AN OVERVIEW OF STATE INCOME TAXES – ARKANSAS AND SURROUNDING STATES

A current topic of conversation among many who are concerned about economic development in Arkansas is how the State's taxation laws, particularly income tax laws, compare with those of neighboring states. A couple of neighboring states, for example, have no personal income tax (Texas and Tennessee). Other states have both individual and corporate tax rates that differ substantially from Arkansas. One (Texas) does not tax corporate net income, instead using a tax regime that provides for alternative methods using revenue with possible deductions for cost of sales or labor costs.

As an accounting firm with considerable expertise in multi-state taxation, we decided to produce a comparison of the effects of tax rules in Arkansas to those of neighboring states. Obviously, such a comparison, to be meaningful, must analyze a variety of types of taxpayers to get a cross section of the disparate effects among the states. With that in mind, however, it would be impossible to anticipate all of the possible variations among potential taxpayers. Our analysis, therefore, is not all-encompassing. That is - it does not anticipate all of the likely differences in state taxation rules that could affect a wide variety of taxpayers. Our analysis reflects a limited sample of taxpayers, giving a flavor of the potential differences.

The scope of our analysis included individual income taxes and corporate income taxes, as well as corporate franchise taxes. The following paragraphs briefly describe the sources of data and the methodology we used.

Individual Income Taxes

The Internal Revenue Service produces composite data derived from samples taken from actual income tax returns. This data stratifies income into seven ranges and identifies individual items of income, deductions and credits for each range. We used the most recent data available (2011). The ranges of income are based on Adjusted Gross Income:

1. Under $15,000
2. $15,000 to $30,000
3. $30,000 to $50,000
4. $50,000 to $100,000
5. $100,000 to $200,000
6. $200,000 to $250,000
7. Over $250,000

The IRS data lists the numbers of returns from the samples along with the amounts of the items for each range. Within each group we used the IRS amounts for individual items of income, deductions and credits divided by the total number of returns to get an average of each item within each range. The objective was to produce a "composite" tax profile for each income range. The use of composites results in some unavoidable skewing because not all returns within a given range contain all of the sampled items. Some items, such as deductions with dollar limitations, may be more widely skewed than items that have percentage limitations, although we created formulas to reduce the likely

misstatement. In the context of our analysis, however, we decided that this potential skewing should not materially affect the overall results of our analysis.

Using the composite data for each income range, we created spreadsheets to estimate state income taxes for each state. All of the states have different structures. For example, some states, such as Missouri, start with federal income and provide adjustments for items the taxation of which differ in that particular state. This is known as a "piggyback" system. Other states, such as Arkansas, start with a blank slate. There are also many different deductions and credits that are specific to each state. Some states, for example, exempt public retirement income or have varying exemptions different for types of retirement income. All states that have individual income taxes have credits against taxes that are specific to that state and have no federal counterpart.

It is important to note that the results produced do not represent a comprehensive analysis of all of the possible variations by state. Using the public retirement example above, it was not possible to insert this variable into the composites because the federal data do not differentiate between public and private pensions. The analysis represents specific profiles by income range with identical assumptions for each state.

Overview of State Tax Rules

All of the states have different exemptions and standard deductions. All of the states tax out-of-state municipal interest and do not allow a deduction for state income taxes (refunds are not taxable). Some of the states do not allow so-called "bonus" depreciation on new business assets subject to depreciation and have limits on asset expensing that are much more restrictive than the federal limits. Here are some of the other provisions by state:

Arkansas

The State of Arkansas general follows the federal rules for income and deductions with exceptions such as:

1. A $6,000 exemption for retirement income
2. A 100% exemption for Social Security income
3. A 30% exclusion is allowed for net long term capital gains
4. Unemployment compensation and alimony are not taxed in Arkansas; the deduction for alimony paid is not allowed
5. Certain federal deductions, such as the Domestic Production Activities Deduction and the Self-Employment Tax Deduction, are not allowed

Arkansas allows married taxpayers to file separately on the same return and apply a separate rate schedule to the taxable income of each spouse. The lowest tax rate is 1% and the highest tax rate is 7%, which kicks in (for 2012) at $34,000 of taxable income. The tax brackets are adjusted for inflation each year.

Missouri

Missouri has a "piggyback" system that starts with federal adjusted gross income and provides for additions and deductions from that amount. Significant among the deductions is one for individual health insurance premiums paid. Like Arkansas, Missouri allows a $6,000 exemption for retirement income and allows other exclusions depending on whether the retirement income is public, private or military. Missouri uses the federal itemized deductions as a starting point but allows deductions for Social Security and Medicare taxes (including self-employment taxes). As in other states, state income is not allowed as a deduction. Missouri also allows a limited deduction for federal income taxes ($5,000 maximum for single filers, $10,000 for joint filers).

Missouri has only two rate brackets, a 3.5% bracket for taxable income up to $9,000 and a 6% rate for everything above $9,000. As in Arkansas, Missouri allows separate tax calculation of each spouse's income when filing one the same return.

Mississippi

Mississippi's tax structure is very similar to that of Arkansas with a somewhat narrower list of items that are excluded from taxation. Mississippi's tax rate schedule has 3 brackets, with the lowest at 3% and the highest at 5%, which kicks in at $10,000 of taxable income. Mississippi also allows separate taxation of spouses on the same return.

Louisiana

Louisiana is a "piggyback" state that starts with federal adjusted gross income. Significantly, Louisiana allows a 100% deduction for federal income taxes. Louisiana also allows a credit for an amount equal to 3.5% of the federal earned income credit. There are 3 rate brackets: 2%, 4%, and 6%, which starts at $50,000 for single taxpayers and $100,000 for married taxpayers. Although Louisiana allows only joint taxation of spouses, a separate rate schedule for joint filers is provided that effectively doubles the singles brackets.

