[DRAFT: August 15, 2018]

Final Report: August 2018

Arkansas Tax Reform and Relief Legislative Task Force

I. Background.

Act 79 of the 2017 Regular Session, the Tax Reform and Relief Act of 2017, established the Arkansas Tax Reform and Relief Legislative Task Force (the "Task Force"), whose purpose under the Act is:

> *"to examine and identify areas of potential tax reform within the tax laws of the State of Arkansas and to recommend legislation to the General Assembly for consideration during the 2019 regular session in order to:*
> *(A) Modernize and simplify the Arkansas tax code;*
> *(B) Make the Arkansas tax laws competitive with other states in order to attract businesses to the state;*
> *(C) Create jobs for Arkansas; and*
> *(D) Ensure fairness to all individuals and entities impacted by the tax laws of the State of Arkansas."*

The Act further required the Task Force to submit a preliminary report of its findings to the Governor, the Speaker of the House of Representatives, and the President Pro Tempore of the Senate by December 1, 2017, and to file a final report with the same entities on or before September 1, 2018.

On December 22, 2017, the Task Force filed with the Governor, the Speaker, and the President Pro Tempore its preliminary report, as compiled by its consultant PFM Group Consulting, LLC. On January 8, 2018, the Task Force made the determination to terminate its contract with PFM. Since that date, the Task Force has utilized the services of the Bureau of Legislative Research (BLR), the Department of Finance and Administration (DFA), and economists from the Tax Foundation and the Institute on Taxation and Economic Policy (ITEP) to assist the members with data gathering and legal and fiscal analyses of the Arkansas tax code that the Task Force has examined as well as its proposed recommendations. The Task Force has also heard from multiple groups and individuals in the general public providing input on Task Force proposals for tax reform and relief, as it works towards its final proposal package.

The work of the Task Force will continue beyond submission of the September 1, 2018 report. The Task Force does not expire until December 31, 2018, and plans to use the months following this report to refine its tax reform and relief package for introduction during the 2019 legislative session. As you review this report, please keep in mind that it is not a static document, but one that is subject to revision or modification by the Task Force as it works to refine its final recommendations.

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II. Work of the Task Force in 2018.

Beginning in March of 2018, the Task Force approached its workload by dividing the tax code into smaller categories on which it would receive information, make proposals to be further refined, and then vote on whether to include those proposals in the final report. The categories studied by the Task Force were: Sales and Use Tax (March 2018), Income Tax (April 2018), Property Tax (May 2018), and Excise and Miscellaneous Taxes (June 2018). The following reflects the proposals from each of those categories that have received approval of the Task Force for inclusion in this final report.

A. Sales and Use Tax.

The following recommendations have been adopted by the Task Force with regard to sales and use tax:

1. ***Regular Review of all Sales and Use Tax Exemptions.*** The Task Force recommends that a comprehensive review of all Arkansas sales and use tax exemptions be conducted at regular intervals in order to determine the feasibility of continuing each exemption based on a cost-benefit analysis of the impact on state revenues.

2. ***Designation of Revenue Generated.*** The Task Force recommends that use of any revenue resulting from a repeal of a sales tax exemption be designated towards offsetting income tax cuts included in its tax reform and relief package. The purpose of repealing exemptions is not to generate revenue for the state.

3. ***Local Sales Tax Caps.*** The Task Force recommends that a maximum rate be established for the total aggregate amount of sales and use tax that may be levied by a county or municipality, effective for tax years beginning January 1, 2019.

   This recommendation would create the following maximum rates:

- The total aggregate amount of sales and use tax that may be levied by a county for general purposes, capital improvements, capital improvements of a community college, food and lodging (also known as the advertising and promotion tax), and economic development may not exceed a total aggregate rate of three percent (3%), effective for tax years beginning January 1, 2019. However, any county that has a total aggregate sales and use tax rate that exceeds three percent (3%) on January 1, 2019, may continue levying a total aggregate sales and use tax rate beyond the three percent (3%) maximum.

- The total aggregate amount of sales and use tax that may be levied by a municipality for general purposes, capital improvements, the temporary

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acquisition, construction, or improvements of parks, food and lodging (also known as the advertising and promotion tax), and economic development may not exceed a total aggregate rate of four percent (4%), effective for tax years beginning January 1, 2019. However, any municipality that has a total aggregate sales and use tax rate that exceeds four percent (4%) on January 1, 2019, may be permitted to continue levying a total aggregate sales and use tax rate beyond the four percent (4%) maximum.

Fiscal Analysis: DFA expects there to be no fiscal impact at the State level when creating a maximum rate on municipal sales tax at four percent (4%) and a county sales tax at three percent (3%) because these are local revenues that are sent to the city and county. DFA's records also indicate that there is currently only one (1) county exceeding the proposed cap.

4. ***Repeal the Sales Tax Exemption for Coin-Operated Car Washes.*** The Task Force recommends the sales tax exemption for services provided by coin-operated car washes where the labor is performed solely by the customer or mechanical equipment be expanded to include services provided by all car washes under Arkansas Code § 26-52-301(3)(B)(ii), beginning July 1, 2019.

