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

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Discussion Topics

- State Taxes in Theory and Practice
- Individual Income Tax History – U.S. and Arkansas
- State Tax Revenue
- Individual Income Tax Characteristics/Benchmarking
- Individual Income Tax Expenditures
- Key Issues



Individual Income Tax Theory and Practice



Income Taxes and the Traditional ‘Three-Legged Stool’

- Individual income tax, sales and use tax, corporate income tax:
 - Each differs in what it taxes and how it impacts economic activity
 - Paid by both businesses and consumers
 - Helps balance the advantages and disadvantages of each type of tax
 - Sales and use tax is the largest of the three, corporate income tax is the smallest (and declining)
 - Share by state varies considerably (especially sales/individual income tax)
 - State and local combined – property tax replaces corporate income tax as the ‘Big Three’ revenue sources

- Key Issues:
 - Mix of consumption/income taxes
 - Volatility of the individual income tax
 - Decline of the corporate income tax as a share of total state tax revenue
 - Federal tax changes’ impact on major state taxes



Consumption versus Income-based Taxes

- In theory, consumption taxes are more economically efficient:
 - Nearly all will pay some tax
 - Avoids taxing savings and capital investment necessary for economic growth
 - No disincentive to work/earn more
- In practice, consumption taxes have some downside:
 - Depending on the base, can be regressive
 - Erosion of the sales tax base – creates horizontal equity and revenue sufficiency issues
- Income tax more likely to solve for sufficiency concerns:
 - Performs very well during economic expansions
 - However, has proven very volatile during economic downturns
 - Some timing issues (such as realized capital gains) make it hard to estimate
- Combining the two is the typical state approach:
 - Both have negative border effects
 - Broad sales tax can mitigate some of the income tax volatility
 - Progressive income tax/refundable credits can mitigate some of the sales tax regressivity



Individual Income Tax History

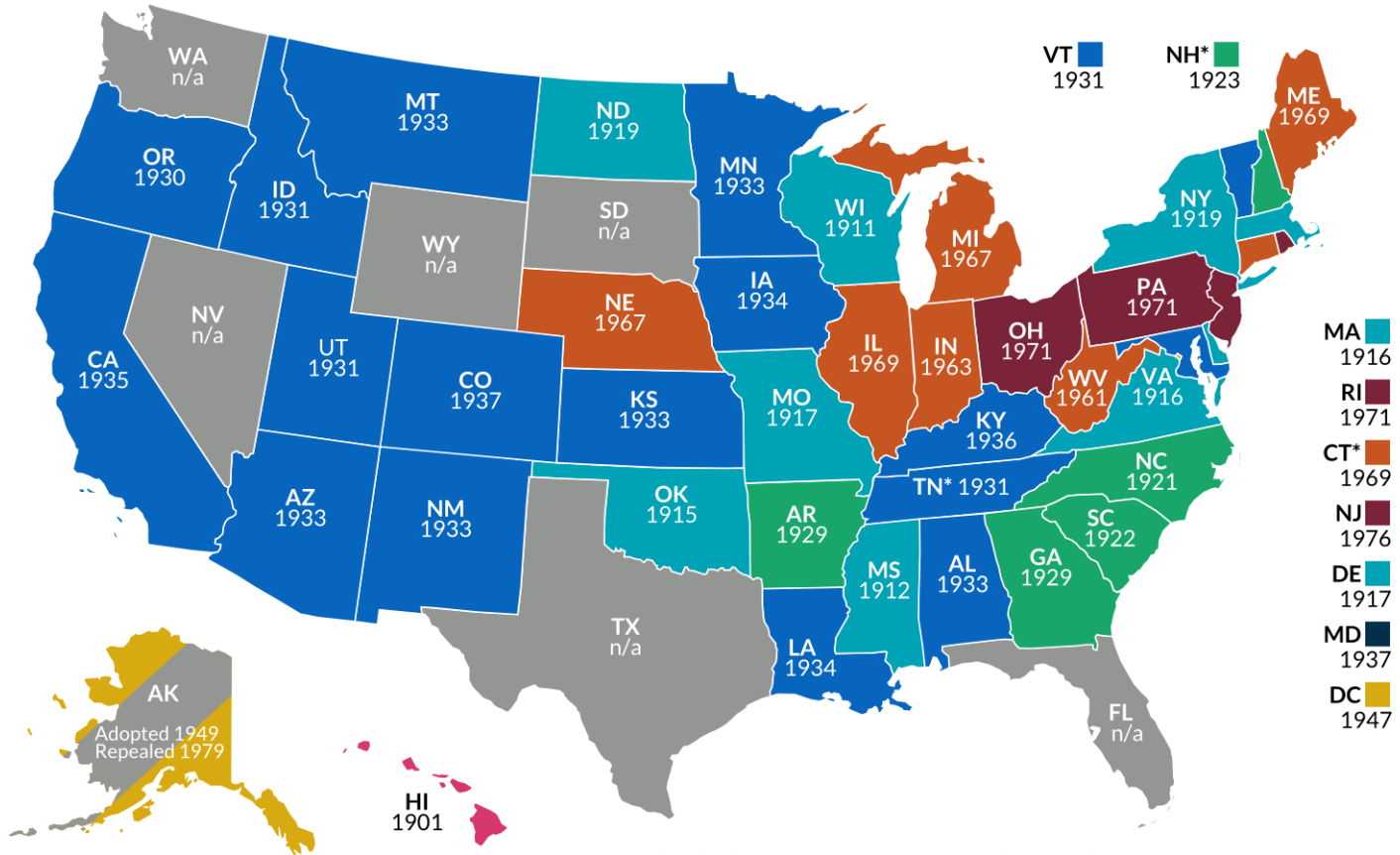


Individual/Personal Income Tax History

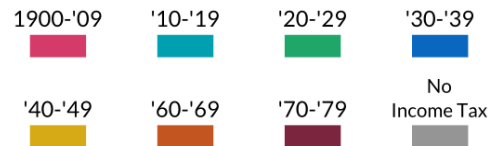
- While there was sporadic prior use of a federal income tax, ratification of the 16th Amendment (1913) cemented its role
 - Proposed by President Taft in 1909 after Supreme Court ruled part of the Wilson-Gorman Tariff Act unconstitutional
 - “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration”
- State income taxes – some preceded 16th Amendment
 - Hawaii enacted in 1901 (while a U.S. territory)
 - First state adoptions were Wisconsin (1911) and Mississippi (1912)
- Most states enacted an income tax by end of the 1930s
 - 10 prior to 1920
 - Additional 5 (including Arkansas) prior to 1930
 - Additional 17 prior to 1940
- Seven states do not have an individual income tax
 - Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming
 - Two states (New Hampshire, Tennessee) only tax dividends and interest income