Oklahoma

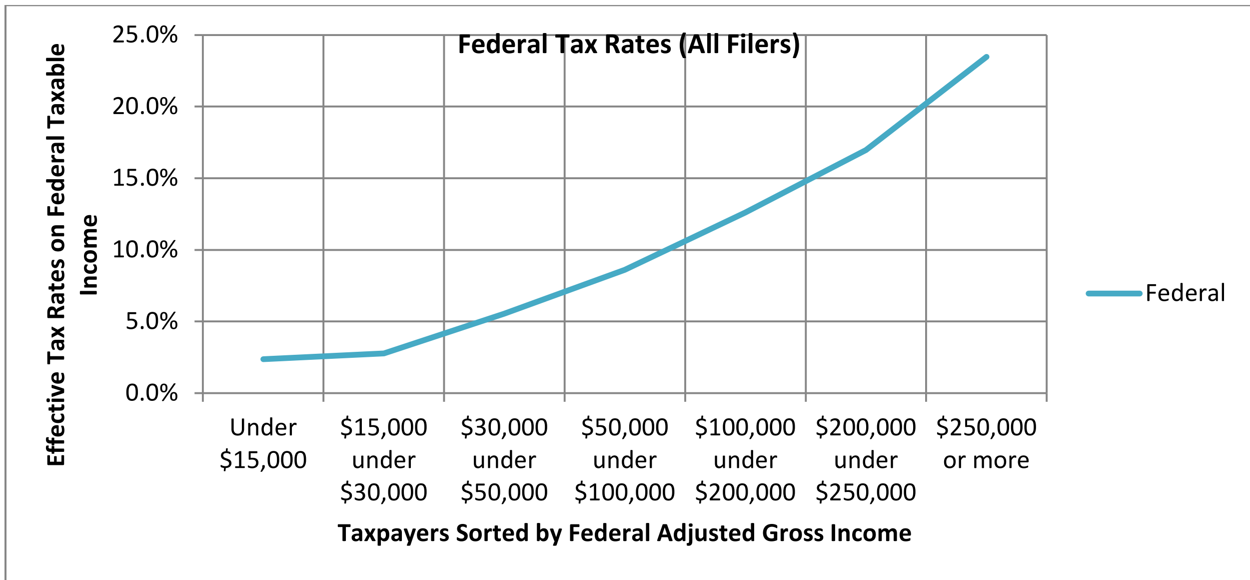
Oklahoma is also a "piggyback" state that starts with federal adjusted gross income. Many of the same exclusions and deduction disallowances are present in Oklahoma as in other states. Significantly, Oklahoma taxes capital gains at 0%. There are 7 rate brackets, the lowest of which is 0.5% and the highest of which is 5.5% which starts at $8,700 for single taxpayers and $15,000 for married taxpayers. Like Louisiana, Oklahoma provides a separate rate schedule with expanded brackets for joint filers in lieu of separate tax calculation.

Comparisons

The following graphs represent the effective rates of taxation within each income group that resulted from the sample inputs. The effective rates are a percentage of federal taxable income. We prepared four graphs:

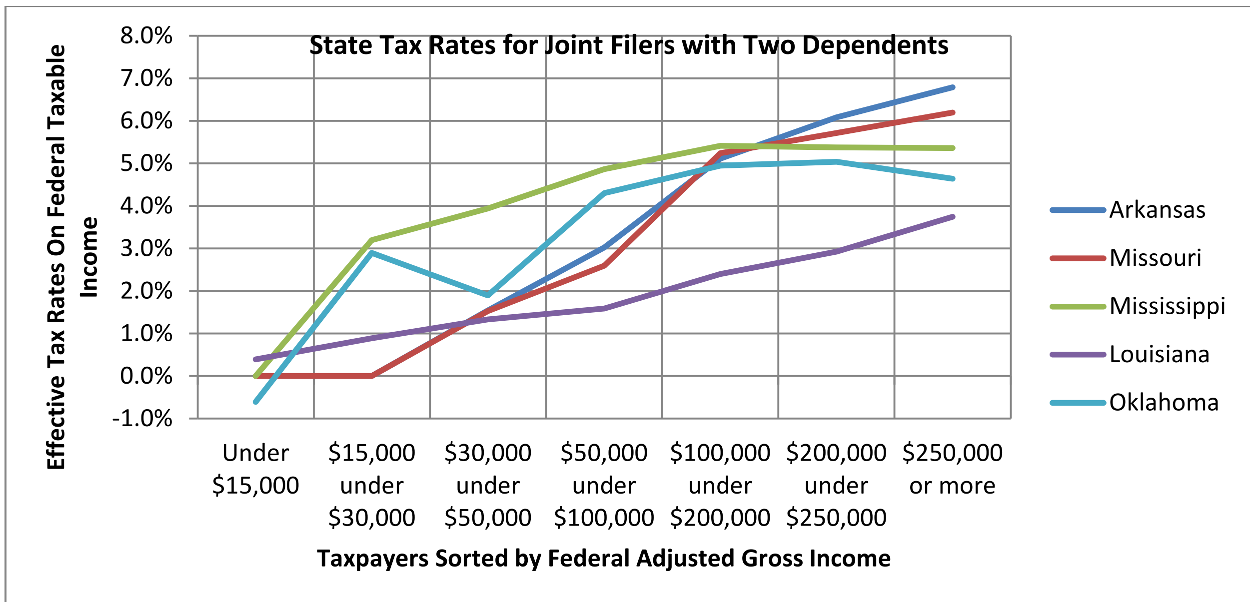
1. Federal Tax Rates (All Filers)
2. State Tax Rates for Joint Filers with Two Dependents
3. State Tax Rates for Joint Filers with No Dependents