   It is further recommended that a new fee be created that would be paid by all car wash operators in Arkansas based on the amount of water used by the car wash operator. Under this recommendation, a car wash operator would pay a monthly or annual fee that would be deposited as general revenues, beginning July 1, 2019, as follows:

   - If the car wash operator uses water from a public water system, a monthly fee of one dollar ($1.00) per one hundred (100) gallons of water used would be assessed on the car wash operator's monthly water bill; and

   - If the car wash operator uses water from a private well or non-public water system, an annual fee of one hundred dollars ($100) for each self-service bay and one thousand dollars ($1000) for each car wash tunnel owned by the car wash operator would be assessed on the car wash operator.

   Fiscal Analysis: According to DFA, exempting all car washes from the sales tax would result in an estimated loss of one million eight hundred one thousand dollars ($1,801,000), of which one million two hundred forty-seven thousand dollars ($1,247,000) would be general revenue. DFA is unable to determine the total of the monthly fee or annual fee proposed. This is due to the fact that DFA does not have information regarding the amount of water, source of water, or specifics regarding the operation of these businesses. However, the revenue from the monthly and annual fees would offset, at least in part, the revenue loss resulting from the extension of the sales tax exemption.

5. ***Repeal the Sales Tax Exemption on Sales of Four-Wheelers and All-Terrain Vehicles for Farm Use.*** The Task Force recommends that the sales tax exemption on all purchases of four-wheelers and ATVs used as farm equipment and machinery be repealed and replaced with a tax rebate, effective for tax years beginning January 1, 2019.

   The purpose of this recommendation is to provide economic relief to farmers from Arkansas sales tax on purchases of farm equipment and machinery used exclusively and directly in farming while limiting the potential for abuse of the sales tax exemption provided for purchases of farm equipment and machinery used exclusively and directly for farming under Arkansas Code § 26-52-403.

   The form and manner of the application for the sales tax rebate to be used by a farmer would be administered by DFA.

   Fiscal Analysis: According to DFA, shifting from an exemption to a rebate for agriculturally qualified four-wheelers and ATVs would not have an immediate impact on the state tax revenue. DFA states that the administrative costs of additional filing requirements for farmers claiming a tax rebate would be offset by a reduction in the number of improperly claimed exemptions that are found through audit.

6. ***Repeal Sales Tax Exemptions for Named Entities.*** The Task Force recommends repealing all sales tax exemptions for named nonprofit entities and creating new, more generalized exemptions for these types of nonprofit entities, effective beginning July 1, 2019. The purposes of this recommendation are to eliminate any potential constitutional issues relating to special legislation for sales tax exemptions provided to specific nonprofit entities and to promote a more fair and equitable sales tax exemption for all nonprofit entities in Arkansas.

   Under this proposal the sales tax exemptions for the following named nonprofit entities would be repealed and replaced with generalized sales tax exemptions:

   - Arkansas Entertainers Hall of Fame Board under Arkansas Code § 13-9-104;
   - Boys' and Girls' Clubs of America and any local councils under Arkansas Code § 26-52-401(8);
   - Poets Roundtable of Arkansas under Arkansas Code § 26-52-401(9);
   - 4-H Clubs and FFA Clubs located in Arkansas, the Arkansas 4-H Foundation, the Arkansas Future Farmers of America Foundation, and the Arkansas Future Farmers of America Association under Arkansas Code § 26-52-401(10);
   - Arkansas Veterans' Home under Arkansas Code § 26-52-401(25);
   - Habitat for Humanity under Arkansas Code § 26-52-401(31);
   - The Salvation Army under Arkansas Code § 26-52-401(33);
   - Heifer Project International, Inc. under Arkansas Code § 26-52-401(34);

- Arkansas Symphony Orchestra Society under Arkansas Code § 26-52-401(37);
- Arkansas Black Hall of Fame Foundation under Arkansas Code § 26-52-401(39);
- Fort Smith Clearinghouse under Arkansas Code § 26-52-424; and
- Arkansas Search Dog Association, Inc. under Arkansas Code § 26-52-443.

Fiscal Analysis: DFA is unable to provide a fiscal analysis for this recommendation. There are an unknown number of nonprofit and not-for-profit entities that may prove eligible for an exemption under the proposal that would create an unknown fiscal impact that DFA is unable to quantify. Any definitions that would apply to the listed entities would likely also apply to other entities not currently listed and therefore may create a fiscal impact for entities not currently able to purchase goods and services exempt from Arkansas sales and use tax.

7. ***Repeal the Sales Tax Exemption for Magazine/Publication Subscription Sales.*** The Task Force recommends that the sales tax exemption on the sale of any publication, other than newspapers, through regular subscription under Arkansas Code § 26-52-401(14) be repealed. This recommendation is contingent on the passage of a law in the State of Arkansas that requires the collection of sales tax by remote sellers (See Sales and Use Tax Recommendation 8, below).

   Fiscal Analysis: According to DFA's "Sales and Use Tax Revenue Impact of Exemptions" presentation to the Task Force on March 19, 2018, repeal of the sales tax exemption for sales of any publication, other than newspapers, through regular subscription may result in a per year increase of approximately one million five hundred and fifty-six thousand dollars ($1,556,000) in general revenues based on FY11.