State Individual Income Taxes: Year of Adoption by State



Individual Income Tax: Year of Adoption by State





Arkansas Individual Income Tax Background

- Enacted in 1929 (14th State to do so)
 - Originally had five brackets
 - Rates ranged from 1.0 percent to 5.0 percent
- Major Changes:
 - 1971 – first tax rate increase, five original brackets expanded to six
 - After the change, rates ranged from 1 percent to 7 percent
 - 2013 to 2015 – Decreased tax rates, adjusted brackets
 - Brackets adjusted starting Jan 1 2012, first bracket rate reduced to 0.9% starting Jan 1, 2014, all other rates reduced Jan 1 2015

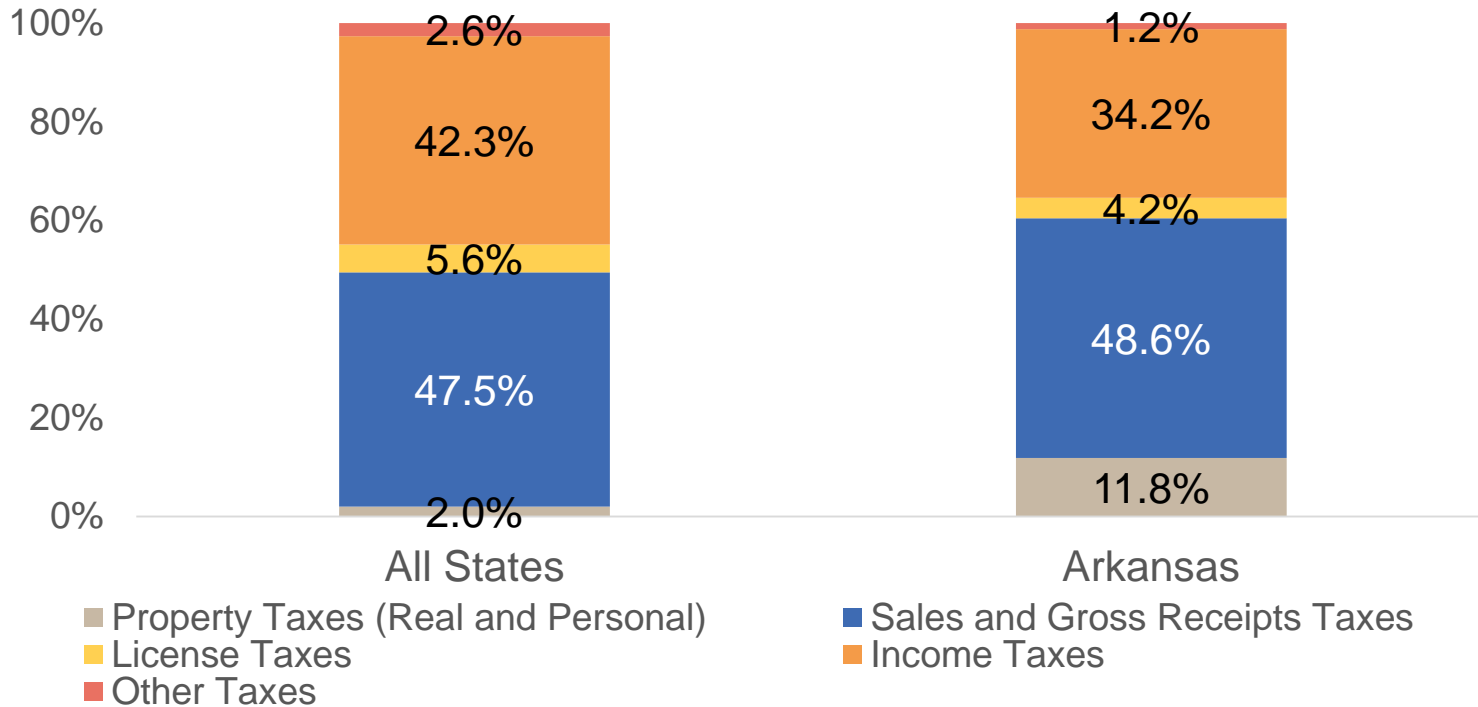
Prior to 2012		2012 to 2015 Changes		2017	
Bracket	Rate	Bracket	Rate	Bracket	Rate
First \$2,999	1.0%	First \$4,099	0.9%	First \$4,299	0.9%
Next \$3,000	2.5%	Next \$4,100	2.4%	Next \$4,200	2.5%
Next \$3,000	3.5%	Next \$4,000	3.4%	Next \$4,200	3.5%
Next \$6,000	4.5%	Next \$8,200	4.4%	Next \$8,500	4.5%
Next \$10,000	6.0%	Next \$13,600	5.9%	Next \$13,900	6.0%
\$25,000+	7.0%	\$34,000+	6.9%	\$35,100+	6.9%



