Department of Finance and Administration

Legislative Impact Statement

Bill: SB571
Bill Subtitle: TO CREATE AN EARNED INCOME TAX CREDIT, AN INCREASED STANDARD DEDUCTION, AND AN INDIVIDUAL INCOME TAX REDUCTION; AND TO PROVIDE FUNDING FOR INCOME TAX REDUCTIONS THROUGH NEW TAXES ON CIGARETTES AND E-CIGARETTES.
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Basic Change :

Sponsors: Senators J. Hendren, Bledsoe, Bond, E. Cheatham, L. Chesterfield, J. Cooper, L. Eads, Elliott, Hester, Irvin, B. Johnson, M. Johnson, G. Leding, Maloch, M. Pitsch, Rapert, D. Wallace

Representatives L. Johnson, Clowney, F. Allen, Blake, Boyd, Breaux, Burch, Cloud, A. Collins, Cozart, D. Douglas, Evans, D. Ferguson, K. Ferguson, Fielding, V. Flowers, D. Garner, Glover, Godfrey, Hawks, Hillman, M. Hodges, Kelly, Love, Lundstrum, Lynch, Magie, McCullough, Murdock, Nicks, Perry, Petty, Richardson, Richey, Rushing, Rye, Scott, Walker, Watson, D. Whitaker

SB571 would amend Arkansas Code provisions regarding state taxation to reduce individual income tax rates, increase the standard deduction, create an earned income tax credit, levy new retail taxes on cigarettes, and levy a new excise tax on e-cigarettes.

The bill would amend the Arkansas low-income tax table to eliminate the 2% bracket (taxable income of $4,500 to $8,899) and increase the standard deduction from $2,200 to $3,300. The reduced tax rates and increased standard deduction would be effective for tax years beginning on and after January 1, 2020.

The bill would establish a refundable earned income tax credit in the Arkansas income tax code beginning for tax year 2020. The credit would be in the amount of at least five percent (5%) of the credit allowed under federal law if there are sufficient funds in the Earned Income Tax Credit Trust Fund to provide the necessary funding. The bill establishes the "Earned Income Tax Credit Trust Fund" to receive deposits from a portion of the new 20% retail tax on cigarettes. The Earned Income Tax Credit Trust Fund would be used to offset the cost of the earned income tax credit allowed. The refundable earned income tax credit would be effective for tax years beginning on and after January 1, 2020 with the fiscal impact being reflected in FY2021 state income tax collections and refundable income tax credits being issued.

Beginning on January 1, 2022, and on January 1 of each following year, DFA would certify the total amount of the earned income tax credits claimed during the previous year and transfer the amount certified from the Earned Income Tax Credit Trust Fund to the General Revenue Fund. The first transfer of funds would occur in FY2022 for the earned income tax credits allowed in FY2021. No funds would be transferred in FY2021 for the FY2021 earned income tax credits allowed.

The bill establishes the "Earned Income Tax Credit Trust Fund" to receive deposits from a portion of the new retail tax on cigarettes. After the first $55 million in revenue from the 20% retail tax on cigarettes is deposited to General Revenue, the remainder of the tax collections would be deposited to the Earned Income Tax Credit Trust Fund. The Earned Income Tax Credit Trust Fund would be used to offset the cost of the earned income tax credits allowed as provided in the bill. Beginning on January 1, 2022, and on January 1 of each following year, DFA would certify the total amount of the income tax credits claimed during the previous year and transfer the amount certified from the Earned Income Tax

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Credit Trust Fund to the General Revenue Fund.

The bill also creates and levies a new special excise tax on cigarettes sold in Arkansas. The tax would be levied at the tax rate of 20% of the retail price and collected by the retailer at the time of sale to the consumer. The tax would be in addition to all other taxes and cumulative to the state and local sales tax. Retailers would file and remit the tax at the same time and in the same manner as filing their state sales tax. The tax returns would be filed electronically and failure to file a return and remittance will result in an assessment of penalty in the amount of 10% of the tax due. The first $55 million in revenue would be deposited to General Revenue Fund with the remainder deposited to the Earned Income Tax Credit Trust Fund.