8. ***Require Remote Sellers to Collect and Remit Arkansas Sales and Use Tax.*** The Task Force recommends requiring out-of-state sellers who do not have a physical presence in the state and who have more than one hundred thousand dollars ($100,000) in sales or at least two hundred (200) separate sales transactions in Arkansas to collect and remit Arkansas sales and use taxes. This requirement would not be retroactive, and any revenues collected as a result of this proposal would be dedicated to reducing taxes. This recommendation would also repeal § 26-51-201(e), which provides for the reduction of the four and five-tenths percent (4.5%) income tax rate for middle-income earners to be reduced based on collections by out-of-state sellers who do not have a physical presence in the state.

   Fiscal Analysis: Based on information DFA presented to the Task Force on July 27, 2018, the estimated impact of enacting the proposed requirement for certain out-of-state sellers to collect and remit Arkansas sales and use taxes would be thirty-five million three hundred seventy-four thousand dollars

($35,374,000), with twenty-four million four hundred ninety-one thousand dollars ($24,491,000) representing the estimated increase in general revenue.

B. Income Tax.

The following recommendations have been adopted by the Task Force with regard to individual and corporate income tax:

1. ***Legislative Review of all Individual and Corporate Income Tax Deductions, Exclusions, and Credits.*** The Task Force recommends a regularly occurring legislative review process of all individual income tax and corporate income tax deductions, exclusions, and credits, in order to determine the feasibility of continuing each deduction, exclusion, or credit based on a cost-benefit analysis of the impact on state revenues.

2. ***Repeal the Throwback Rule.*** The Task Force recommends repealing the "throwback rule" for multistate business income under Arkansas Code § 26-51-716, effective for tax years beginning January 1, 2019.

   The "throwback rule" is part of the calculation used by Arkansas concerning the apportionment of business income by multistate businesses for income tax purposes. Arkansas uses an apportionment formula consisting of property, payroll, and double sales factors to apportion income of a multistate business. Under Arkansas law, all sales must be reported somewhere, otherwise a taxpayer will have untaxed "nowhere" income. "Nowhere" sales are recaptured and placed in the Arkansas sales factor under Arkansas Code § 26-51-716, which is referred to as the "throwback rule."

   Fiscal Analysis: DFA estimates that repealing the "throwback rule" would have resulted in an estimated revenue reduction of twenty-four million five hundred thousand dollars ($24,500,000) for fiscal year 2018, based on the fiscal impact statement prepared for HB1790 of 2017, which proposed to repeal the "throwback rule" under Arkansas Code § 26-51-716.

3. ***Single Sales Factor Apportionment.*** The Task Force recommends amending the apportionment formula for taxing multistate business income to use a single sales factor apportionment, effective for tax years beginning January 1, 2019.

   Under Arkansas Code § 26-51-709, Arkansas apportions all business income owed to the state using a three-factor formula with a double-weighted sales factor. Arkansas calculates apportionment by adding a business's property, payroll, and double the sales and dividing the sum by four (4). Under this proposal, multistate business income would be apportioned by dividing the taxable entity's gross receipts from business conducted in Arkansas by the taxable entity's gross receipts from its entire business nationwide.

Fiscal Analysis: According to DFA, amending the apportionment formula for taxing multistate business income to use a single sales factor would result in an estimated increase of eight million eight hundred thousand dollars ($8,800,000) in general revenues based on fiscal year 2016.

4. ***Net Operating Losses.*** The Task Force recommendation is to incrementally increase the carry-forward period on net operating losses for all businesses to twenty (20) years. Currently, Arkansas tax law states that net operating losses may be carried forward for a maximum of five (5) years under Arkansas Code § 26-51-427, with the exception that the net operating loss carry-forward period for steel manufacturers under Arkansas Code § 15-4-2404 is a maximum of ten (10) years.

   Under this recommendation, the net operating loss carry-forward period under Arkansas Code § 26-51-427 would be incrementally increased from five (5) years to twenty (20) years as follows:

   - For the tax year beginning January 1, 2019, the net operating loss carry-forward period would be increased to eight (8) years;
   - For the tax year beginning January 1, 2020, the net operating loss carry-forward period would be increased to eleven (11) years;
   - For the tax year beginning January 1, 2021, the net operating loss carry-forward period would be increased to fourteen (14) years;
   - For the tax year beginning January 1, 2022, the net operating loss carry-forward period would be increased to seventeen (17) years; and
   - For tax years beginning on or after January 1, 2023, the net operating loss carry-forward period would be increased to twenty (20) years.

   The net operating loss-carry forward period for steel manufacturers under Arkansas Code § 15-4-2404 would also be incrementally increased from ten (10) years to twenty (20) years as follows:

   - For the tax year beginning January 1, 2020, the net operating loss carry-forward period would be increased to eleven (11) years;
   - For the tax year beginning January 1, 2021, the net operating loss carry-forward period would be increased to fourteen (14) years;
   - For the tax year beginning January 1, 2022, the net operating loss carry-forward period would be increased to seventeen (17) years; and
   - For tax years beginning on or after January 1, 2023, the net operating loss carry-forward period would be increased to twenty (20) years.