Individual Income Tax Revenue



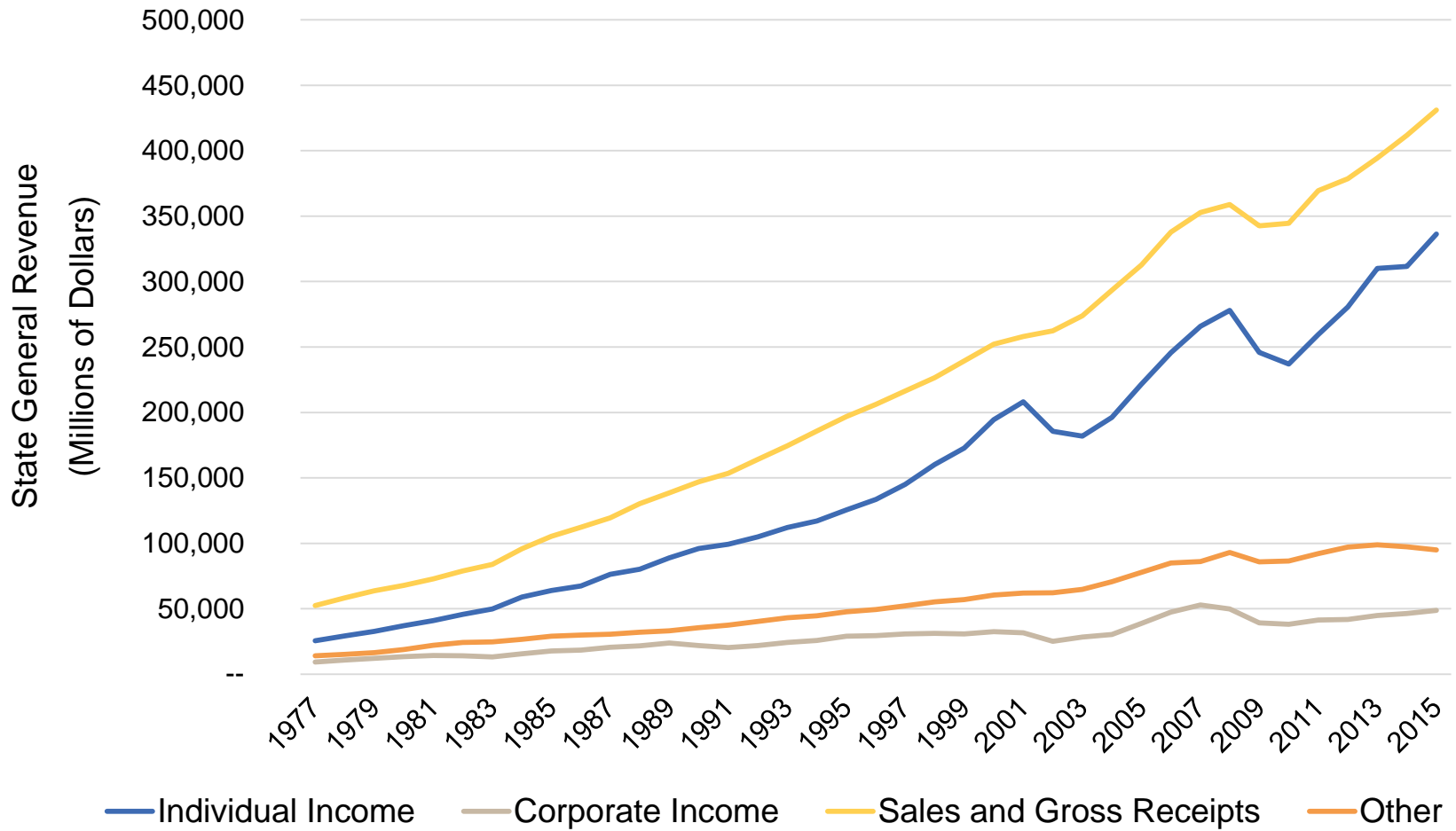
State Tax Revenues by Tax Category, 2016



- **“Other Taxes”** include death and gift, severance, documentary and stock transfer, and other taxes not elsewhere classified
- **“License Taxes”** include alcoholic beverages, public utilities, motor vehicles, motor vehicle operators, corporations in general, hunting and fishing, amusements, occupation and businesses, and other license taxes



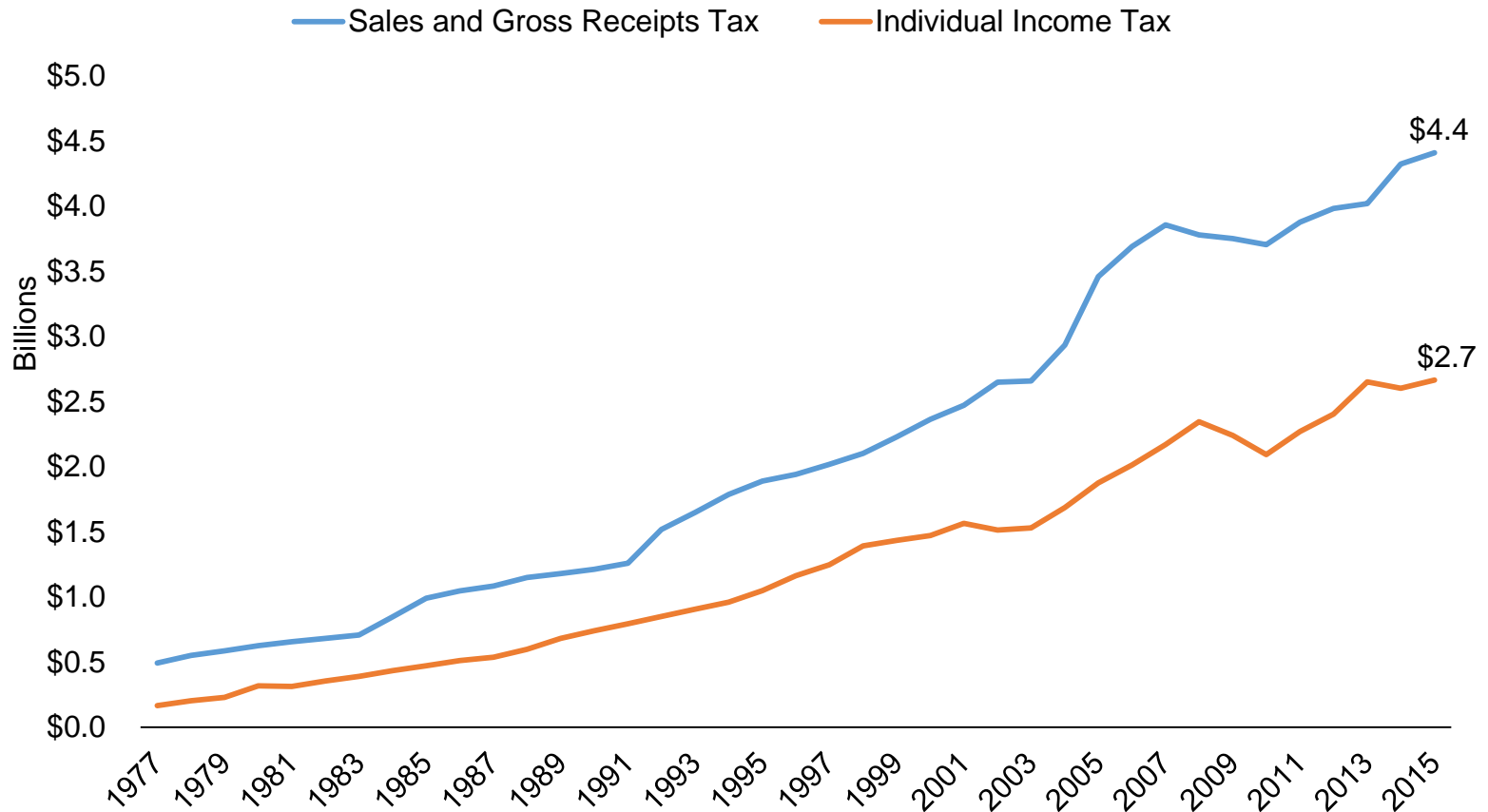
State Tax Revenues by Tax Category, Historic (1977-2015)