4. State Tax Rates for Single Filers



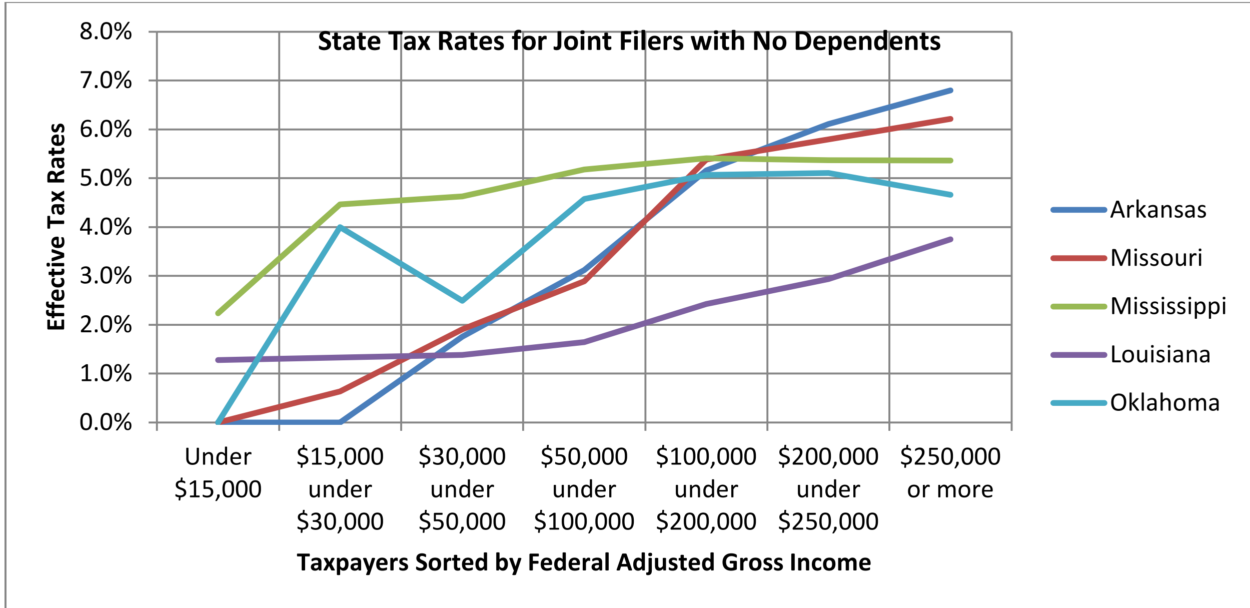
Notes:

1. The data for this graph was taken directly from the IRS samples with no adjustments.



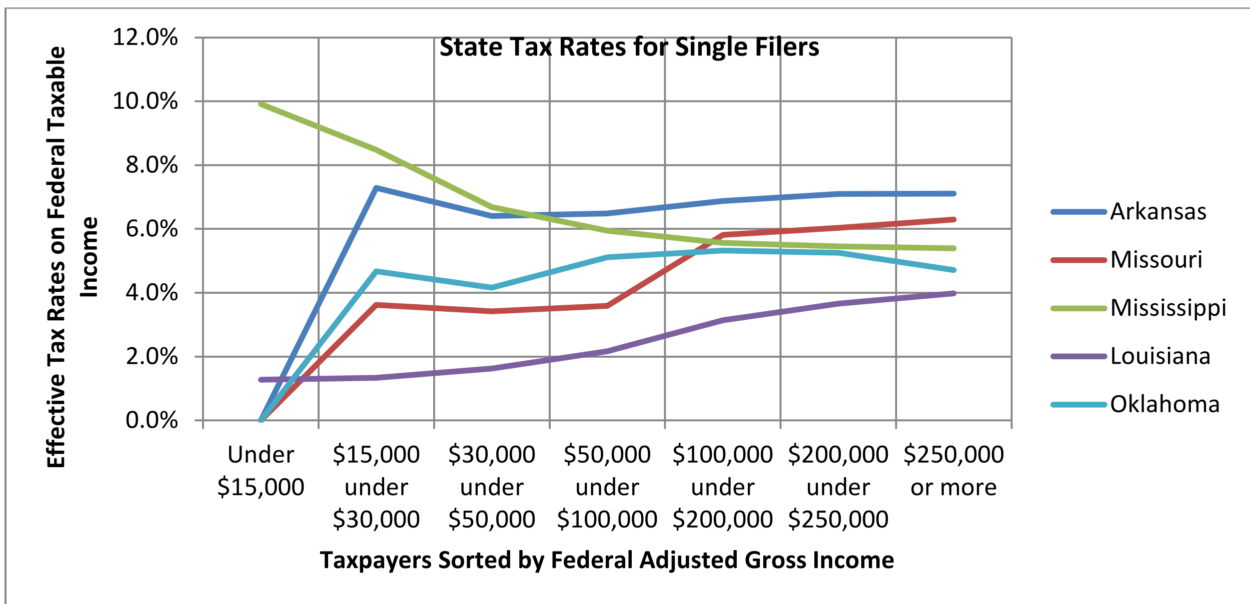
Notes:

1. Although there appears to be a regressive "kink" in the Oklahoma rates between the second and third brackets, this is actually due to the base (Federal Taxable Income) that was used. Since larger standard deductions and exemptions are allowed for federal filing purposes than in most states, even a small amount of state income taxes can be expressed as a relatively high tax rate because the federal taxable income is so much smaller than the state taxable income.
2. The negative rate in the Oklahoma graph in the lowest group is due to refundable credits.



Notes:

1. The Arkansas rates are zero for the first two groups because special "Low Income" rate schedules are provided for joint filers with taxable income under $23,600 ($14,800 for single filers).
2. The effective Louisiana rates are lower than the statutory rates because of the 100% deduction for federal income taxes. This is most pronounced in the higher income groups.