   Fiscal Analysis: DFA projects that increasing the net operating loss carry-forward period under this recommendation would result in a loss of approximately one hundred fifty-nine million four hundred eighty-four thousand dollars ($159,484,000) in fiscal year 2044 and every year thereafter.

According to DFA the breakdown of revenue loss from corporate income tax and individual income tax when implementing the proposal, starting in tax year 2025 is as follows:

Tax Year	**Fiscal Year**	Carry Forward Year	Estimated Revenue Loss – Corporate Income Tax	Estimated Revenue Loss – Individual Income Tax	**Total Estimated Revenue Loss**
2025	**2026**	6	$12,879,618	$3,954,796	**$16,834,414**
2026	**2027**	7	$25,081,360	$7,701,445	**$32,782,805**
2027	**2028**	8	$36,605,229	$11,239,946	**$47,845,175**
2028	**2029**	8	$36,605,229	$11,239,946	**$47,845,175**
2029	**2030**	9	$47,451,222	$14,570,301	**$62,021,523**
2030	**2031**	10	$57,619,341	$17,692,508	**$75,311,849**
2031	**2032**	11	$67,109,586	$20,606,568	**$87,716,154**
2032	**2033**	11	$67,109,586	$20,606,568	**$87,716,154**
2033	**2034**	12	$75,921,956	$23,312,481	**$99,234,437**
2034	**2035**	13	$84,056,451	$25,810,247	**$109,866,698**
2035	**2036**	14	$91,513,072	$28,099,866	**$119,612,938**
2036	**2037**	14	$91,513,072	$28,099,866	**$119,612,938**
2037	**2038**	15	$98,291,818	$30,181,338	**$128,473,156**
2038	**2039**	16	$104,392,689	$32,054,662	**$136,447,351**
2039	**2040**	17	$109,815,686	$33,719,839	**$143,535,525**
2040	**2041**	17	$109,815,686	$33,719,839	**$143,535,525**
2041	**2042**	18	$114,560,808	$35,176,869	**$149,737,677**
2042	**2043**	19	$118,628,056	$36,425,752	**$155,053,808**
2043	**2044**	20	$122,017,429	$37,466,488	**$159,483,917**

5. ***Individual Income Tax Brackets.*** The Task Force recommends amending and simplifying the Arkansas individual income tax rates and brackets under Arkansas Code § 26-51-201, effective for tax years beginning January 1, 2019. The Task Force considered three (3) possible options for reforming the individual income tax brackets, as follows:

   a. ***"Option A"***, which would reduce the number of individual income tax tables from three (3) to one (1) and reduce the top marginal rate for individuals from six and nine-tenths percent (6.9%) to six and five-tenths percent (6.5%). The individual income tax table under this recommendation would be as follows:

Individual Income Tax Bracket	Tax Rate
$0-$4,299	0.0%
$4,300 - $8,399	2.0%
$8,400 - $12,599	3.0%
$12,600 - $20,999	3.4%

$21,000 - $35,099	5.0%
$35,100 - $80,000	6.0%
$80,000+	6.5%

b. ***"Option B" combined with an Earned Income Tax Credit***, which would reduce the number of individual income tax tables from three (3) to one (1) and reduce the top marginal rate for individuals from six and nine-tenths percent (6.9%) to six and five-tenths percent (6.5%). The individual income tax table under Option B would be as follows:

Option B	
Individual Income Tax Bracket	Tax Rate
$0-$4,299	0.9%
$4,300 - $8,399	2.4%
$8,400 - $12,599	3.4%
$12,600 - $20,999	4.4%
$21,000 - $35,099	5.0%
$35,100 - $80,000	6.0%
$80,000+	6.5%

The simplification of the individual income tax brackets and tables under this proposal would be combined with a refundable Earned Income Tax Credit (EITC) of ten percent (10%) of the federal EITC.

c. ***Reduction of the Top Individual Income Tax Rate***, which would reduce the top personal income tax rate from 6.9% to 6.0% but would not affect the rate in any of the other brackets.

At its meeting on August 7, 2018, the Task Force members were asked to rank the three (3) options regarding individual income tax rates, numbering them one through three, with one being their preferred option and three being their least favorite option. After the rankings were tallied, ***Option A was determined to be the preference of the Task Force***, and is adopted as its recommendation herein.

Option A Fiscal Analysis: DFA estimates that the proposed recommendation for amending and simplifying the individual income tax brackets as described in Option A, above, will result in a revenue impact of $276,437,336, as follows:

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Brackets		# of Returns	Revenue	Revenue Impact
$0 to $4,299	0.0%	139,298	$24,086	-$505,602
$4,300 to $8,399	2.0%	88,007	$998,694	-$973,825
$8,400 to $12,599	3.0%	97,904	$3,899,035	-$1,505,319
$12,600 to $20,999	3.4%	206,267	$45,060,925	-$12,695,334
$21,000 to $35,099	5.0%	249,458	$185,030,490	-$36,688,817
$35,100 to $80,000	6.0%	315,511	$645,096,527	-$67,061,340
$80,000 and up	6.5%	170,365	$1,460,366,876	-$157,007,099
		1,266,810	$2,340,476,633	-$276,437,336

6. ***Corporate Income Tax Brackets.*** The Task Force recommends reducing the corporate income tax rates and creating a tax trigger for further reductions to the top marginal corporate income tax rate under Arkansas Code § 26-51-205, effective for tax years beginning January 1, 2019.

