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Arkansas Tax Update

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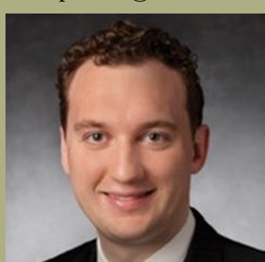

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InvestArk Program Under Fire

Michael O. Parker

The InvestArk program, which incentivizes existing Arkansas businesses to expand, modernize, or upgrade their operations, has recently come under scrutiny as state leadership is considering cutting or trimming the program to boost revenue. InvestArk is vital, however, for protecting jobs in a state that has a sales and use tax system that discourages capital investments by existing companies. Concerned businesses should contact their representatives immediately, as the continuation of the program is at stake in the upcoming 2016 special legislative session being called to address highway funding issues.

InvestArk Encourages Plant Investment in Order to Retain and Create Jobs

Under InvestArk, Arkansas manufacturers and others can earn a 7% investment tax credit if they invest $5 million or more in modernizing or upgrading their operations and have been doing business in Arkansas for at least two years. The tax credits are then used to reduce the taxpayer's state sales and use taxes due each month by 50% until the credits are exhausted, not to exceed five years.

InvestArk was established by the Arkansas General Assembly in 1985 for several very good reasons, including:

- "To provide financial incentives for existing manufacturing firms in Arkansas *to invest in new plants and equipment to modernize and stay competitive*;
- To encourage manufacturing firms *to remain in business in the state rather than divest Arkansas operations and expand elsewhere*; [and]
- *To retain and create jobs*."[1]

The 1985 Act also included an Emergency Clause declaring:

- "That industrial concerns in Arkansas are experiencing *intense competition, both domestic and from abroad*;

- That *to remain competitive in domestic and international markets requires, among other things, new investments* in modern, efficient plants and equipment by industry;

- That the investments required for industrial plant modernization or expansion may *represent extraordinary investments*; [and]

- That *failure to act immediately will result in the loss of jobs for Arkansas*."[2]

Since 1985, the InvestArk program has been so effective that the Legislature has extended it well beyond the manufacturing sector. As competition for corporate headquarters, distribution centers, call centers, technology companies and a variety of non-retail businesses has increased, these additional types of businesses have also become eligible to earn tax credits on major investment projects.

InvestArk is at Risk of Being Modified or Eliminated to Raise Revenue

The success of the InvestArk program has drawn criticism from those who would like to redirect the perceived revenue cost of the program for other purposes. Department of Finance and Administration records indicate that between 2012 and 2014, 96 companies participating in the program earned nearly $110 million in sales and use tax credits, representing over $1.5 billion in new capital investment.[3] Yet a Special Report by the office of Arkansas Legislative Audit recently concluded that: "InvestArk projects do not return positive cost-benefit ratios because they do not require job creation; therefore the only potential tax benefits identified are construction benefits."[4] Critics of the Report suggest that the Report's conclusions are contrived; are driven by erroneous assumptions;[5] and are out of touch with both the real world and the declared purposes of InvestArk when created in 1985 and as expanded since that time.

The Report acknowledges that: "The methodology used in preparing this report was *developed uniquely* to address the stated objectives," and was not performed in accordance with "Government Auditing Standards." (Emphasis supplied.) But most important, the Report states that the economic model the auditors selected will *only* produce "positive cost benefit ratios" if projects "require job creation."[6] The projected plant closures, relocations and job losses that the InvestArk program was designed to avert are ignored as having no "benefit" for purposes of the auditors' cost benefit analysis.

Notwithstanding the flaws in the Legislative Audit Report, Governor Asa Hutchinson is being quoted as asking Arkansas Economic Development Director Mike Preston to review all of the state's economic development incentives and tax credits: "to see which ones are creating jobs, which ones are important to be competitive and which ones are outdated or ineffective. … We are looking at them all and InvestArk is one of those among all of those."[7] Quotes from other legislators suggest InvestArk is both "on the table" and "on the chopping block."[8] A special legislative session is anticipated to address highway funding within the next 60-90 days. The InvestArk issue is expected to be front and center at that time.

InvestArk is Critical to Arkansas' Manufacturing Competitiveness

Misconceptions and misinformation driven by the Legislative Audit Report aside, economic developers and others concerned with preserving jobs in the manufacturing sector and remaining "in the hunt" for corporate headquarters expansions, distribution centers, technology companies and other emerging sector businesses understand that the economic conditions that make InvestArk so important in preserving Arkansas jobs are even more pronounced today than they were in 1985. In that year the state sales and use tax rate had just been increased from 3% to 4% (beginning in 1983), local government taxing authority was being expanded,[9] and Arkansas manufacturers were feeling the pinch.

