EXHIBIT C-1

January 23, 2018

Memorandum

To: Arkansas Tax Reform and Relief Legislative Task Force

From: Randall Bauer, PFM

RE: Project Close-out

As you may recall, there were several items discussed at the January meeting of the Task Force where I indicated that PFM would provide additional data or information. In a subsequent meeting with the Task Force Chairs, I agreed that, in the interest of cost savings, PFM would limit its responses to those that could be readily provided without additional research and analysis that would be charged to the State.

The following contains updates and edits related to those requests. PFM also provides a brief summary of general advice for the Task Force based on the data and analysis provided to date. This is all provided to the State at no additional charge. PFM has, in the spirit of cooperation and assistance to the Task Force, chosen not to invoice for any work done to complete this memo after the Task Force meeting on January 8, 2018.

Technical Changes

Attached to this memo is an updated version of the presentation on individual income taxes. There are three technical corrections that have been made to pages from the presentation. These are:

1. Page 9 identifies the history of changes to the Arkansas individual income tax rates. While the data is accurate, changes since 2015 were not included. An additional column has been added that provides the updated brackets and rates for tax year 2017. An additional bullet has been added to also explain the timing for the changes to the brackets and rates in 2012, 2014 and 2015.

2. Slide 19 lists the Arkansas marginal tax rate for $10,001 income as 3.4 percent and for $25,001 as 5.9 percent; these have been updated for 2017 as 3.5 and 6.0 percent, respectively.

3. Page 22 reflects the actual effective rates for the State of Mississippi individual income tax.

4. Page 24, the Arkansas treatment for military pension income in 2018 is exempt (previously exempt up to $6,000).

Additional Explanation

1. **Earned Income Tax Credits.** Questions were raised related to state efforts to deal with concerns about waste, fraud and abuse associated with the credit. All states that currently offer the credit apply it as a ‘percent of the federal credit.’ This

dramatically reduces the administrative costs associated with the credit and puts the onus on the federal government to determine eligibility for the credit. At the same time, that also means that there is no state mechanism to improve on the eligibility determination or reporting process.

2. **State Apportionment.** States apportion income among multiple states that may be taxed via state corporate income taxes in a variety of ways. Page 19 of the corporate income tax presentation details the formulas that states use for this purpose. A question was asked as to how this works in practice. The following details how the formula would work for the State of Arkansas, which uses a three factor formula based on a corporation's share of its property, payroll and sales in Arkansas, with sales 'double weighted' in the formula.

   To illustrate how this formula works, assume that a corporation has sales of $100 million, an overall payroll of $15 million and property in various states with a valuation of $40 million. Within the State of Arkansas, assume that the corporation has sales of $5 million, payroll of $1 million and property valued at $4 million. Using these figures, the corporation's sales, payroll and property factors are:

   - Sales factor = 0.050 ($5 million divided by $100 million)
   - Payroll factor = 0.067 ($1 million divided by $15 million)
   - Property factor = 0.100 ($4 million divided by $40 million)

   As a result, under the Arkansas double weighted sales factor formula, the apportionment percentage is 6.67 percent (0.050 + 0.050 + 0.067 + 0.100 divided by 4). It is notable that under an equally weighted three factor formula, the apportionment percentage would be 7.23 percent (0.050 + 0.067 + 0.100 divided by 3). Under a single sales factor formula, the apportionment percent would be 5.0 percent.[1] While this example suggests that a single factor formula would be preferable, there are examples that can be constructed that show alternate results. In short, there are winners and losers in each of the common apportionment formulas.

3. **Key State Issues for the Tax Cuts and Jobs Act (TCJA).** As discussed, there are a variety of issues related to the changes in the federal tax reform bill (TCJA) that will impact on state revenues, for Arkansas, primarily on the corporate income tax. While this was going to be a subject for a subsequent Task Force meeting, the following is a summary listing of key issues and how they may impact on Arkansas state revenues:

   - Full expensing of qualified depreciable assets. Besides expanding the definition of qualified property, this allows taxpayers to immediately expense the entire cost of the qualified depreciable assets. This would reduce Arkansas corporate income tax revenue.

   - Net operating losses. Prior law permits taxpayers to carry back a net operating loss (NOL) two years and carry forward an NOL 20 years to offset taxable income in those years. The TCJA limits the deduction to 80 percent of taxable income. It is notable that Arkansas allows NOL to be carried

[1] "State Apportionment of Business Income," Wolters Kluwer, CCH White Paper, September 2014, p. 3.

forward for just five years, which is the shortest time period of the benchmarked states. Were the State to conform with the 80 percent limit, it would increase state corporate income tax revenue.

- Repatriation toll charge. Foreign subsidiaries of international corporations will be subject to a toll charge on previously untaxed earnings. Were the State to conform, it would provide a one-time increase in corporate income tax revenue.

- Global intangible low-taxed income. This section requires a US shareholder to include as income the 'global intangible low-taxed income' (GILTI) of its controlled foreign corporations (CFC). This will have the effect of subjecting to tax CFC's combined net income above a routine equity return on tangible depreciable business assets that is not otherwise subject to US tax or to foreign tax at a minimum rate or not otherwise specifically excluded. Conforming with this section will likely increase state corporate tax revenue.