   First, this recommendation would reduce the rate of corporate income tax on corporate income between twenty-five thousand one dollars ($25,001) and one hundred thousand dollars ($100,000), inclusive, from six percent (6%) to five and nine-tenths percent (5.9%), effective tax years beginning January 1, 2019.

   Second, this recommendation would create a tax trigger for reducing the top marginal rate of corporate income tax on corporate income in excess of one hundred thousand dollars ($100,000) to five and nine-tenths percent (5.9%), effective for tax years beginning January 1, 2019.

   The structure of the tax trigger will be determined at a later date by the Task Force based on a comprehensive plan for providing tax reform and relief.

   Fiscal Analysis: Based on the most recent corporate income tax returns, DFA estimates that the fiscal impact of this recommendation would be an initial loss of six million five hundred thousand dollars ($6,500,000) and a total phased-in fiscal impact to be a loss of thirty-eight million seven hundred thousand dollars ($38,700,000), if the top marginal rate for corporate income is reduced to five and nine-tenths percent (5.9%).

7. ***Repeal the Capital Gains Tax Exemption.*** The Task Force recommends repealing the capital gains tax exemption for capital gains over ten million dollars ($10,000,000) under Arkansas Code § 26-51-815(b)(3), effective for tax years beginning January 1, 2019.

   The revenue generated by the repeal of the capital gains tax exemption for capital gains over ten million dollars ($10,000,000) would be utilized to reduce the top income tax rate on individual earners or to reduce the income tax rate for all individual earners.

Fiscal Analysis: According to DFA, the repeal of the capital gains tax exemption for capital gains over ten million dollars ($10,000,000) under Arkansas Code § 26-51-815 may result in a general revenue increase of four million six hundred and fifty thousand dollars ($4,650,000).

8. ***Repeal the Political Contribution Income Tax Credit.*** The Task Force recommends the repeal of the political contribution income tax credit, effective for tax years beginning January 1, 2019.

   Fiscal Analysis: According to DFA, repeal of the political contributions income tax credit may result in an increase of seven hundred fifty-nine thousand dollars ($759,000) per year in general revenue based on figures from fiscal year 2016.

9. ***Create a Pass-Through Entity Tax.*** The Task Force recommends creating an optional pass-through entity tax (PET) for Arkansas businesses that operate as pass-through entities in Arkansas. The purpose of this recommendation 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 recommendation 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 recommendation 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 recommendation 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 recommendation; however, implementation of

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this recommendation 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.

C. Property Tax.

The following recommendations have been adopted by the Task Force with regard to property tax:

1. ***Business Inventory Tax Credit.*** The Task Force recommends creating a non-refundable income tax credit equal to the amount of property tax the taxpayer paid on business inventory, with a carry-forward period of ten (10) years. The income tax credit created under this recommendation and the tax deduction offered under Arkansas Code § 26-51-416 would be mutually exclusive, and business inventory that is exempt from property tax would not be subject to the income tax credit. Implementation of this recommendation would likely require changes at the county level to allow taxpayers to identify the portion of property tax paid that is eligible for the income tax credit, and taxpayers would be required to provide proof of payment of the property tax to claim the income tax credit. The income tax credit would be effective for tax years beginning on and after January 1, 2019.

   Fiscal Analysis: According to the Arkansas Assessment Coordination Department (ACD), Arkansas collected an estimated seventy million two hundred ten thousand dollars ($70,210,000) from ad valorem property tax levied on business inventory based on collections from 2016. According to DFA, depending on the nature of a tax credit or deduction to offset the ad valorem personal property tax paid on business inventory, such a tax credit or deduction may result in an estimated loss of general revenues of up to seventy million two hundred ten thousand dollars ($70,210,000) based on collections from 2016.

2. ***Franchise Tax on Corporations.*** The Task Force recommends changing the filing date for the franchise tax, transferring the administration and collection authority for the franchise tax to DFA, and eliminating the franchise tax penalty on closed businesses.

   Fiscal Analysis: According to DFA, transferring the corporate franchise tax to DFA – Office of Corporation Income Tax would require an additional three (3) to four (4) employees to oversee corporate franchise tax in conjunction with the corporate income tax and programming costs. One-time programming costs to add the franchise tax to DFA's computer system would be six hundred thirty thousand dollars ($630,000), and ongoing costs for upkeep would be two hundred seventy thousand dollars ($270,000). The Secretary of State's Office appropriation currently includes costs to administer the corporate franchise tax.