Arkansas taxes more manufacturing inputs at a higher rate than any of its surrounding states or other states throughout the southern region, particularly with respect to investments updating machinery and equipment.[10] As tax rates go up, the disparity in operating costs compared to facilities in other states increases accordingly.[11] The original InvestArk credit established in Act 529 of 1985 was 7%, which was 3% above the state tax rate and well in excess of the prevailing combined state and local tax rates in effect at the time. Today the state tax rate is 6.5%, and Arkansas's combined state and local tax rates are virtually the highest in the country, totaling well in excess of 10% in some locations.[12] The InvestArk credit has been adjusted to a formula amount 0.5% over the state tax rate, resulting in a present tax credit of 7%, same as in 1985, while prevailing sales and use tax rates on machinery and equipment updates have more than doubled. Under these circumstances, considerations supporting the program now include the following:

1. Arkansas has the 7th highest tax cost in the country for a mature capital intensive manufacturing firm; higher than any state in the South with the exception of Mississippi. It is of the ten highest tax cost states for a manufacturing firm to do business.[13]

2. Arkansas and California are identical in the rate of tax applied to a mature capital intensive manufacturing firm.[14]

3. The situation is not much better for mature labor-intensive manufacturers, where Arkansas is shown as having the 11th highest tax cost among the states; again highest in the South with the exception of West Virginia.[15]

4. Arkansas has the highest composite (state and local) sales and use tax rate on manufacturing machinery and equipment in the country. This applies to retrofits, partial replacements, maintenance activities, and generally all purchases and installations with the exception of new/expanded facilities and complete replacements.[16]

5. 40 of the 50 states do not impose tax on manufacturing machinery and equipment at all.[17]

6. No state in the southern region imposes tax on manufacturing machinery and equipment with the exception of Alabama, at a rate less than half of the Arkansas composite rate, and Mississippi at 1.5%.[18]

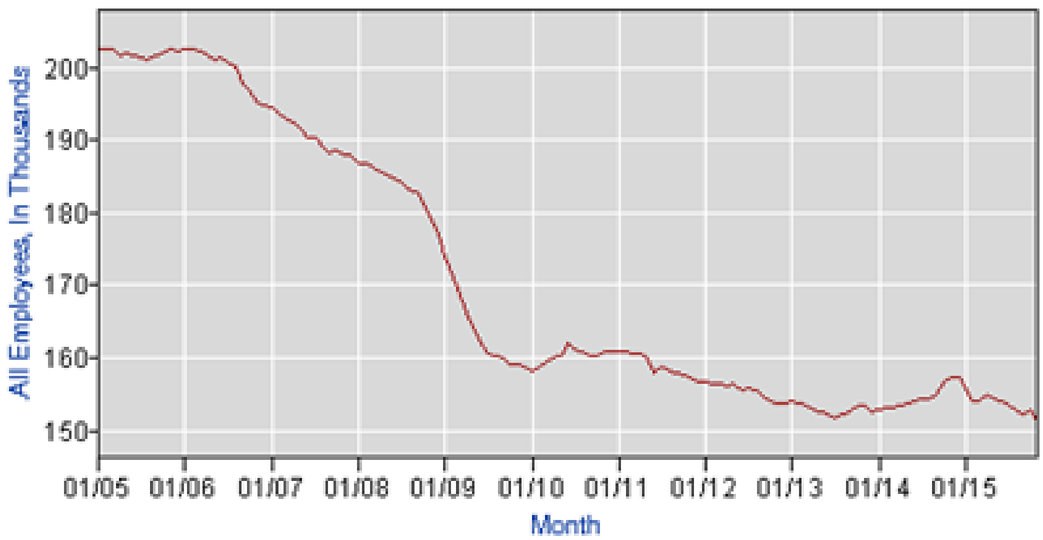
7. Under even the best of circumstances, if a manufacturing firm has invested major capital to earn InvestArk credits, and it applies the credits to reduce its effective state rate by 50% until the investment credits are exhausted, its composite sales/use tax rate on manufacturing M&E is STILL the highest in the South.[19]

8. The vast majority of firms shown as taking advantage of the InvestArk capital investment credit are mature capital intensive manufacturing firms.[20]

Other observations:

A. The Arkansas Business and Economic Development Incentives Study conducted by Fluor Location Strateggies and presented to the Arkansas Bureau of Legislative Research in 2006 classified Arkansas as the single "worst" of the twelve states in the Southeast Region on the taxation of industrial materials used in manufacturing.[21]

B. Arkansas has lost 47,000 more manufacturing jobs since the Fluor Study was published; 80,000+ in the past 15 years.[22]



C. Each time the Arkansas legislature redirects sales tax revenues to pay for tax breaks for individual consumers, either to further reduce *ad valorem* taxes for homeowners (virtually the lowest in the country), or repeal the tax on groceries, or spread individual income tax brackets, or pay for sales tax holidays or other populist initiatives that do nothing to promote and preserve jobs, it shifts more and more tax burden to business in general and manufacturing in particular; all without addressing the stark inequities in the Arkansas sales tax structure on manufacturing.

