Department of Finance and Administration

Legislative Impact Statement

Bill: HB1714
Bill Subtitle: TO CREATE THE ELECTIVE PASS-THROUGH ENTITY TAX ACT; TO IMPOSE A TAX ON PASS-THROUGH ENTITIES; AND TO EXCLUDE CERTAIN INCOME FROM GROSS INCOME FOR PASS-THROUGH ENTITIES.

Basic Change :

Sponsor: Rep. Jett

HB1714 creates a voluntary tax that pass-through entities would pay if owners of at least 50% of the voting rights of a pass-through entity agree to do so for tax years beginning on or after January 1, 2020. The tax would be a flat rate of 6.6% for tax years beginning in 2020 and 5.9% for tax years beginning on or after January 1, 2021. Income of a member that is subject to the pass-through entity tax would be excluded from Arkansas income tax. Income subject to a similar tax in another State or the District of Columbia would be exempt from Arkansas income tax. Non-resident members of an entity subject to the pass-through entity tax is not required to file an Arkansas income tax return if all pass-through entities the member has an ownership interest in pay the pass-through entity tax.

Pass-through entities electing to be subject to the pass-through entity tax would be allowed the same provisions for net operating losses as provided in § 26-51-427. The pass-through entity tax is due before the 15th day of the fourth day of the taxable year. The pass-through entity tax would be subject to all interest and penalty provisions of the Arkansas Tax Procedure Act. The pro-rata interest of each member of a pass-through entity shall be reported to each member on forms prescribed and furnished by DFA. The bill is effective for tax years beginning on or after January 1, 2020.

Revenue Impact :

No net revenue impact, but the Department will incur costs to implement and administer the tax. Those costs are estimated to be $890,000 the first year and $725,000 beginning with the second year and following.

Taxpayer Impact :

Taxpayers who are members of a pass-through entity that elects to pay the pass-through entity tax would have income from that entity exempt from Arkansas income tax. Pass-through entities would be required to pay the pass-through entity tax on or before the 15th day of the fourth month of the taxable year.

All pass-through entities that elect to pay this voluntary tax will likely be required to make estimated payments. This could increase accounting costs.

Resources Required :

The upfront estimate of computer programming costs to implement this new tax type from the Arkansas Integrated Revenue System (AIRS) team is $390,000. Once the initial part of the project is complete, the annual computer maintenance provided by AIRS is estimated to be $225,000.
The Income Tax Section will need an estimate of three additional taxpayer service representatives, four additional auditors, one additional audit supervisor, and additional inhouse data entry staff at a cost of approximately $500,000 per year in salaries and benefits.

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Time Required :

Adequate time is provided for implementation.

Procedural Changes :

Computer applications, forms, instructions, and procedure manuals will need to be created. Department employees will need to be educated as well as the tax community.

Other Comments :

There is no relief provided for minority owners who do not wish for the pass-through entity to pay the pass-through entity tax, especially for taxpayers wishing to deduct their share of a loss when a pass-through entity has a loss for the year. The intent of the bill is to allow business owners to circumvent the new federal laws limiting the deduction for state and local taxes to $10,000.

Legal Analysis :

On December 22, 2017, the President signed into law the Tax Cuts and Jobs Act of 2017 (the "Act"), which amends the Internal Revenue Code of 1986. Prior to the passage of the Act, individuals and corporations could take a deduction for state and local income taxes paid or accrued during the taxable year ("SALT deduction"), and the deduction had no limit. However, the Act imposes a cap on the SALT deduction during the tax years 2018 through 2025. While the SALT deduction has been capped, the Act continued the deduction for all ordinary and necessary expenses paid or incurred in carrying on any trade of business.

HB1714 would provide for a tax at the current top marginal rate as applied for individual income tax purposes on certain business entities that elect to be subject to the tax ("affected business entity"). The tax would be levied on the aggregate next taxable income, as defined for individual income tax purposes, of each of the members of the affected business entity. The election would be available only to a business entity that engages in a business for profit, would be required to file an income tax return, and does not have multiple classes of membership. HB1714 would require that the tax be paid in quarterly estimated installments. Failure at the end of the year to have paid ninety percent of the tax owed would subject the affected business entity to the same penalty as applied to all other taxes for which the payment does not exceed ninety percent of what is owed by the time the tax is due.

HB1714 provides a corresponding exclusion from gross income to the members of the affected business entity. The exclusion from gross income for a member is the amount of the tax paid by the affected business entity multiplied by that member's percentage of ownership of the profits. An affected business entity is required to report to the director of the Department of Finance and Administration the percentage of ownership of the profits of an affected business entity with respect to each of its members. The percentages reported are conclusive for purposes of each member's corresponding exclusion from gross income unless the member can prove that the report was fraudulent.

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The tax election and the exclusion from gross income would take effect for tax years beginning on and after January 1, 2020.

To the extent that bill attempts to provide tax relief for those individuals who have been affected by the cap on the SALT deduction, there appears to be a drafting error. The amount of the exclusion from gross income should be the amount of the member's taxable income subject to the tax on the affected business entity. This needs to be fixed to prevent the members' incomes from being taxed twice.

The IRS has not specifically stated that the tax set forth in HB1714 would be deemed a business expense. Further the cap on the SALT deduction is set to end after 2025, but the tax and the exclusion established in HB1714 would continue after that time. HB1714 affects all members of an affected business entity regardless of whether a member's SALT deduction would be limited by the cap.