Department of Finance and Administration

Legislative Impact Statement

Bill: HB1209 Amendment Number: H2
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 :

Sponsors: Reps. Jett and Lundstrum; Sen. Dismang

House Amendment No. 2 --- HB1209-H2 makes two changes to a business entity's election to be subject to the voluntary tax. First, the amendment allows a business entity that has multiple classes of membership to elect to be subject to the tax. Second, the amendment requires that the business make its election on an annual basis.

HB1209-H2 also changes the rate of tax that applies to income derived from a net capital gain. Under current law, if a taxpayer realizes a net capital gain, fifty percent (50%) of the income derived from the capital gain is exempt from state income tax. HB1209-H2 reduces the rate that applies when a business entity elects to be subject to the voluntary tax to match the state income tax amount that applies when an individual taxpayer realizes a net capital gain.

HB1209-H2 clarifies that the business entity can elect to receive against its liability for the voluntary tax any credit that the business entity would otherwise have received against its income-tax liability.

Original Bill --- HB1209 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 elect to do so. The tax would be a flat rate of 5.9% for tax years beginning on or after January 1, 2022. 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 are 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 month of the taxable year. The pass-through entity tax would be subject to all interest and penalty provisions of the Arkansas Tax Procedure Act (ATPA). The pro-rata interest of each member of a pass-through entity shall be reported to each member on forms prescribed and furnished by the Department of Finance and Administration (DFA).

The bill is effective for tax years beginning on or after January 1, 2022.

Revenue Impact :

Estimated increase in State General Revenue of up to $4.24 million.

[The $4.24 million revenue impact above assumes the number of taxpayers that elect to opt-in to pay the voluntary pass-through entity tax is 5,995 partnerships and 11,750 S-corps. This estimate is based on partnerships and S-corps that have net income greater than $80,000 per number of partners or shareholders. The revenue impact is based on the difference between the flat tax rate paid by the pass-through entity versus the progressive tax rate of a taxpayer using the upper-income table. This

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difference would be $239. If the number of entities that elect to be taxed at the entity level is different than the estimate above, the revenue impact would either increase or decrease.

45,826 pass-through entity returns reported income in 2019. This includes 12,658 partnership returns and 33,168 S-Corp returns. The total net Arkansas income for those entities was $8,180,177,837, which includes $3,313,968,056 for partnerships and $4,866,209,781 for S-Corps.]

Taxpayer Impact :

Up to 45,826 entities could elect to pay the pass-through entity tax. Pass-through entities may elect to pay the pass-through entity tax on or before the 15th of the fourth month of the taxable year.

Resources Required :

The initial 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 estimated three additional fiscal support analysts, four additional auditors, one additional audit supervisor, and additional in-house data entry staff at a cost of approximately $500,000 per year in salaries and benefits.

Time Required :

Adequate time is provided for implementation.

Procedural Changes :

Computer programs, tax forms and instructions and training manuals will need to be updated. DFA employees will need to be educated as well as the tax community.

Other Comments :

None.

Legal Analysis :

Original Bill --- On December 22, 2017, President Trump 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. The Act imposes a cap on the SALT deduction during the tax years 2018 through 2025. Recently, the IRS released Notice 2020-75, which states that the IRS expects to propose regulations to clarify that amounts paid by a partnership or an S corporation to a state, a political subdivision of a state, or the District of Columbia to satisfy its liability for income taxes are not subject to the cap on the SALT deduction.

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HB1209 would provide 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 (an "affected business entity"). The tax would be levied on the aggregate net 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. HB1209 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.

HB1209 provides a corresponding exclusion from gross income to the members of the affected business entity. The exclusion from gross income for a member would be the member's income subject to the tax on the affected business entity multiplied by that member's percentage of ownership of the profits of the entity. An affected business entity is required to report to the Secretary of DFA 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.

The tax election and the exclusion from gross income would be effective for tax years beginning on and after January 1, 2022. Further, the cap on the SALT deduction is set to end after 2025, but the tax and the exclusion established in HB1209 would continue after that time. HB1209 affects all members of an affected business entity regardless of whether a member's SALT deduction would be limited by the cap.