Source: Tax Policy Center, State & Local Government Finance Data Query, 2017



Arkansas Major Source Tax Revenue (1977 to 2015)





Individual Income Tax Share of Total State Collections

State	Percent of Total Tax Collections
Missouri	49.2%
North Carolina	46.0%
Nebraska	43.9%
Iowa	37.2%
Oklahoma	35.3%
Alabama	35.2%
Louisiana	30.8%
Indiana	29.7%
Arkansas	29.4%
Kansas	27.7%
Mississippi	23.5%
Tennessee	2.4%
Texas	No individual income tax

Source: Federation of Tax Administrators



Individual Income Tax Characteristics and Benchmarking



Individual Income Tax Overview

- States generally structure their individual income taxes similarly to the federal income tax
 - Value in conformity – taxpayer understanding and compliance
 - Most states tailor the structure to meet specific state needs
 - Common areas of difference are in deductions, exemptions and credits
 - Common state issue is conformance with IRC changes
- Benchmarking is impacted by Texas and Tennessee
 - Tennessee's individual income tax applies only to dividends and interest
 - Texas does not have an income tax
- Other key structural issues
 - Personal exemptions, credits and standard deduction
 - Treatment of sources, such as social security, pension and capital gains
 - Flat versus progressive tax rates



Individual Income Tax Rates

State	Lowest Rate	Highest Rate
Iowa	0.36%	8.98%
Arkansas	0.90%	6.90%
Nebraska	2.46%	6.84%
Missouri	1.50%	6.00%
Louisiana	2.00%	6.00%
North Carolina	5.49%	5.49%
Kansas	2.90%	5.20%
Oklahoma	0.50%	5.00%
Alabama	2.00%	5.00%
Mississippi	3.00%	5.00%
Indiana	3.23%	3.23%
Tennessee	4.00%	4.00%
	(Dividends and Interest Income Only)	(Dividends and Interest Income Only)
Texas	N/A	N/A

Source: Federation of Tax Administrators

Note: Tennessee Hall Tax Rate on Dividends and Interest is being phased out, 1% reduction each year



Individual Income Tax Brackets

State	Number of Brackets	Lowest	Highest
Missouri	10	\$1,000	\$9,001
Iowa	9	\$1,573	\$70,785
Oklahoma	6	\$1,000	\$7,200
Arkansas	6	\$4,299	\$35,100
Nebraska	4	\$3,090	\$29,830
Alabama	3	\$500	\$3,001
Louisiana	3	\$12,500	\$50,001
Kansas	3	\$15,000	\$30,000
Mississippi	3	\$5,000	\$10,001
North Carolina	1		
Indiana	1		
Tennessee	1		
Texas	N/A	N/A	N/A



Marginal Tax Rate by Income (Married Filed Jointly)

State	\$10,001	\$25,001	\$50,001	\$75,001	\$100,001
Missouri	6.00%	6.00%	6.00%	6.00%	6.00%
North Carolina	5.49%	5.49%	5.49%	5.49%	5.49%
Alabama	5.00%	5.00%	5.00%	5.00%	5.00%
Mississippi	5.00%	5.00%	5.00%	5.00%	5.00%
Tennessee	5.00%	5.00%	5.00%	5.00%	5.00%
Iowa	4.50%	6.48%	7.92%	8.98%	8.98%
Oklahoma	4.00%	5.00%	5.00%	5.00%	5.00%
Nebraska	3.51%	3.51%	5.01%	6.84%	6.84%
Arkansas	3.50%	6.00%	6.90%	6.90%	6.90%
Indiana	3.23%	3.23%	3.23%	3.23%	3.23%
Kansas	2.90%	2.90%	4.90%	5.20%	5.20%
Louisiana	2.00%	4.00%	4.00%	4.00%	6.00%
Texas	N/A	N/A	N/A	N/A	N/A

Source: Federation of Tax Administrators



State Personal Exemptions or Credits

State	Single	Married	Dependents
Mississippi	\$6,000	\$12,000	\$1,500
Louisiana	\$4,500	\$9,000	\$1,000
Kansas	\$2,250	\$4,500	\$2,250
Missouri	\$2,100	\$4,200	\$1,200
Indiana	\$1,000	\$2,000	\$2,500
Alabama	\$1,500	\$3,000	\$500
Oklahoma	\$1,000	\$2,000	\$1,000
Tennessee	\$1,250	\$2,500	\$0
Nebraska*	\$132	\$264	\$132
Iowa*	\$40	\$80	\$40
Arkansas*	\$26	\$52	\$26
North Carolina	\$0	\$0	\$0
Texas	N/A	N/A	N/A

* States that apply a credit

Source: Federation of Tax Administrators, PFM updates



State Standard Deduction

State	Single	Married, Filing Jointly	Married, Filing Separately	Head of Household
Alabama	\$2,000 to \$2,500	\$4,000 to \$7,500	\$2,000 to \$3,750	\$2,000 to \$4,700
Arkansas	\$2,200	\$4,400	\$2,200	\$2,200
Indiana	None	None	None	None
Iowa	\$1,950	\$4,810	\$1,950	\$4,810
Kansas	\$3,000	\$7,500	\$3,750	\$5,500
Louisiana	\$4,500	\$9,000	\$4,500	\$9,000
Mississippi	\$2,300	\$4,600	\$2,300	\$3,400
Missouri	Federal	Federal	Federal	Federal
Nebraska	Federal	Federal	Federal	Federal
North Carolina	\$7,500	\$15,000	\$7,500	\$12,000
Oklahoma	Federal	Federal	Federal	Federal
Tennessee	None	None	None	None
Texas	N/A	N/A	N/A	N/A

Source: Wisconsin Legislative Fiscal Bureau, PFM updates



Effective Tax Rate by Income (Married Filing Jointly, Two Dependent Children)