Notes:

1. As mentioned before, the appearance of regressive rates is due to the base on which the rates are calculated.

General Comments

There are considerable differences between the tax rates of all the states and the size of the rate brackets. The states with the lowest rates are ranked as follows:

1. Oklahoma – 0.5%, but it only applies to the first $1,000 of income ($2,000 for joint filers)
2. Arkansas – 1%, which applies to the first $4,099 of income
3. Louisiana – 2%, which applies to the first $12,500 of income ($25,000 for joint filers)
4. Mississippi – 3%, which applies to the first $5,000 of income
5. Missouri – 3.5%, which applies to the first $9,000 of income

The states with the highest rates are ranked as follows:

1. Arkansas – 7%, which starts at $34,000 of income
2. (Tie) Louisiana – 6%, which starts at $50,000 of income ($100,000 for joint filers), and
3. (Tie) Missouri – 6%, which starts at $9,000 of income
4. Oklahoma – 5.5%, which starts at $8,700 of income ($15,000 for joint filers)
5. Mississippi – 5%, which starts at $10,000 of income

The Louisiana rate is actually overstated because of the deduction for federal income taxes allowed by the state.

Conclusions

As shown in the preceding graphs, Arkansas has the highest rate of tax for higher-income individuals than any other neighboring state, although the difference between Arkansas and some of the other states is not dramatic. Arkansas has among the lowest rates for low-income individuals, at least for married taxpayers. Arkansas also has some of the most sharply progressive rates among the states sampled, with rates over 6 brackets ranging from 1% to 7%. In comparison, Missouri and Mississippi have (almost) a flat tax, with their top rates beginning at $9,000 and $10,000, respectively. Oklahoma's top rate begins at $15,000 of taxable income. Louisiana would appear to have a sharply progressive rate scheme on paper, but in practice it is among the least progressive, due to the deduction for federal income taxes.

Corporate Income and Franchise Taxes

We considered corporate income taxes and franchise taxes together because both taxes are interrelated and are often reported and paid on the same tax return. While income taxes represent a tax on corporate earnings, franchise taxes are usually structured as a tax on corporate net worth. Texas is the glaring exception to this general rule, which has a so-called franchise tax using formulas derived from earnings.

All states have rules for the determination of corporate taxable income that are different from the federal rules. We began by listing some common federal-state differences and then we prepared a grid showing the disparate treatment of each by state. A brief explanation of the nature of each difference is as follows:

- Federal Depreciation Rules – The Internal Revenue Code allows a 50% first-year deduction for certain non-realty assets placed in service for the first time. This provision expires at the end of 2013, if not extended. The federal code (Section 179) also allows the limited expensing of non-realty assets when placed in service. The deduction limit for each taxpayer is $500,000 through the end of 2013, and is phased out when annual investments in qualified property exceed $2,000,000. The limits after 2013 are currently $25,000 and $200,000, respectively.
- Loss Carrybacks and Carryforwards – When a taxpayer incurs a net operating loss (NOL), the Internal Revenue Code generally allows the loss to be “carried back” two (2) years to obtain a refund of income taxes paid in those years. If not exhausted by carryback, the NOL can be carried forward a maximum of twenty (20) years.
- Federal and State Income Tax Deductions – The federal rules do not allow federal income taxes to be deducted but do generally allow the deduction of state and local income taxes.
- Depletion Deductions - For federal tax purposes, depletion deductions for energy producers may be based on the cost of the natural resources (cost depletion) or may be a percentage of the revenue produced (percentage depletion).
- The federal Domestic Production Activities Deduction is allowed as a certain percentage of net production income for manufacturers and other producers.
- Capital Losses – The federal rules do not permit the deduction of net capital losses in any year, although the losses may be carried forward to be absorbed by future capital gains.
- Dividends-Received Deduction – Corporations are generally allowed a 70% deduction for dividends received from other corporations.
- Credit Add-backs – Some federal credits, such as those related to job creation, require that the deduction for the credit activity, such as wages, be reduced by the amount of the credit. Most states allow the full deduction for the credit activities.
- S Corporation rules, which allow the taxation of corporate income directly to shareholders, have been adopted by many states. Other states allow variations of these arrangements while others do not recognize them at all.

	Arkansas	Missouri	Tennessee	Mississippi	Louisiana	Texas	Oklahoma
Federal Depreciation Rules	Does not conform	Conforms to federal	Does not conform	Does not conform	Conforms to federal	Not applicable	Does not conform
Loss Carrybacks	Not allowed	Conforms to federal	Not allowed	2 years	3 years	Not applicable	Conforms to federal
Loss Carryforwards	5 years	Conforms to federal	15 years	20 years	15 years	Not applicable	Conforms to federal
Federal Income Tax Deduction	Not allowed	50% deduction	Not allowed	Not allowed	Yes	Not applicable	Not allowed
Percentage Depletion	Not allowed	Allowed	Not allowed	Not allowed	Allowed	Not applicable	Allowed
Domestic Production Activities Deduction	Not allowed	Allowed	Not allowed	Not allowed	Allowed	Not applicable	Allowed
Treatment of Capital Gains	Fully taxed	Fully taxed	Fully taxed	Fully taxed	Fully taxed	Not applicable	Excluded if derived from in-state property
Capital Losses in Excess of Gains	Not allowed	Not allowed	Allowed	Not allowed	Not allowed	Not applicable	Not allowed
Dividends Received Deduction	Not allowed	Allowed	Not allowed	Not allowed	Not allowed	Not applicable	Not allowed
Federal Credit Add-backs	Allowed	Not Allowed	Allowed	Allowed	Allowed	Not applicable	Allowed
S Corporations	Allowed	Allowed	Not allowed	Allowed	In-state shareholders only	Not applicable	Allowed

Texas' Margin Tax

The State of Texas, while having no income tax or separate franchise tax, has what is called a "Margin Tax" on corporations and other business organizations. Taxpayers may select one of three formulas:

1. Total Revenue times 70%,
2. Total Revenue less Cost of Goods Sold (specifically defined under Texas rules), or
3. Total Revenue less Compensation paid to Employees

The basic tax rate is 1%, while a 0.5% rate applies to retailers and wholesalers. There is an exemption for very small entities and a reduced tax rate for entities with under $10 million revenue.