This proposal also levies a new "E-Cigarette Privilege Tax" at the tax rate of 68% of the selling price from the manufacturer or wholesaler to the retailer on e-cigarettes sold in this state. “E-cigarette” is defined to mean a vapor product or an e-liquid product as those terms are defined by current Arkansas law. The privilege tax would be imposed, reported, remitted and administered in the same manner and at the same time as taxes on tobacco products under the Arkansas Tobacco Products Tax Act. The proposal requires the privilege tax to be separately stated and identified on each invoice or statement as the "E-cigarette Privilege Tax." The privilege tax levied under this section applies to the inventory and stocks of e-cigarettes held by a wholesaler or a retailer on the effective date of the act. The revenue generated would be deposited as state General Revenue.

The provisions of the bill providing the increased standard deduction, reduced tax rate, and the earned income tax credit would be effective for income tax years beginning on and after January 1, 2020. The provisions of the bill levying the special 20% retail tax on cigarettes and the e-cigarette privilege tax would be effective on the first day of the second calendar month following the effective date of this act, which is anticipated to be September 1, 2019.

<u>Revenue Impact :</u>

FY2020

(9 Months of New Tax Collections)

20% Retail Excise Tax on Cigarette Sales

+$30.0 Million Net Gain in State General Revenue
· -$20.1 Million Loss of Existing Cigarette Tax General Revenue -- Reduced Consumption
· -$4.9 Million Loss of Existing Sales Tax General Revenue -- Reduced Consumption
· +55.0 Million Gain from New 20% Retail Tax on Cigarette Sales
-$2.8 Million Loss in Special Revenue
· -$0.6 Million Loss of Existing Cigarette Tax Special Revenue -- Reduced Consumption
· -$2.2 Million Loss of Existing Sales Tax Special Revenue -- Reduced Consumption
+$45.1 Million Gain from 20% Retail Tax on Cigarette Sales -- Earned Income Tax Credit Trust Fund

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Privilege Tax on E-Cigarettes

+$5.56 Million Gain to State General Revenue

Rate Reduction in Low-Income Tax Table

-$8.35 Million Reduction in General Revenue

Increase in Standard Deduction from $2,200 to $3,300

-$20.85 Million Reduction in General Revenue

Earned Income Tax Credit

No Impact to General Revenue

+$45.1 Million Gain from 20% Retail Tax on Cigarette Sales -- Earned Income Tax Credit Trust Fund

FY2020 – Net General Revenue Impact

+ 30 Million – 20% Excise Tax on Cigarette Sales
+ $5.56 Million – Privilege Tax on E-Cigarettes
- $8.35 Million – Rate Reduction in Low-Income Tax Table
- $20.85 Million – Increase Standard Deduction

+ $6.4 Million Net Gain to General Revenue

FY2020 – Transfers -- Earned Income Tax Credit Trust Fund

+$45.1 Million Gain from 20% Retail Tax on Cigarette Sales deposited into Earned Income Tax Credit Trust Fund

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FY2021

20% Retail Excise Tax on Cigarette Sales

+$22.3 Million Net Gain in State General Revenue
- -$26.3 Million Loss of Existing Cigarette Tax General Revenue -- Reduced Consumption
- -$6.4 Million Loss of Existing Sales Tax General Revenue -- Reduced Consumption
- +55.0 Million Gain from 20% Retail Tax on Cigarette Sales

-$3.7 Million Loss in Special Revenue
- -$0.8 Million Loss of Existing Cigarette Tax Special Revenue -- Reduced Consumption

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· -$2.8 Million Loss of Existing Sales Tax Special Revenue -- Reduced Consumption
+$75.7 Million Gain from 20% Retail Tax on Cigarette Sales -- Earned Income Tax Credit Trust Fund

Privilege Tax on E-Cigarettes

+$7.42 Million Gain to State General Revenue

Rate Reduction in Low-Income Tax Table

- $16.7 Million Reduction in General Revenue

Increase in Standard Deduction from $2,200 to $3,300

- $41.7 Million Reduction in General Revenue

Earned Income Tax Credit

- $38.35 Million Reduction in General Revenue assuming 5% Federal EITC

+$75.7 Million Gain from 20% Retail Tax on Cigarette Sales -- Earned Income Tax Credit Trust Fund