Much more will be said and written about the importance of preserving the InvestArk investment tax credit program for all of its original justifications, and to attract and preserve Arkansas jobs in other business sectors as well. It is important for the facilities that compete within their companies for capital investments, and for companies that have used the credit program to improve their return on investment and overcome the high tax cost of doing business in Arkansas, to let their elected representatives know that jobs are at stake in Arkansas that will depend on decisions being made in the next 60-90 days.

[1] Act 529 of 1985.
[2] *Id.*
[3] http://www.Arkansasonline.com/ARecondev/
[4] Special Report: *Cost-Benefit of Selected Economic Incentive Projects for the Period July 1, 2003 through December 31, 2014*, Report Date October 16, 2015 ("Report").
[5] For example, that all jobs are retained, capital investment continues unabated and economic activity and resulting tax collections are unaffected beyond the direct tax increase to recipients if InvestArk is repealed.
[6] Report, p.8.
[7] Arkansas Democrat Gazette Newspaper, *Details awaited on roads proposal*, January 24, 2016.
[8] *Id.*
[9] *See, e.g.*, Ark. Code Ann. §26-74-301 et. seq. codifying Act 991 of 1981, as amended.
[10] *See*, *Building A Better Arkansas Tax System, Evaluating the Options*, Winthrop Rockefeller Foundation (January 1997) p. 24; *Location Matters, The State Tax Costs of Doing Business*, Tax Foundation & KPMG (2015) ("Tax Foundation").
[11] *Id.*
[12] Example: Ashdown 2%, Little River County 2.250%.
[13] Tax Foundation, p.10.
[14] *Id.*
[15] Tax Foundation, p.20.
[16] Tax Foundation, Appendix B.
[17] *Id.*
[18] *Id.*
[19] Exa. (6.5%+2.5%=9%) - 3.25%= 5.75%; Tax Foundation, Appendix B, Little Rock.
[20] http://www.Arkansasonline.com/ARecondev/
[21] Fleur Report, p. 42.
[22] Bureau of Labor Statistics Series SMS05000003000000001.

About the DDH State and Local Tax Team

MICHAEL O. PARKER's practice emphasizes taxation, business law and regulatory issues. He received his B.A. degree from Vanderbilt University and his J.D. degree, with honors, from the University of Arkansas School of Law at Fayetteville. Organizational activities include service as special tax counsel and legislative representative on tax issues for the Arkansas State Chamber of Commerce and Associated Industries of Arkansas. Mr. Parker is a past chairman of the Section on Taxation of the Arkansas Bar Association and has been appointed by the Governor as a Special Justice to the Arkansas Supreme Court. Honors include continued selection for *Best Lawyers in America* in *Tax Law, Litigation and Controversy-Tax* and *Trusts and Estates*. He is the author of the Arkansas chapter of the American Bar Association's *Sales and Use Tax Deskbook*, and is a frequent author of articles on Arkansas tax issues.

MATTHEW C. BOCH's practice emphasizes state and local taxes and incentives. He formerly was a partner at a major international law firm, practicing in Chicago. Matt represents taxpayers at all stages of tax controversies, from audits to appellate litigation, as well as providing planning and compliance advice. Matt also represents clients seeking and negotiating economic development incentives and clients facing incentive compliance or clawback issues. Mr. Boch serves as an Assistant Editor of the *Journal of Multistate Taxation and Incentives* and as Editor-in-Chief of ConNEXUS, the newsletter of the American Bar Association State and Local Taxes Committee. He regularly publishes and speaks on tax and incentive issues. Matt also coauthors the Arkansas Tax and Incentives Update blog published by Dover Dixon Horne. Matt is licensed to practice in Arkansas and Illinois, as well as before the United States Tax Court.

THANE J. LAWHON's practice also emphasizes taxation, business law and regulatory issues. He received his B.S. degree from the University of Arkansas at Fayetteville, his M.B.A. degree from the University of Arkansas at Little Rock, and his J.D. degree, with honors, from the William H. Bowen School of Law. Mr. Lawhon is a member of the American, Arkansas and Pulaski County Bar Associations. He is co-author of the Arkansas chapter of the American Bar Association's *Sales and Use Tax Deskbook*, and is a frequent contributor to articles, updates and materials regarding state and local tax issues.

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