State	\$25,001	\$50,001	\$75,001	\$100,001
Oklahoma	5.00%	5.00%	5.00%	5.00%
Effective	0.46%	2.62%	3.41%	3.81%
Louisiana	4.00%	4.00%	4.00%	6.00%
Effective	0.50%	2.25%	3.16%	3.87%
Indiana	3.23%	3.23%	3.23%	3.23%
Effective	2.77%	3.04%	3.12%	3.17%
Arkansas	5.90%	6.90%	6.90%	6.90%
Effective	0.60%	3.80%	4.53%	5.88%
(If credit an exemption)	\$900	\$1,700	\$1,700	\$1,500
Mississippi	5.00%	5.00%	5.00%	5.00%
Effective	0.53%	2.84%	3.49%	3.87%

Source: PFM Calculations based on state tax forms 2016



Treatment of Social Security Income

State	Treatment of Social Security Benefits
Alabama	Exempt
Arkansas	Exempt
Indiana	Exempt
Iowa	Exempt, but up to half of benefits may be subject to alternate tax
Kansas	Exempt if federal AGI is less than or equal to \$75,000
Louisiana	Exempt
Mississippi	Exempt
Missouri	Exempt, subject to AGI limits
Nebraska	Exempt if income is at or below \$43,000
North Carolina	Exempt
Oklahoma	Exempt
Tennessee	Exempt
Texas	N/A



Treatment of Pension Income

State	Private	State & Local	Federal Civilian	Military
Alabama	Payments from defined benefit plans are exempt	Most exempt	Exempt	Exempt
Arkansas	Exempt up to \$6,000	Exempt up to \$6,000	Exempt up to \$6,000	Exempt
Indiana	Same as federal	Same as federal	Exempt up to \$8,000	Exempt up to \$5,000
Iowa	Exempt up to \$6,000	Exempt up to \$6,000	Exempt up to \$6,000	Exempt
Kansas	Same as federal	Some exempt	Exempt	Exempt
Louisiana	Exempt up to \$6,000	Exempt up to \$6,000	Exempt	Exempt
Mississippi	Exempt	Exempt	Exempt	Exempt
Missouri	Exempt up to \$6,000	Exempt up to \$36,976	Exempt up to \$36,976	90% Exempt
Nebraska	Same as federal	Same as federal	Same as federal	State Calculation
North Carolina	Same as federal	Some exempt	Some exempt	Some exempt
Oklahoma	Exempt up to \$10,000	Exempt up to \$10,000	Exempt up to \$10,000	Greater of \$10,000 or 75%
Tennessee	Exempt	Exempt	Exempt	Exempt
Texas	N/A	N/A	N/A	N/A

Source: Wisconsin Legislative Fiscal Bureau, Arkansas tax treatment is for 2018 tax year.



Effective Tax Rate by Income (Married, Pension 40%, Social Security 40%, Other 20%)

State	\$25,001	\$50,001	\$75,001	\$100,001
Oklahoma	5.00%	5.00%	5.00%	5.00%
Private Pension	0.00%	0.01%	0.88%	1.41%
State/Local/Federal Pension	0.00%	0.01%	0.88%	1.41%
Louisiana	4.00%	4.00%	4.00%	6.00%
Private/State/Local Pension	0.00%	0.27%	0.97%	1.25%
Federal/Military Pension	0.00%	0.00%	0.00%	0.05%
Indiana	3.23%	3.23%	3.23%	3.23%
Private/State/Local Pension	1.71%	1.85%	1.89%	1.91%
Federal Civilian Pension	0.67%	1.32%	1.54%	1.65%
Military Pension	1.06%	1.52%	1.67%	1.75%
Arkansas	5.90%	6.90%	6.90%	6.90%
Private/State/Local/Federal Civilian Pension	0.00%	1.07%	1.73%	2.19%
Military Pension (tax year 2018)	0.00%	0.04%	0.21%	0.36%
Mississippi	5.00%	5.00%	5.00%	5.00%
All Pensions	0.00%	0.00%	0.12%	0.27%



Federal Income Tax Deductible

- Allowing the deduction of federal taxes paid from state income also reduces effective tax rates
- As a result, Iowa's top rate of 8.98 percent is estimated to be 5.50 – 6.00 percent

State	Federal Income Tax Deductible
Alabama	Yes
Arkansas	No
Indiana	No
Iowa	Yes
Kansas	No
Louisiana	Yes
Mississippi	No
Missouri	Yes
Nebraska	No
North Carolina	No
Oklahoma	No
Tennessee	No
Texas	No



Federal Starting Point

- Most states start their individual income tax calculations at federal adjusted gross income, although a few use taxable income
- Arkansas primarily differs in treatment of active military pay, pension income