FY2021 – Net General Revenue Impact

+ 22.3 Million – 20% Excise Tax on Cigarette Sales
+ $7.42 Million – Privilege Tax on E-Cigarettes
- $16.7 Million – Rate Reduction in Low-Income Tax Table
- $41.7 Million – Increase Standard Deduction
- $38.35 Million – 5% EITC

- $67.1 Million Net Reduction to General Revenue

FY2021 – Transfers -- Earned Income Tax Credit Trust Fund

+$75.7 Million Gain from 20% Retail Tax on Cigarette Sales deposited into Earned Income Tax Credit Trust Fund

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FY2022

20% Retail Excise Tax on Cigarette Sales

+$22.3 Million Net Gain in State General Revenue
· -$26.3 Million Loss of Existing Cigarette Tax General Revenue -- Reduced Consumption
· -$6.4 Million Loss of Existing Sales Tax General Revenue -- Reduced Consumption

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· +55.0 Million Gain from 20% Retail Tax on Cigarette Sales
-$3.7 Million Loss in Special Revenue
· -$0.8 Million Loss of Existing Cigarette Tax Special Revenue -- Reduced Consumption
· -$2.8 Million Loss of Existing Sales Tax Special Revenue -- Reduced Consumption
+$75.7 Million Gain from 20% Retail Tax on Cigarette Sales -- Earned Income Tax Credit Trust Fund

Privilege Tax on E-Cigarettes

+$7.42 Million Gain to State General Revenue

Rate Reduction in Low-Income Tax Table

- $16.7 Million Reduction in General Revenue

Increase in Standard Deduction from $2,200 to $3,300

- $41.7 Million Reduction in General Revenue

Earned Income Tax Credit

- $38.35 Million Reduction in General Revenue assuming 5% Federal EITC

+$75.7 Million Gain from 20% Retail Tax on Cigarette Sales -- Earned Income Tax Credit Trust Fund

FY2022 – Net General Revenue Impact

+ 22.3 Million – 20% Excise Tax on Cigarette Sales
+ $7.42 Million – Privilege Tax on E-Cigarettes
- $16.7 Million – Rate Reduction in Low-Income Tax Table
- $41.7 Million – Increase Standard Deduction
- $38.35 Million – 5% EITC
+ 38.35 Million – Transfer from EITC Trust Fund to General Revenue

- $28.7 Million Net Reduction to General Revenue

FY2022 – Transfers -- Earned Income Tax Credit Trust Fund

+$75.7 Million Gain from 20% Retail Tax on Cigarette Sales deposited into Earned Income Tax Credit Trust Fund
- $38.35 Million – Transfer from EITC Trust Fund to General Revenue

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For purposes of clarification, the three year fiscal impact is summarized below:

	GENERAL REVENUE			EITC TRUST FUND			SPECIAL REVENUE		
Millions of $									
	FY20	**FY21**	**FY22**	**FY20**	**FY21**	**FY22**	**FY20**	**FY21**	**FY22**
20% Cigarette Retail Tax	55.0	55.0	55.0	45.1	75.7	75.6	0.0	0.0	0.0
Cigarette Excise Tax (consumption decline, stamps)	-20.1	-26.3	-26.3	---	---	---	-0.6	-0.8	-0.8
Sales Tax (consumption decline)	-4.9	-6.4	-6.4	---	---	---	-2.2	-2.8	-2.8
E-Cigarette Tax	5.6	7.4	7.4	---	---	---	---	---	---
Change in Low-Income Tax Table	-8.4	-16.7	-16.7	---	---	---	---	---	---
Increase in Standard Deduction	-20.8	-41.7	-41.7	---	---	---	---	---	---
Earned Income Tax Credit (5%)*	---	-38.4	-38.4	---	---	---	---	---	---
	---	---		---	---	---			
Transfer from EITC Trust Fund to General Revenue*			38.4			-38.4	---	---	---
TOTAL	**6.4**	**-67.1**	**-28.7**	**45.3**	**75.6**	**37.2**	**-2.8**	**-3.7**	**-3.7**

*For cash flow purposes, FY2022 unofficial estimates are added to show impact of first transfer of revenues from EITC Trust Fund to General Revenue. Additionally, the cost of Earned Income Tax Credit is assumed at 5% level although more revenues in the Trust Fund could result in higher credit levels.