3. ***State Guidelines on Assessing Exempt Property.*** The Task Force recommends requiring the Assessment Coordination Department (ACD) to create statewide guidelines for the assessment of exempt property that are established by ACD and that counties are required to comply with. This recommendation would also give ACD the authority to oversee and enforce property tax laws and would require ACD to inform Legislative Council or the Joint Budget Committee concerning any non-compliant counties so that the Legislative Council or the Joint Budget Committee can determine whether to recommend to the General Assembly that the non-compliant county's turnback funds be reduced or withheld until the county becomes compliant.

   Fiscal Analysis: DFA is unable to provide a fiscal or administrative impact on this proposal.

D. Excise and Miscellaneous Tax.

The following recommendations have been adopted by the Task Force with regard to excise and miscellaneous taxes:

1. ***Index Fuel Taxes.*** The Task Force recommends indexing motor fuel and distillate special fuel tax rates based on the inflation rate of construction costs, with the minimum tax rate set at the current tax rate and the maximum tax rate set at three percent (3%) over the tax rate of the previous year. Under this recommendation, the indexing of the motor fuel and distillate special fuel taxes would be structured to comply with the International Fuel Tax Agreement (IFTA).

   Fiscal Analysis: Without specific guidance on the construction costs and how to adjust the motor fuel taxes, DFA is unable to provide a fiscal impact statement or analysis.

   DFA could publish on a quarterly, biannual, or annual basis the amount of the adjustment to the motor fuel, distillate special fuel, and other related taxes based on a defined formula provided by legislation. The fiscal impact will be dependent on the inflationary measure chosen by the General Assembly. Additionally, the General Assembly should consider whether such an indexing could allow for a reduction in the motor fuel tax in certain circumstances.

2. ***Road User Fee for Electric and Hybrid Vehicles.*** The Task Force recommends creating a road user fee for electric and hybrid vehicles at the point of registration and using the resulting revenue for highway funding.

   Fiscal Analysis: According to DFA, the average number of electric vehicles that are renewed each year based on the previous three (3) calendar years is three hundred ninety-one (391) per year, and the average number of hybrid vehicle registration renewals over the same period is fourteen thousand five hundred

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(14,500). The total number of registered electric vehicles is one thousand three hundred eight (1,308), and the total number of registered hybrid motor vehicles is forty-one thousand two hundred fifty-two (41,252). These numbers have shown an increase over the past several years.

Based on DFA's fiscal analysis of HB2241 of 2017, which would have levied a registration fee of one hundred eighty-four dollars ($184) on electric vehicles and ninety dollars ($90) on hybrid vehicles, the fiscal impact would have been approximately one million eighty-two thousand six hundred thirty-four dollars ($1,082,634). However, that fiscal impact was based on four hundred nineteen (419) electric vehicles and sixteen thousand three hundred forty (16,340) hybrid vehicles.

III. REMI – Dynamic Scoring.

On March 19, 2018, the Task Force authorized the BLR to enter into a contract with Regional Economic Models, Inc. (REMI) for the production of dynamic fiscal notes regarding tax reform and relief proposals submitted to REMI by the Task Force. The contract between the BLR and REMI was approved by the Legislative Council at its meeting on April 16, 2018.

The Task Force voted to send the following proposals to REMI for dynamic fiscal scoring at its June 26 meeting:

- ***Individual Income Tax Brackets – "Option A"*** *(as described in Section II.B.5.a. of this report);*
- ***Individual Income Tax Brackets – "Option B" combined with an EITC*** *(as described in Section II.B.5.b. of this report);*
- ***Reduction of the Top Individual Income Tax Rate*** *(as described in Section II.B.5.c. of this report); and*
- ***Tax Foundation Suggested Tax Reform Package.*** At the meeting of the Task Force on June 21, 2018, Ms. Nicole Kaeding with the Tax Foundation presented her suggested reforms for the Arkansas tax code.[1] From those recommendations, the Task Force sent the following to REMI for dynamic scoring:

  Lowering the top individual income tax rate to 6.0%;
  Lowering the top corporate income tax rate to 6.0%;
  Repeal of the Throwback rule;
  Single Sales Factor Apportionment;
  Repeal of the Inventory Tax; and
  Repeal of the Franchise Tax.

[1] *Arkansas Options for Tax Reform,* Nicole Kaeding, Tax Foundation, June 21, 2018, p. 15.

On August 6, 2018, representatives of REMI appeared before the Task Force to present the dynamic fiscal notes for the four (4) proposals sent to them. (See *Appendix A,* REMI Legislative Impact Statements).

A. Individual Income Tax Rate Proposals

With regard to the proposed revisions to individual income tax rates, REMI evaluated Option A, Option B combined with a refundable EITC, and the proposal to reduce the top individual income tax rate to 6.0% (the "Governor's Proposal") in an identical manner. The legislative impact statements for each individual income tax rate proposal utilized the following methodology:

> *fiscal, economic, and demographic estimates based on three different analytical approaches to evaluating the [proposals]: (1) assessing changes in business production costs; (2) assessing changes to disposable personal income; and (3) a blended approach taking both production costs and disposable personal income into consideration.*
>
> *For each approach, two scenarios are simulated using a dynamic economic model – one based on tax cuts alone, and the other factoring in corresponding cuts to government spending given the sizable static decrease in revenue.*[2]

This approach resulted in six (6) scenarios for each of the three individual income tax proposals.