Tax Reform Observations

Over the past several months, the PFM team has provided general background, benchmarking and analysis related to Arkansas' major state and local taxes. Based on that discussion, we provide the following observations:

- **Arkansas uses a balanced set of major revenue sources for both state and local government.** The major taxes that are generally in place for state and local governments exist in Arkansas. In particular, the State has reduced reliance on property taxes for local government revenue through widespread use of local sales taxes, and local governments have more flexibility in their application than is found in many other states. The project team believes the current sources of local government revenue are sufficient and do not require major changes.

- **Arkansas is similar to most states in relying on sales and use tax for its largest revenue source.** There are logical arguments for relying on this consumption-based tax as its primary revenue source. While the Arkansas state and combined state and local rate puts it at the high end of the scale, this is fairly typical within the region, which reduces some of the negative impacts of border competition issues.

  At the same time, base erosion is a key concern about sales taxes in general. The shift of consumption toward services is significant, and capturing the sales tax on the entirety of e-commerce purchases is difficult. However, there is a good chance that the Supreme Court may rule in favor of an expanded definition of nexus for the purpose of compelling e-tailers to collect sales tax on behalf of state and local governments, which has the potential to significantly increase State revenue.

- **Individual income tax rates are high relative to the benchmark states.** Comparisons of marginal and effective rates suggest that this is

an area where the State could look to reduce its rates, particularly at the high end of the scale. Getting the top rate into the range of 5 percent (or going to a flat tax with personal exemptions and/or standard deduction that reduces the impact on lower-income taxpayers) would get the state more in alignment with its benchmark states.

- **Excise taxes are generally in the middle range of the benchmark states.** It is notable that in comparing revenues over a five-year period, most excise taxes are relatively flat, with only gaming revenues showing significant growth. A logical approach here would be to maintain the relative position and increase these taxes as other states also do so. The one excise tax that has not been increasing in conjunction with other states is motor fuel. While the Arkansas rate is above average compared to peer states, it has not been increased since 2001.

- **Federal tax changes create some opportunity to restore balance between individual and corporate income taxes.** Over time, the corporate income tax has been declining as a share of overall state revenue, both nationally and in Arkansas. As previously noted, there are some aspects of the TCJA that may provide increased corporate income tax revenue, depending on whether the State chooses to conform with these new components of the federal tax code. This may be an opportunity for the State to obtain additional corporate income tax revenue that could be used to help reduce individual income tax rates.

- **The issue of selective versus broad-based tax cuts.** As with most tax analysis, the concept of enacting a tax structure (or individual tax) that is broad-based and uses the lowest possible rate is appealing. The challenge, of course, is to create that structure while maintaining sufficient revenue to support essential services. Combatting base erosion is also an issue.

  From our perspective, the concept of a broad base also means that taxes that are applied to a relatively small base should be subject to significant scrutiny. Excise taxes, which, if translated into a general sales tax, would exhibit high rates of taxation, are an obvious example. Of course, there are 'user fee' and 'Pigovian tax' arguments that can be made for these, and they are targeted at consumption, which somewhat limits deleterious impacts on the economy.

  From our perspective, there are a couple of specific taxes, the franchise and inventory taxes, which should be targeted for reduction or elimination. Both are applied to businesses in ways that potentially reduce business investment. Both target specific types of businesses or business activities that do not adhere to the 'broad base' principle of taxation. It is notable that many states have eliminating or are in the process of reducing these taxes.

- **'Paying for' rate reductions.** While the Task Force (and ultimately the Governor and the Legislature as a whole) will have to decide whether the tax reform and tax relief package is to be revenue neutral or reduce overall tax collections (at least in the short-term) by some agreed to

amount, it is a fact that States – unlike the federal government – must balance their budgets on a year by year basis. Should the State wish to make tax changes that are at least somewhat offset, the following are some alternatives for consideration:

- Expand the sales tax base to cover additional services. The example provided by North Carolina, where services associated with maintenance and repair are subject to taxation, is a logical course of action. There have been broader efforts, such as was detailed in the preliminary report related to Governors Fallin and Kasich in Oklahoma and Ohio, to tax services. None of these has been successful to date, but if put forward as part of a broad-based tax reform package, with reduced individual income tax rates and/or sales tax rates, it may be possible. In general, few states (other than those without a broad-based individual income tax) have taken on professional services (such as doctors, lawyers and accountants). States have had better luck with expanding the base on consumer-based services.

- Reduce sales tax exemptions. The framework used by the State of Kansas can be emulated, and it provides a basis for discussion of whether these exemptions fit into logical categories. It is notable that the 'preferred' sales tax treatment for groceries applies to high end purchases as well as basic food items.

- Use refundable credits (rather than rate changes) to address issues of regressivity. While issues of regressivity are real, sometimes the 'blunt instrument' approach to addressing it is not cost effective. Besides the example of the sales tax exemption for food, in many states deductions and credits can more effectively address issues of regressivity than rate reductions. In some instances, a flat tax (coupled with deductions and credits) yields lower effective rates for these individuals and families.

PFM appreciates the opportunity to assist the Task Force on this vitally important topic. If members of the Task Force or State staff have questions about any of the topics covered in presentations or written reports, please contact us. We will be happy to discuss or provide additional information without additional charges applied to the State.