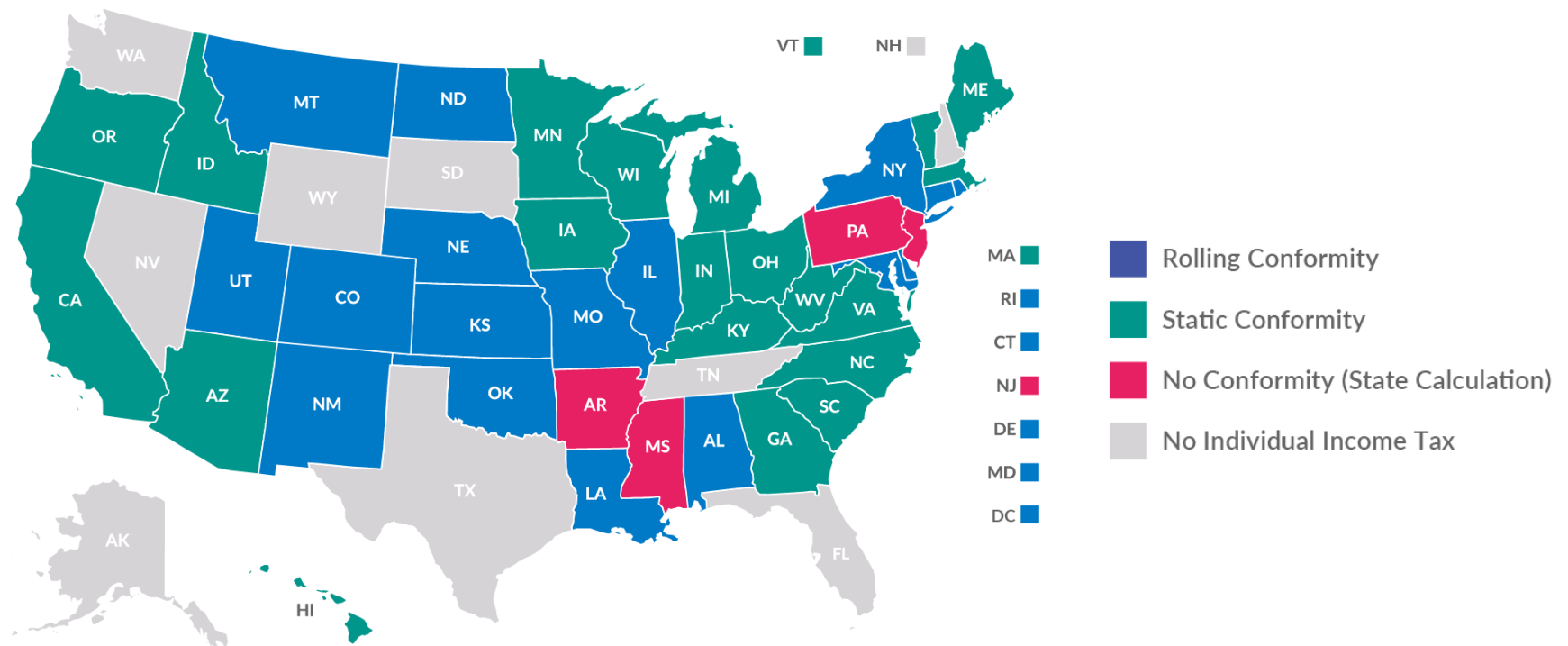
State	Starting Point
Alabama	---
Arkansas	---
Indiana	Adjusted Gross Income
Iowa	Adjusted Gross Income
Kansas	Adjusted Gross Income
Louisiana	Adjusted Gross Income
Mississippi	---
Missouri	Adjusted Gross Income
Nebraska	Adjusted Gross Income
North Carolina	Adjusted Gross Income
Oklahoma	Adjusted Gross Income
Tennessee	---
Texas	---

Source: Federation of Tax Administrators



State Conformity with Federal IRC

- Most states conform on either an automatic (rolling) or point-in-time (static) basis
- Arkansas is one of three states that does not



Source: Tax Foundation



Treatment of Capital Gains and Losses

State	Treatment of Capital Gains
Alabama	Same as federal, except all gains are taxable and all losses deductible in year incurred
Arkansas	100% excluded if realized after 2014 and gain exceeds \$10 million
Indiana	Same as federal
Iowa	100% exclusion for qualifying capital gains on certain business and farm assets and from involuntary conversions related to eminent domain; 50% exclusion of gain from sale of employer securities of an Iowa corporation to a qualified Iowa employee stock ownership plan
Kansas	Gains from the sale of certain Kansas bonds, livestock, and Christmas trees grown in Kansas are exempt
Louisiana	Deduction for net gain from the sale of a Louisiana-domiciled business
Mississippi	Same as federal plus exemptions for gains from the sale of authorized shares in Mississippi-domiciled financial institutions and certain domestic businesses
Missouri	Exempts gain from conversion of condemned property and 25% exclusion for certain sales of low-income housing.
Nebraska	Deduction for special capital gains from stock sales by Nebraska residents who are employees of qualified corporations doing business in Nebraska.
North Carolina	Same as federal plus exemption for gains from certain North Carolina obligations issued before July 1, 1995.
Oklahoma	Deduction for gains from certain Oklahoma property and stock. 50% exclusion for sales of historic battle site property to the state.
Tennessee	Capital gains from stock and mutual funds are taxable if distributed as dividends. Otherwise, capital gains from the sale of stock and mutual funds are not taxable. Capital losses are not deductible.
Texas	N/A

Source: Wisconsin Legislative Fiscal Bureau



Treatment of Unemployment Compensation

- Unemployment compensation is taxed for federal income tax purposes
- Most states (34) conform with the federal tax treatment

State	Treatment of Unemployment
Alabama	Exempt
Arkansas	Same as federal (effective 1/1/2018)
Indiana	Limited exclusion as provided under 1986 federal law
Iowa	Same as federal
Kansas	Same as federal
Louisiana	Same as federal
Mississippi	Same as federal
Missouri	Same as federal
Nebraska	Same as federal
North Carolina	Same as federal
Oklahoma	Same as federal
Tennessee	Exempt
Texas	N/A

Source: Wisconsin Legislative Fiscal Bureau, updated for Arkansas legislative action



Treatment of Active Duty Military Pay

- Taxed at the federal level, with a combat zone exclusion (CZE)

State	Treatment of Active Duty Military Pay
Alabama	Same as federal
Arkansas	Exempt
Indiana	CZE and exempt up to \$5,000 for total of active duty and active reserves, military retirement, and survivor's benefits.
Iowa	Exempt plus tax forgiven if killed in a combat zone or due to a terrorist or military action or missing and presumed dead. Deductions for certain student loan repayments of active duty military.
Kansas	Same as federal
Louisiana	CZE and up to \$30,000 excluded for service outside Louisiana under certain conditions.
Mississippi	CZE and exempt up to \$15,000 in National Guard and Reserve pay.
Missouri	All income earned in a combat zone is exempt.
Nebraska	Same as federal
North Carolina	Same as federal
Oklahoma	Exempt including Reserve and National Guard
Tennessee	Exempt
Texas	N/A



Itemized Deductions

State	Itemized Deductions
Alabama	State itemized deductions
Arkansas	State itemized deductions
Indiana	None
Iowa	Same as federal
Kansas	State itemized deductions
Louisiana	Taxpayers who itemize deductions for federal tax purposes may deduct the excess of federal itemized deductions (after the federal income limitation) over the federal standard deduction.
Mississippi	Federal itemized deductions
Missouri	Federal itemized deductions
Nebraska	Federal itemized deductions
North Carolina	State itemized deductions
Oklahoma	Same as federal
Tennessee	None
Texas	N/A



Individual Income Tax Expenditures



Significant Individual Income Tax Expenditures

- The State offers a variety of credits, deductions, exemptions and exclusions that impact individual income taxpayer liability
 - Many of the adjustments provided are common among states
 - Some areas where the State differs from federal treatment (such as no state and local tax deduction, allowed deductions for post secondary education tuition and volunteer firefighter expenses)
- **Retirement Exemption:** The first \$6,000 of qualified retirement income is exempt (\$225 million in 2014)
- **Other State Tax Credit:** Allows a credit for Arkansas residents for income taxes paid to another state on income taxed by both Arkansas and the other state (\$56 million in 2014)
- **Charitable Contributions Deduction:** Allows a deduction for charitable contributions pursuant to IRC §170 (\$56 million in 2014)