Franchise Taxes

The State of Arkansas and all of the surrounding states, except Texas, calculate corporate franchise taxes with rates applied to various measures of corporate net worth. Arkansas' franchise tax is calculated on only one component of net worth – capital stock, or, the par value of all outstanding shares. This is a very unique arrangement which allows corporate taxpayers to control their franchise tax liabilities

through management of their capital structure. Missouri's franchise tax is based on the greater of capital stock or the book value of net worth, while Tennessee, Mississippi, Louisiana, and Oklahoma base franchise taxes on net worth alone. Missouri is in the process of phasing out its franchise tax, which will be complete by January 1, 2016. Oklahoma has replaced its franchise tax with what it calls a Business Activity Tax (BAT), which is assessed as a nominal amount for new entities. For existing entities, the BAT is equal to the last franchise tax amount owed under the old system. Oklahoma has a ceiling or maximum franchise tax of $20,000.

Methodology Used in Comparisons

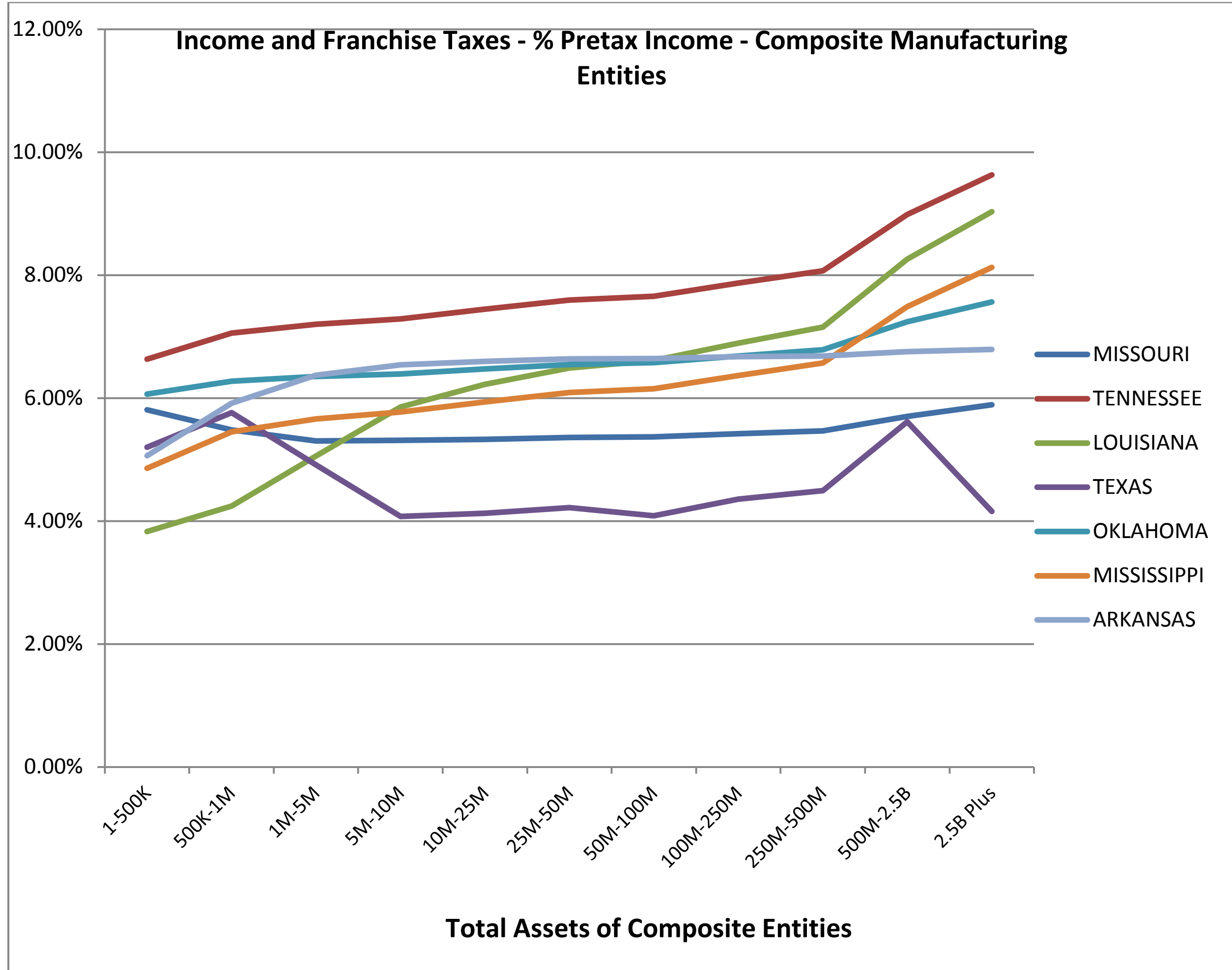
We obtained access to a database that provides basic federal income tax data for corporate taxpayers. The database, which uses annual information released by the Internal Revenue Service, includes separate data sets for companies sorted both by asset size and type of industry. We selected eight broad industries for our sample:

1. Manufacturing
2. Wholesale/Retail
3. Trucking
4. Finance and Insurance
5. Information Services
6. Construction
7. Food Processing
8. Accommodation and Food Services

We then created a series of interactive spreadsheets to apply the tax rules of each state to composite "entities" created by the intersection of the industry classification and the asset size category. Because the IRS-provided data was not detailed enough to apply some of the different state rules, our analysis admittedly lacks some precision. Many of the rules listed in the above paragraphs, however, relate to the timing of deductions, not their allowance or disallowance.