1. REMI's conclusions with regard to ***"Option A"*** were as follows:[3]

- Production-Cost Approach:
  "[R]eflects the potential for tax cuts to cause a reduction in costs for businesses, which in turn affect the economy in ways that an income-only approach may not capture. Since Option A would affect after-tax wages and salaries, the plan would change the competitive position of Arkansas-based employers seeking to attract workers. Employers in the state have to compensate for the tax burden in order to compete with employers based in lower-tax states.

  The production-cost approach shows annual economic output growing on average over 5 years by $421.4 million and an average annual increase of 3,267 jobs, with more than 92 percent of the growth occurring in private non-farm employment. It also shows a net loss of $271.5 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would

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[2] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Governor's Proposal, Executive Summary, p. 1; Option A, Executive Summary, p. 1; and Option B, Executive Summary, p. 1.
[3] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Option A, p. 16.

be concentrated in the public sector while the private sector would gain jobs."

- Income-Focused Approach:
  "[S]hows annual economic output growing on average over 5 years by $310.7 million and an average annual increase of 2,446 jobs, with 90 percent of the growth occurring in private non-farm employment. It also shows a net loss of $268.3 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be mostly concentrated in the public sector."

- Blended Approach:
  "[S]hows annual economic output growing on average over 5 years by $321.9 million and an average annual increase of 2,528 jobs, with more than 90 percent of the growth occurring in private non-farm employment. It also shows a net loss of $268.6 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be mostly concentrated in the public sector."

2. REMI's conclusions with regard to ***"Option B" combined with a refundable EITC*** were as follows:[4]

- Production-Cost Approach:
  "[R]eflects the potential for tax cuts to cause a reduction in costs for businesses, which in turn affect the economy in ways that an income-only approach may not capture. Since Option B and the EITC would affect after-tax wages and salaries, the plan would change the competitive position of Arkansas-based employers seeking to attract workers. Employers in the state have to compensate for the tax burden in order to compete with employers based in lower-tax states.

  The production-cost approach shows annual economic output growing on average over 5 years by $313.5 million and an average annual increase of 2,430 jobs, with more than 92 percent of the growth occurring in private non-farm employment. It also shows a net loss of $202.6 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be concentrated in the public sector while the private sector would gain jobs."

- Income-Focused Approach:
  "[S]hows annual economic output growing on average over 5 years by $231.3 million and an average annual increase of 1,820 jobs, with over 90

[4] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Option B, p. 16.

percent of the growth occurring in private non-farm employment. It also shows a net loss of $200.2 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be mostly concentrated in the public sector."

- Blended Approach:
  "[S]hows annual economic output growing on average over 5 years by $239.6 million and an average annual increase of 1,882 jobs, with more than 90 percent of the growth occurring in private non-farm employment. It also shows a net loss of $200.4 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be mostly concentrated in the public sector."

3. REMI's conclusions with regard to the ***"Governor's Proposal"*** were as follows:[5]

- Production-Cost Approach:
  "[R]eflects the potential for tax cuts to cause a reduction in costs for businesses, which in turn affect the economy in ways that an income-only approach may not capture. Since the Governor's Proposal would affect after-tax wages and salaries, the plan would change the competitive position of Arkansas-based employers seeking to attract workers. Employers in the state have to compensate for the tax burden in order to compete with employers based in lower-tax states.

  The production-cost approach shows annual economic output growing on average over 5 years by $274.0 million and an average annual increase of 2,124 jobs, with more than 92 percent of the growth occurring in private non-farm employment. It also shows a net loss of $176.8 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be concentrated in the public sector while the private sector would gain jobs."

- Income-Focused Approach:
  "[S]hows annual economic output growing on average over 5 years by $202.4 million and an average annual increase of 1,593 jobs, with 90 percent of the growth occurring in private non-farm employment. It also shows a net loss of $174.7 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be mostly concentrated in the public sector."

[5] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Governor's Proposal, p. 15.

- Blended Approach:
  "[S]hows annual economic output growing on average over 5 years by $239.6 million and an average annual increase of 1,882 jobs, with more than 90 percent of the growth occurring in private non-farm employment. It also shows a net loss of $200.4 million in revenue. Corresponding cuts in government spending would compensate for this loss. Output and job growth would turn negative, though the job loss would be mostly concentrated in the public sector."

Overall, the dynamic scoring results for each proposal with regard to revenue loss showed a difference of roughly six percent (6%) between the net revenue loss in the dynamic analyses by REMI and the static fiscal impacts provided by DFA.