Significant Individual Income Tax Expenditures

- **Deduction for Border City Exemption:** Act 28 of 1977 allows residents of a border community to lower their income tax rate (\$19.4 million in 2014)
 - Residents of a town with a “street state line” that borders a state without an individual income tax rate may hold an election to lower their income tax to equal those of the border state
 - In exchange, the state sales tax rate would be one percent higher
 - Use of the exemption is limited to Texarkana

- **Capital Gains:** The State provides a lower tax rate for capital gains income; legislation has altered the State’s treatment over time (over \$40 million in 2014)
 - Starting with the 1991 tax year, the capital gains tax rate could not exceed 6 percent (while the top marginal income tax rate was 7 percent)
 - In 1999, 6 percent tax rate cap was removed, and instead the State allowed taxpayers to exclude 30 percent of the capital gain starting in 2000
 - In 2013, exclusion was increased to 50 percent and gains in excess of \$10 million were exempted
 - Starting July 1, 2016, capital gains tax exclusion is 50 percent

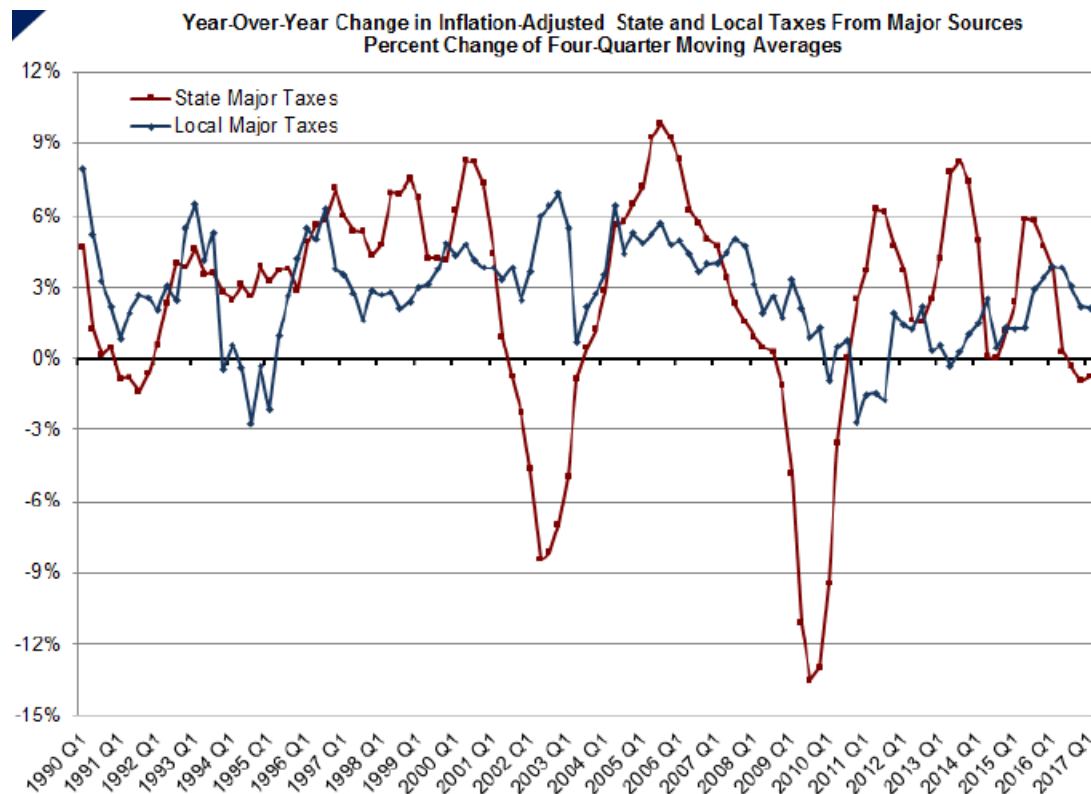


Key Issues



Individual Income Tax Key Issues: Volatility

- Income Tax Susceptible to Wide Swings
 - Often based on changes in the business cycle



Sources: U.S. Census Bureau, Quarterly Summary of State & Local Government Tax Revenue & Bureau of Economic Analysis (GDP).
Notes: (1) Percentage change of 4-quarter moving averages. (2) Data are for four major tax categories only: general sales tax, personal income tax, corporate income tax, & property tax. (3) Data are adjusted for inflation. (4) No adjustments for legislative changes.