The following graphs show the intersections of the *overall effective tax rates* (including both income taxes and franchise taxes), *as a percentage of corporate net income as reported in the IRS data*. The horizontal axes of the graphs represent the size of the entities in the IRS database. Not all of the size categories are identical for all of the graphs, since some size categories in certain industries contained too few data points for meaningful representation.

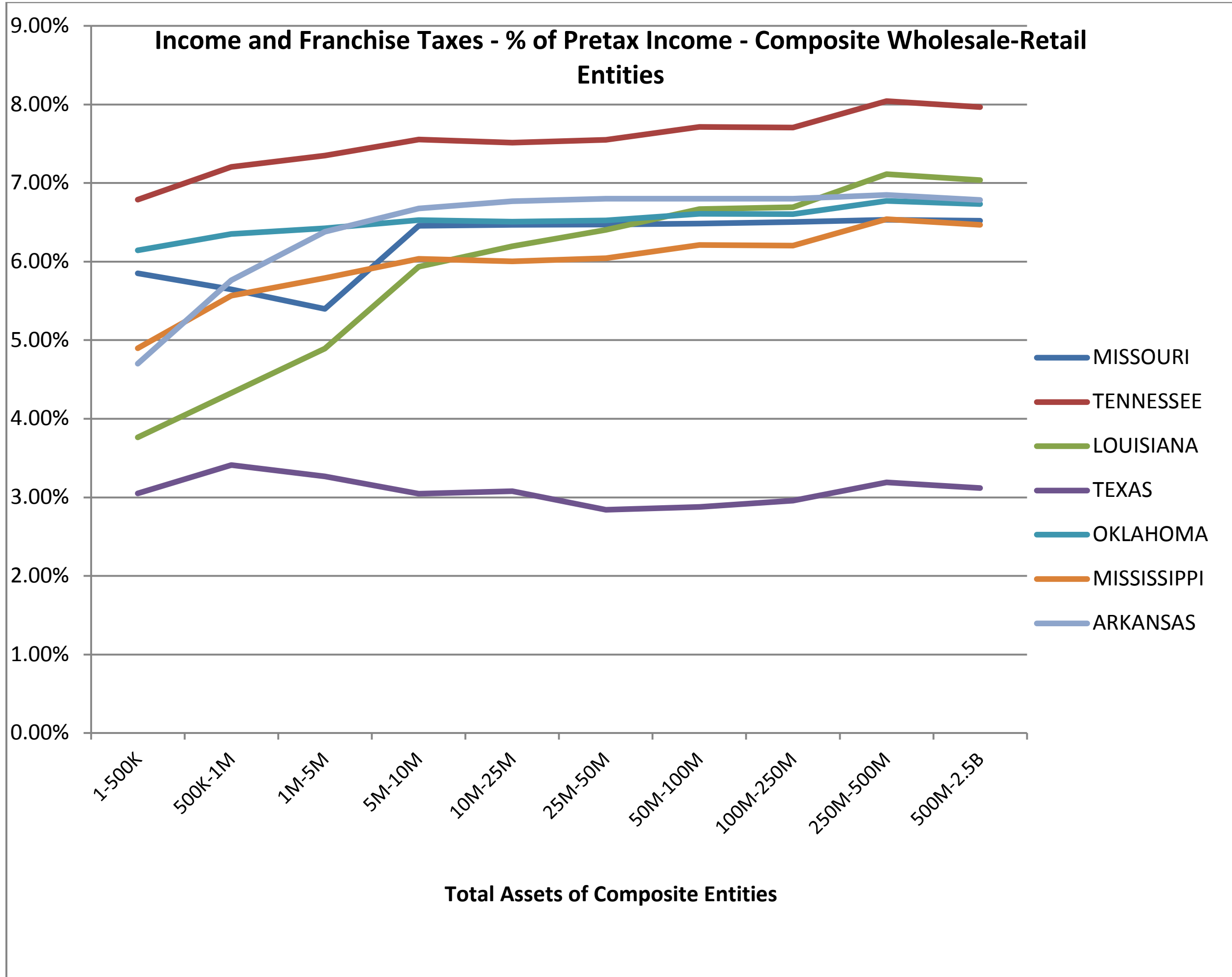
Industry: Manufacturing



Notes:

1. Tennessee's combination of a relatively high franchise tax rate (0.25%) and high single income tax rate (6.5%, termed an "excise tax") puts it at the top of the graph.
2. Texas is at the bottom of the graph due to reporting option that allows the deduction of cost of manufactured goods from gross revenue. The entities in the sample had costs that ranged from 49% to 74% of revenue. Caveat: The Texas rules define these costs somewhat differently than the IRS or, for that matter, most conventional accounting systems. Again, the limited detail of the IRS data does not allow the adjustment of these amounts.