REMI then conducted a separate dynamic fiscal analysis for the remaining components of the Tax Foundation's proposals. For each of the following proposals, REMI ran only a single scenario:

B. Corporate Income Tax Proposal

This proposal would reduce the top corporate income tax rate from 6.5% to 6.0%. REMI stated in its conclusion that the "results show annual economic output growing on average over 5 years by $46.3 million and an average annual increase of 356 jobs, with more than 93 percent of the growth occurring in private non-farm employment. It also shows a net loss of $30.8 million in revenue."[6]

C. Throwback Rule

This proposal would repeal the throwback rule for multistate business income under Arkansas Code § 26-51-716, effective for tax years beginning January 1, 2019. REMI's dynamic fiscal analysis results "show annual economic output growing on average over 5 years by $28.7 million and an average annual increase of 152 jobs, with more than 92 percent of the growth occurring in private non-farm employment. It also shows a net loss of $24.5 million in revenue."[7]

D. Single Sales Factor Apportionment

This proposal would amend the apportionment formula for taxing multistate business income to use a single sales factor apportionment, effective for tax years beginning January 1, 2019. REMI's dynamic fiscal analysis results "show annual economic output falling on average over 5 years by $13.8 million and an average annual

[6] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Corporate Income Tax Proposal, p. 2.
[7] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Throwback Rule Repeal Proposal, p. 2.

decrease of 94 jobs, with more than 91 percent of the decline occurring in private non-farm employment. It also shows a net increase of $8.6 million in revenue."[8]

E. Inventory Tax

The proposal analyzed was a repeal of the business inventory tax. REMI's dynamic fiscal analysis results "show annual economic output growing on average over 5 years by $88.1 million and an average annual increase of 488 jobs, with more than 91 percent of the growth occurring in private non-farm employment. It also shows a net gain of $2.8 million in state revenue."[9]

F. Franchise Tax

The proposal analyzed was a repeal of the franchise tax. In analyzing this proposal, REMI did so "in combination with a decrease in general state government expenditures to model the scenario in which the lost education funding is made up elsewhere in the state budget." The loss in education funding was estimated to be $21 million. REMI's dynamic fiscal results "show annual economic output falling on average over 5 years by $9.1 million and an average annual decrease of 149 jobs, but a small increase in private non-farm employment. It also shows a net loss of $29.3 million in revenue."[10]

IV. Task Force Priorities.

In June 2018, the members of the Task Force were asked to determine their priorities with regard to formulating a $200 million tax reform and relief package. (See *Appendix B,* sample $200 million Priorities Worksheet). The rankings provided by the members were analyzed by Richard Wilson, Assistant Director, Research Services Division, BLR, in order to determine the overall priorities for the Task Force. (See *Appendix C,* $200 million Priorities Spreadsheet). The analysis of the members' priority rankings indicated that the Task Force's top four (4) priorities were:

1. Repeal of the Throwback Rule combined with Single Sales Factor Apportionment;
2. Simplification of the Individual Income Tax Brackets and Tables under "Option A" (as set forth above);
3. Incremental Increase of the Carry-Forward Period for Net Operating Losses; and
4. Lowering the top rates for Individual and Corporate Income Tax.

[8] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Single Sales Factor Proposal, p. 3.
[9] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Inventory Tax Repeal Proposal, p. 2.
[10] *Legislative Impact Statements,* Peter Evangelakis, Ph.D., Senior Economist, REMI, Franchise Tax Repeal Proposal, p. 3.

At its August 7, 2018 meeting, the members were asked to complete a revenue increase worksheet to show their priorities (from 1 to 6) with regard to elimination of certain exemptions or deductions, collection of sales and use tax from new sources, and creation of excise taxes or fees. (See *Appendix D,* sample Revenue Increase Worksheet). The rankings were analyzed by Richard Wilson, and the priorities fell as follows (See *Appendix E,* Revenue Priorities Table):

1. Collection of Sales and Use Tax by Remote Sellers;
2. Repeal of the Capital Gains Tax Exemption over $10 million;
3. Repeal of the Income Tax Credit for Political Contributions;
4. Creation of a Road User Fee for Electric and Hybrid Vehicles;
5. Repeal of the Sales Tax Exemption for Magazine Subscriptions; and
6. Indexing Motor Fuel and Distillate Special Fuel Taxes.

V. Conclusion.

As it continues its work of formulating a tax reform and relief package, the Task Force will meet regularly throughout the remainder of 2018. The Task Force's next step is to analyze its adopted recommendations with regard to the revenue impacts and the possibilities of any offsets of those impacts through recommendations that repeal exemptions or tax credits or that create new fees or excise taxes. The Task Force will examine the feasibility of tax triggers or other phase-in options for its plan in order to minimize the impact to the state's budget due to revenue loss resulting from proposed tax cuts.

The Task Force is working toward the introduction of legislation during the 2019 legislative session and will begin proposing and discussing bill drafts in the coming weeks. Throughout this process, the Task Force will continue to request input from the BLR, DFA, the Tax Foundation, ITEP, and REMI, in order to ensure that it has all relevant analyses of its proposed legislation. It is the intention of the Task Force to strive to fulfill its mandate under the Act to identify areas of potential reform within the Arkansas tax code in order to make Arkansas competitive with surrounding states, bring business and jobs to the state, and provide fairness and relief to the taxpayers of Arkansas.

VI. Appendices.

A. REMI Legislative Impact Statements
B. $200 Million Priorities Worksheet
C. $200 Million Priorities Spreadsheet
D. Revenue Increase Priorities Worksheet
E. Revenue Increase Priorities Table

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