Key Issues: Volatility of Non-recurring Sources

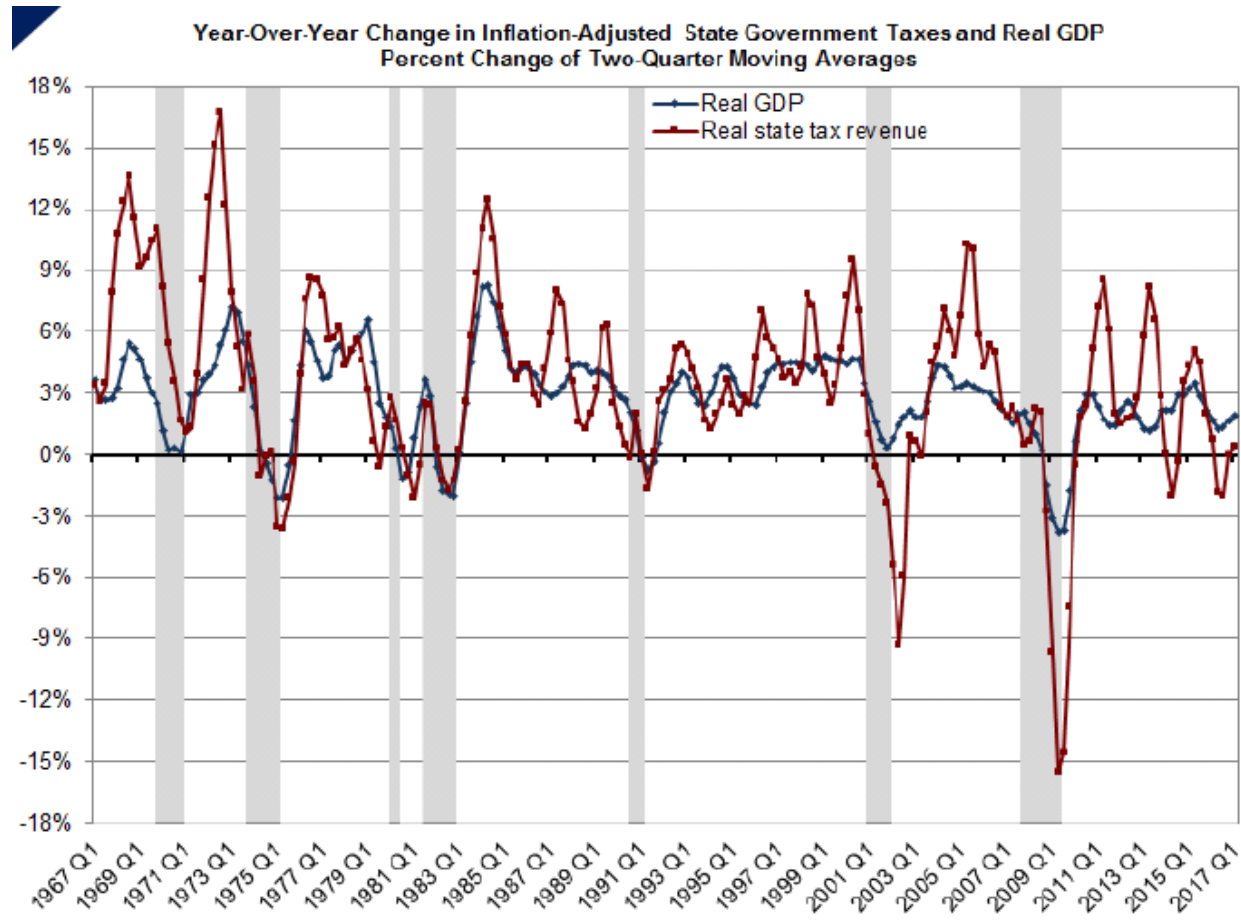
Capital Gains as a Percent of GDP





Key Issues: Volatility

- Overall State Tax Revenues More Volatile than Economy



Sources: U.S. Census Bureau (tax revenue) and Bureau of Economic Analysis (GDP)

Notes: (1) Percentage change of two-quarter moving averages; (2) No legislative adjustments; (3) Recession periods are shaded.

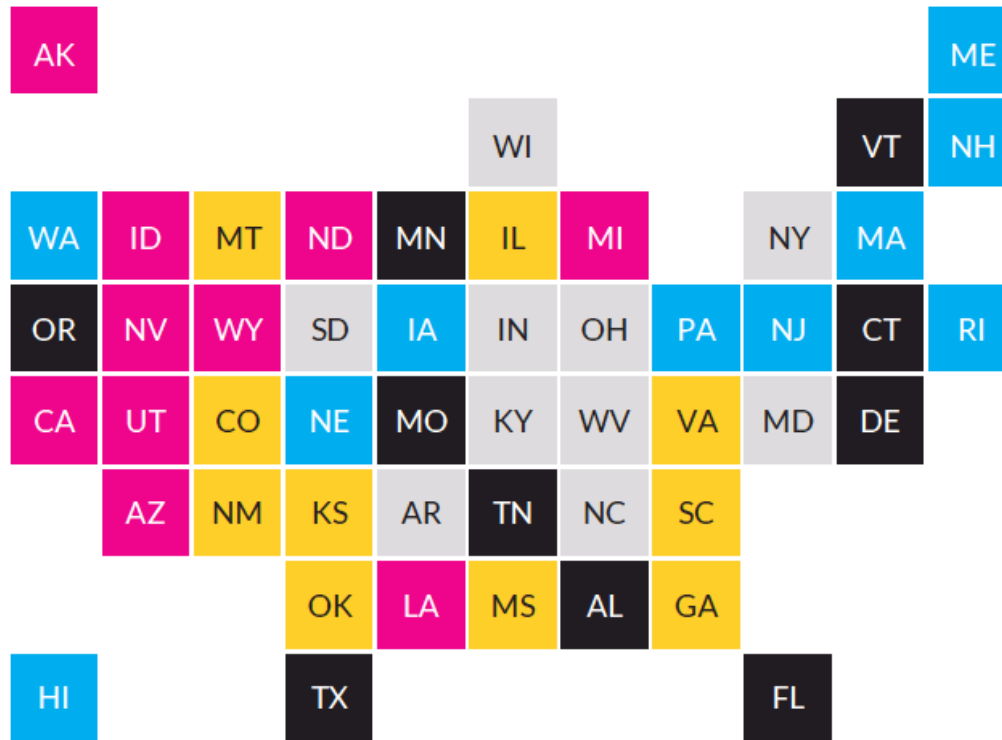


State Comparison of Tax Structure Volatility

State General Revenue Volatility

Standard deviation of annual percent change in revenues, 2006–15

0–4.4% 4.4%–5.5% 5.5%–6.5% 6.5%–8.0% Over 8.5%





Key Issues: Regressivity and Income Inequality

- An argument for individual income taxes is they are generally progressive
 - Most structures are progressive
 - Even flat taxes are generally progressive because of personal exemptions and credits
- Many states use refundable credits to increase progressivity and/or reduce regressivity
 - State earned income credits generally piggy-back on the federal credit
 - 29 states have an EITC, including Kansas, Louisiana and Oklahoma
 - State EITC ranges from 3 to 85 percent of federal credit
 - There are concerns about complexity and fraud related to the EITC
- Income Inequality
 - Generally prevailing view is individual income taxes can be used to reduce inequality
 - However, can impact on business and individual location decisions
 - Recent NBER paper concludes that state individual income tax policy reforms (tax itself, withholding, enhanced tools to reduce evasion) resulted in greater economic inequality



Key Issues: Tax Burden – Per Capita Income Tax Collections

State	Per Capita State and Local Income Tax Collections
Nebraska	\$1,128
Iowa	\$1,065
North Carolina	\$1,045
Missouri	\$939
Indiana	\$916
Arkansas	\$877
Kansas	\$866
Oklahoma	\$764
Alabama	\$682
Louisiana	\$592
Mississippi	\$557
Tennessee	\$37
Texas	N/A

Source: Wisconsin Legislative Fiscal Bureau



Key Issues

- Generally higher individual income tax rates than surrounding states
- Complexity in determining brackets/completing return
- Possible changes to credits/exemptions
- Impact of federal tax changes



Questions and Discussion