[Cigarettes --- Impact Loss to General Revenues resulting from consumption reductions affecting existing sales and cigarette excise taxes based on an elasticity determination based on economic analysis with observations of first few months of Oklahoma's recent cigarette tax increase and its impact on cigarette consumption. A 1% increase in retail price leads to a 0.82% decline in consumption. Retail average pricing used in analysis for the 20% Retail tax is from data published by the Tobacco Institute that reflects average price per pack in Arkansas of $5.83. Required minimum per package pricing by retailers in Arkansas as published by the Arkansas Tobacco Control Board ranges from $3.45 per package to $8.58 per package using the March 2019 pricing sheet with the most commonly recognized brands with required retail prices ranging from $5.75 to $6.25. The analysis assumes that retail prices remain the same for the next two years. Unknown cross-border loss could occur and impact the analysis. Anticipated Arkansas cigarette packages to be sold under current Law for FY2020 = 143.7 million, under the proposal = 120.1 million.]

[E-Cigarettes --- Revenue Estimate based on sales volumes of same products in Pennsylvania which levied special excise taxes in 2016. Sales per capita calculated and applied to Arkansas population and proposed 68% excise tax rate.]

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Taxpayer Impact :

Individual income tax filers would be eligible for an increased standard deduction, reduced tax rate, and refundable earned income tax credits. Retailers of cigarettes and manufacturers/wholesalers of e-cigarettes would be subject to remittance of new excise taxes and privilege taxes.

All taxpayers claiming the standard deduction will have a decrease in taxable income. Taxpayers with taxable income less than $22,199 will have a decrease in income taxes. Taxpayers receiving the federal EITC could claim a percentage of the federal EITC on the Arkansas return as a refundable tax credit.

Resources Required :

Computer programs, tax forms and instructions will need to be updated. Additional auditors will be needed to audit Earned Income Tax Credit and to amend returns based off federal tax adjustments.

Time Required :

Adequate time is provided to modify and create new tax reporting procedures and processes and modify DFA computer registration and filing abilities for the new taxes on cigarettes and e-cigarette products necessary for implementation.

Procedural Changes :

The proposal will require modifications to the state's tax system to allow for the new tax types and the distribution method of funds collected for this tax type.

Other Comments :

Retail Tax on Cigarettes --- Transfers to General Revenue --- The provisions for the levying the new retail level tax on cigarettes provides for the tax distribution to be the first $55 million deposited to General Revenue. If the intent of this transfer is to offset the revenue reduction resulting from the reduced income tax rates and the increased standard deduction, and after taking into consideration the loss of General Revenue resulting from reduced cigarette sales caused by the increased retail sales prices, sufficient additional revenues for the income tax changes may not be available.

E-Cigarette Taxation --- Tobacco excise tax is levied at the wholesale level. The definition of a wholesaler specifically defines wholesaler to mean a person other than a manufacturer or a person owned or operated by a manufacturer. The definition of a manufacturer specifically includes a person that mixes, compounds, repackages, or resizes e-liquids or vapor products. There are many retailers for e-cigarettes and vapor products that also meet the definition of a manufacturer as the result of their own manufacture of products to be sold in their retail stores. The bill may benefit from an amendment to provide that the tax will be due from retailers that also manufacture their own products.

It may also be recommended that the bill be amended when providing for taxation of e-cigarette products manufactured by retailers to provide the monetary value upon which the tax is to be levied and calculated by the retailers.

Retail Tax on Cigarettes --- General Revenue Deposit --- The provisions for the levying the new retail level tax on cigarettes provides for the tax distribution would be with the first $55 million in revenue to be deposited to General Revenue with the remainder deposited to the Earned Income Tax Credit Trust Fund. This provision does not state if the General Revenue deposit is a one-time event or is to occur each fiscal year. Amending language for the provisions should be provided in the Code to clarify the meaning and intent of the language.

On page 3, line 29 states "the credit allowed under this section shall be at least five percent (5%)." This language may conflict with language page 3, lines 23-28 where DFA is instructed to determine the percentage of the credit based on the amount of money in the Earned Income Tax Credit Trust Fund. More specifically, it is unclear whether the intent of the bill is to prohibit a tax credit of less than 5% if there are insufficient funds available to fully fund a credit of 5% or more.

