

INCOME TAX PROPOSAL #30
for consideration by the
ARKANSAS TAX REFORM AND RELIEF LEGISLATIVE TASK FORCE

TOPIC: Pass-Through Entity Tax

Summary of Proposal for Consideration

This proposal would create an optional pass-through entity tax (PET) for Arkansas businesses that operate as pass-through entities in Arkansas. The purpose of this proposal is to increase fundamental fairness between owners of C corporations and owners of pass-through entities as it relates to each owner's ability to fully deduct state and local taxes (SALT) from the owner's federal income tax liability.

The new federal tax law, the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, limits the federal SALT deduction for individual filers to ten thousand dollars (\$10,000). However, under the TCJA, a C corporation may take an unlimited SALT deduction. This means that owners of C corporations are able to reduce their federal income tax liability to a greater extent than owners of pass-through entities, as it relates to the SALT deduction.

Under current law, a pass-through entity reports Arkansas income attributable to the owners of the pass-through entity directly to the Department of Finance and Administration (DFA), and the owners of the pass-through entity are required to pay income tax to DFA. However, C corporations pay Arkansas income tax directly to DFA. This proposal would allow a pass-through entity to elect to pay Arkansas income tax directly to DFA in the same manner as a C corporation, which would allow a pass-through entity to take a SALT deduction under federal law in the same manner as a C corporation.

This proposal is intended to be revenue neutral for the state. The intended effect of the PET is only to allow owners of pass-through entities to reduce their share of federal income tax liability, specifically as it relates to the SALT deduction. Furthermore, this proposal is intended to minimize procedural changes and additional responsibilities for DFA. Finally, this proposal would be designed according to guidance received from and the requirements of the Internal Revenue Service.

Fiscal Analysis

According to DFA, there is no tax revenue cost to the state regarding collections under this proposal; however, implementation of this proposal would require additional staffing and computer programming for DFA. Additional employees and processing costs would be approximately five hundred thousand dollars (\$500,000) per year with an additional cost for programming to create a new tax type within the integrated tax system.

Potential Legal Issues

None.