Key Corporate Tax Issues

- Federal Tax Reform
  - Changes to Section 179 pass-through expensing and bonus depreciation
  - Adjustments to net operating loss provisions
  - Changes to deductions for net interest expense

- Consideration of rate changes
  - State corporate rate changes in past five years mostly rate reductions
  - Possible move to a single rate

- Apportionment
  - State movement has been toward a single sales factor
  - Arguments/data on both sides of the issue
  - Recent study for New Mexico suggested that increasing the sales factor weigh showed ‘a small but positive gain in employment and income’

- Other Issues
  - Options to improve on current business tax climate rankings
  - Conforming with federal IRC after Tax Cuts and Jobs Act
Questions and Discussion