Legal Analysis :

SB571 creates the Earned Income Tax Credit Trust Fund (Trust Fund). The Trust Fund is established to offset the cost of a state Earned Income Tax Credit (EITC). The Trust Fund consists of funds deposited under § 26-57-1603, carry forward balances, and any other funds authorized by law. SB571 creates an EITC in an amount equal to at least five percent (5%) of the credit allowed to a taxpayer under the federal EITC (codified at 26 U.S.C. § 32). The federal EITC is a refundable income tax credit for low to moderate income working individuals and families, based on the taxpayer's income level and number of qualifying children. The EITC is allowed subject to the availability of sufficient funds in the Trust Fund. Based upon the language in proposed § 26-51-515(b)(2) that the credit "shall be at least five percent," it is unclear whether the EITC can ever be less than 5% if there were insufficient funds in the Trust Fund.

Beginning on January 1, 2022, the bill requires the Department of Finance and Administration (DFA) to annually certify the amount of tax credits claimed in the preceding calendar year. The amounts certified shall be transferred from the Trust Fund to the General Revenue Fund Account of the State Apportionment Fund. The bill requires DFA to notify taxpayers of their potential eligibility for the tax credit. It is unclear whether DFA would be required to notify all Arkansas taxpayers or only Arkansas taxpayers who qualified for the federal EITC.

SB571 amends the income tax tables in § 26-51-201(a)(8) for individuals, trusts, and estates. The bill eliminates the two percent (2%) tax rate and extends the zero percent (0%) tax rate to include income from $0 up to $8,899. The bill raises the standard deduction allowed for income tax purposes from $2,200 per taxpayer to $3,300 effective January 1, 2020. The bill also raises the standard deduction allowed for married couples, permitting each spouse to claim $3,300 effective January 1, 2020.

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The bill levies an additional excise tax of twenty percent (20%) on retail receipts or proceeds of cigarettes in addition to all other taxes currently imposed on cigarettes. The tax must be collected and remitted electronically by the retailer and the failure to do so will result in an assessment for the return and a penalty of ten percent (10%).The first $55 million of the revenues from the tax are deposited into the General Revenue Fund, with the remaining revenues to be deposited into the Trust Fund.

SB571 levies an excise tax on "e-cigarettes" as that term is defined in § 26-57-203(12). The amount of the tax is equal to the combined sixty-eight percent (68%) tax rate that is already levied on tobacco products other than cigarettes. The bill requires that the tax be separately stated and identified on all invoices and statements. The revenues from the tax are deposited into the General Revenue Fund.

DFA would be limited in its ability to administer the EITC and would be required to rely upon federal determinations of eligibility and information including the error rate for the federal EITC. The bill does not require an apportionment of the credit for non-residents, creating the possibility that non-residents will receive credits that exceed income earned in Arkansas and will create the possibility of non-residents filing to obtain refunds when they have no Arkansas source income. Finally, DFA will already have published the instructions for the subsequent year's tax forms before the date on which DFA must determine and certify the EITC credit amount for that tax year. This may create a delay in the ability of DFA to process returns or increase expense by requiring an additional publication after the initial instructional publication.

The bill requires the promulgation of rules by the DFA, the Director of Arkansas Tobacco Control, and the Arkansas Tobacco Control Board on an accelerated timeline. The rules are to be finalized sufficiently in advance for approval by the Legislative Council before a September 1, 2019 deadline. This rule's deadline presents administrative complications including the fact that most of the provisions of the bill that require rules will not be effective until after the promulgation deadline. The remaining provision would go into effect within thirty days of that deadline. It is unclear whether the agencies would even have authority to promulgate and publish notice for rules that are required by a statute which is not yet effective. Moreover, the accelerated timeline to promulgate rules would require that the rules drafting process begin in February to provide adequate time to draft, review, approve, publish, and report the rules to the ALC sufficiently in advance of the August ALC meeting for them to be able to be approved and promulgated by September 1.

The EITC and income tax reductions are effective for tax years beginning on or after January 1, 2020. The excise taxes on cigarettes and e-cigarettes are effective on the first day of the second calendar month following the effective date of the act.