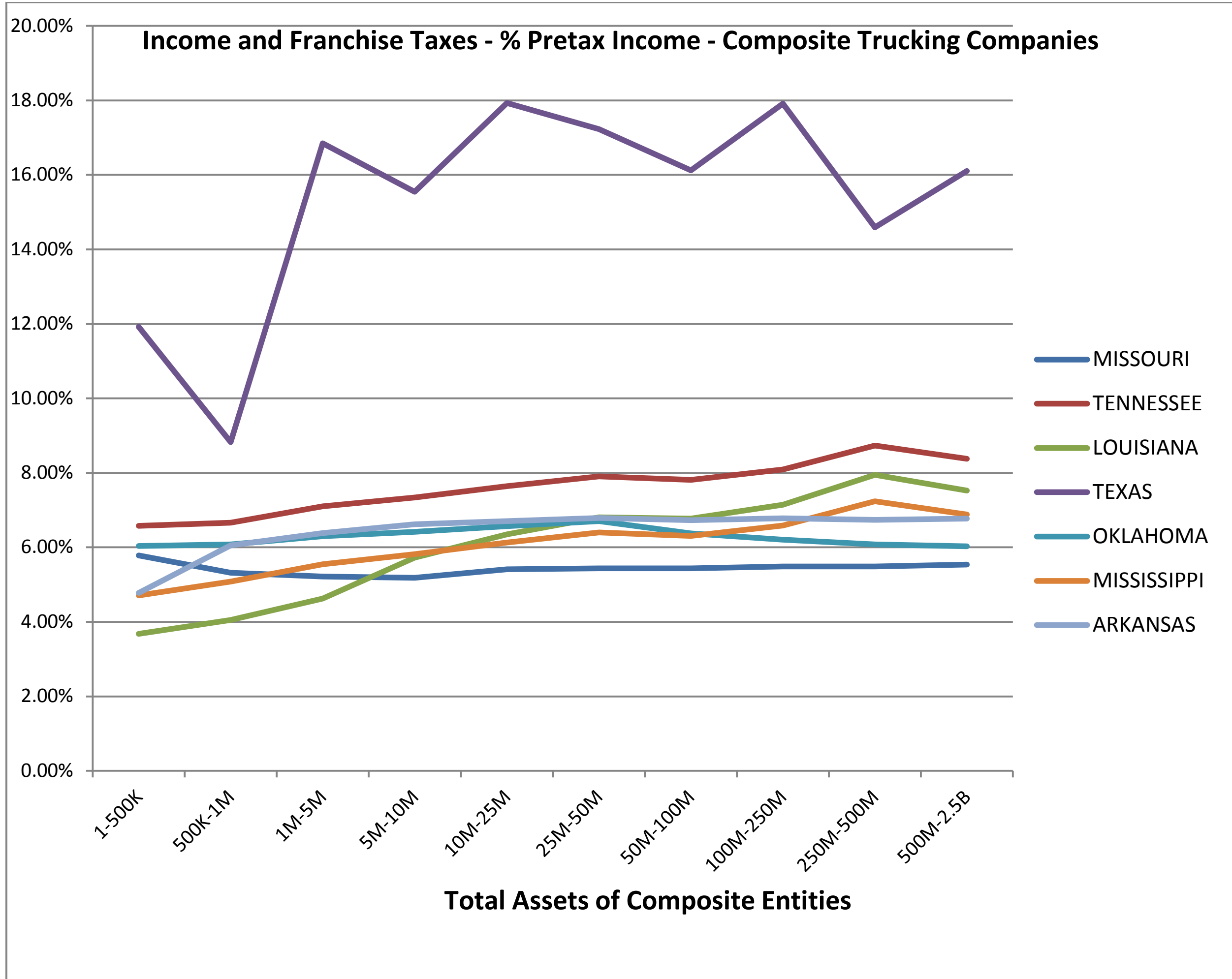
Industry: Wholesale/Retail



Notes:

1. Tennessee is again at the top of the graph for the reasons stated above.
2. Texas is at the bottom of the graph because wholesale/retail entities are taxed at 0.5% instead of the usual 1.0%.

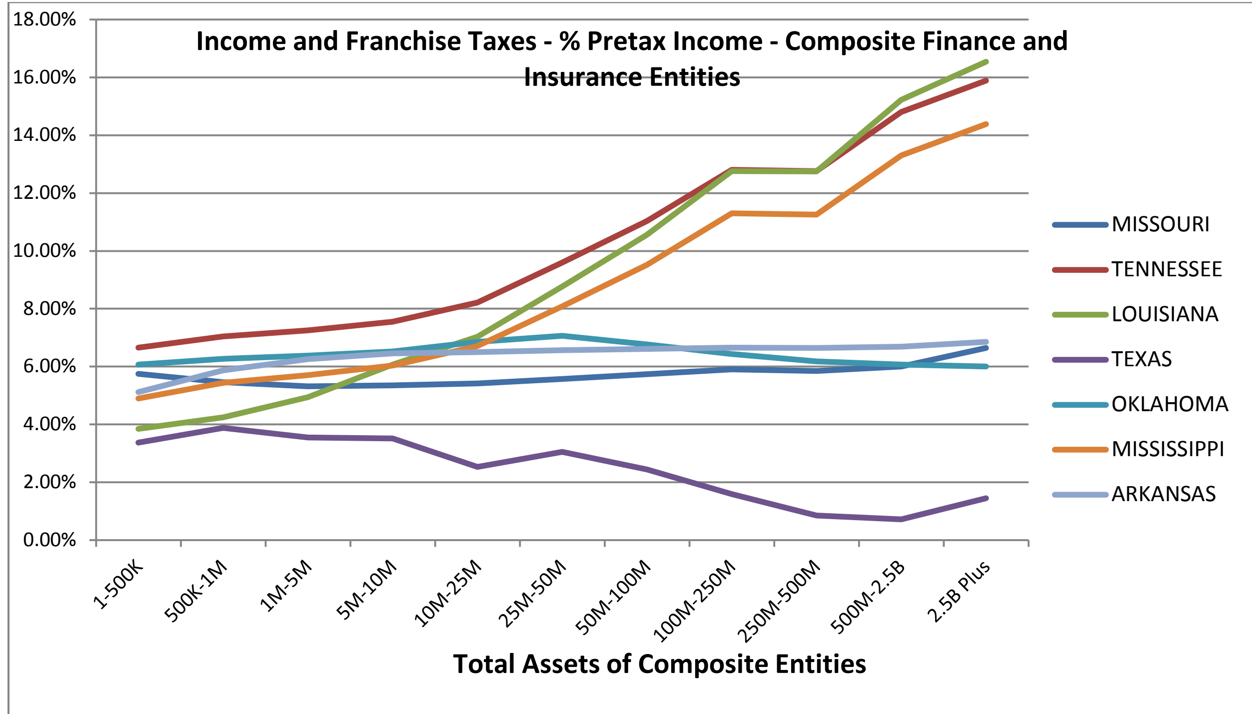
Industry: Trucking



Notes:

1. Texas is at the (far) top of the graph presumably due to the low net margins of the trucking industry. The industry does not sell goods and therefore cannot deduct those costs. Unlike wholesale/retail concerns, trucking companies are taxed at the 1.0% rate.
2. Of the largest 25 trucking companies in the United States in 2013 (as ranked by *Journal of Commerce*), 12 were headquartered in the south, 2 were in Arkansas, 3 were in Tennessee and none were in Texas.

Industry: Finance and Insurance



Notes:

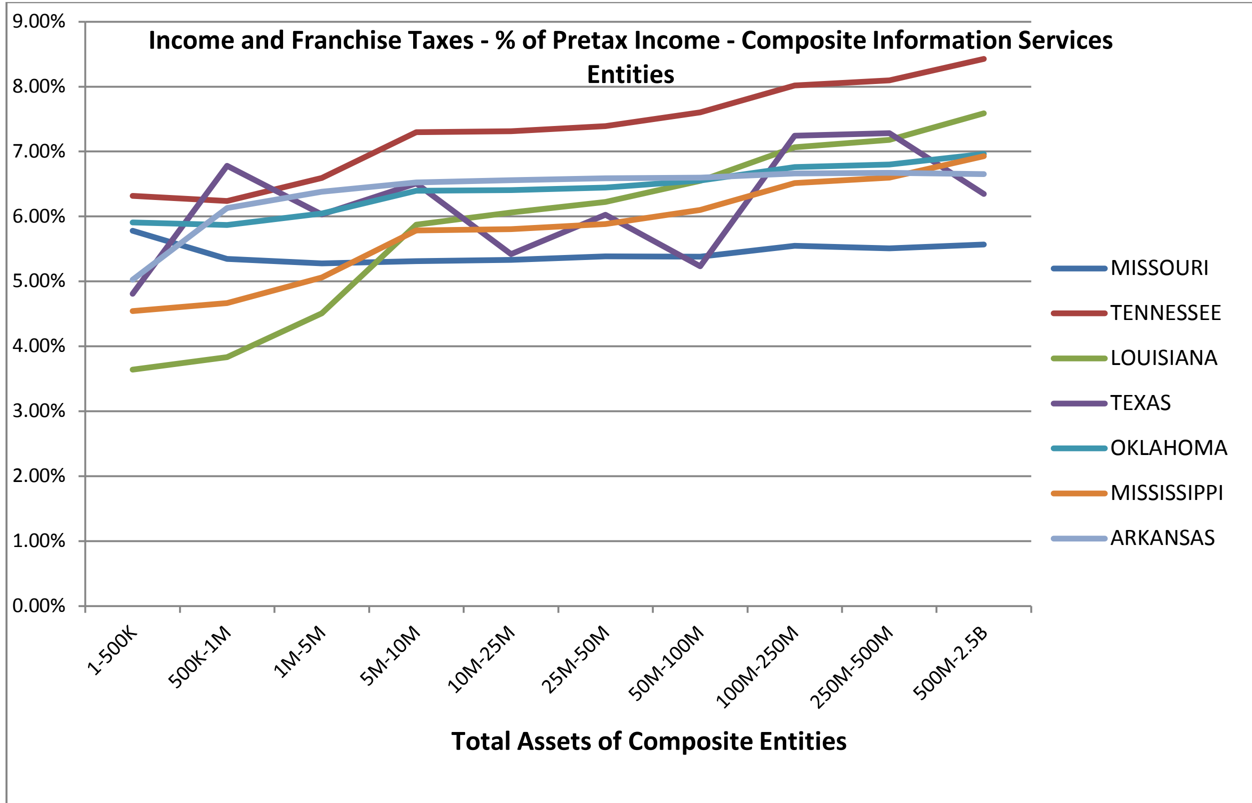
1. Louisiana, Tennessee and Mississippi stand out at the top of the chart due to the convergence of industry attributes and the franchise tax rules in those states. The entities in the finance and insurance industry have much lower returns (net income) as a percentage of net equity than any of the other industries. This is particularly true in the larger size categories. For example, the following is a comparison of the finance and insurance industry to the manufacturing industry (net income as a percentage of net equity for the highest five asset categories):

	50M-100M	100M-250M	250M-500M	500M-2.5B	2.5B Plus
Composite Finance and Insurance Entities	5.5%	4.0%	4.0%	3.0%	2.7%
Composite Manufacturing Entities	21.6%	18.2%	15.9%	10.0%	8.0%
Differences	-16.1%	-14.3%	-11.9%	-7.0%	-5.3%

   The effect of this is that franchise taxes represent a much higher proportion of net income than in other industries. Missouri is not in that group because of a low (and disappearing) franchise tax rate. Arkansas' franchise tax base is only a part of net equity, while Oklahoma has a cap on franchise tax.

2. Texas does not tax corporate equity, and in the finance and insurance industry net margins are fairly high (so that taxes on revenue-based formulas are relatively lower). These factors combine to place Texas at the bottom of the chart.
3. Some states do not tax the earnings of insurance companies. That fact is not reflected in this analysis.

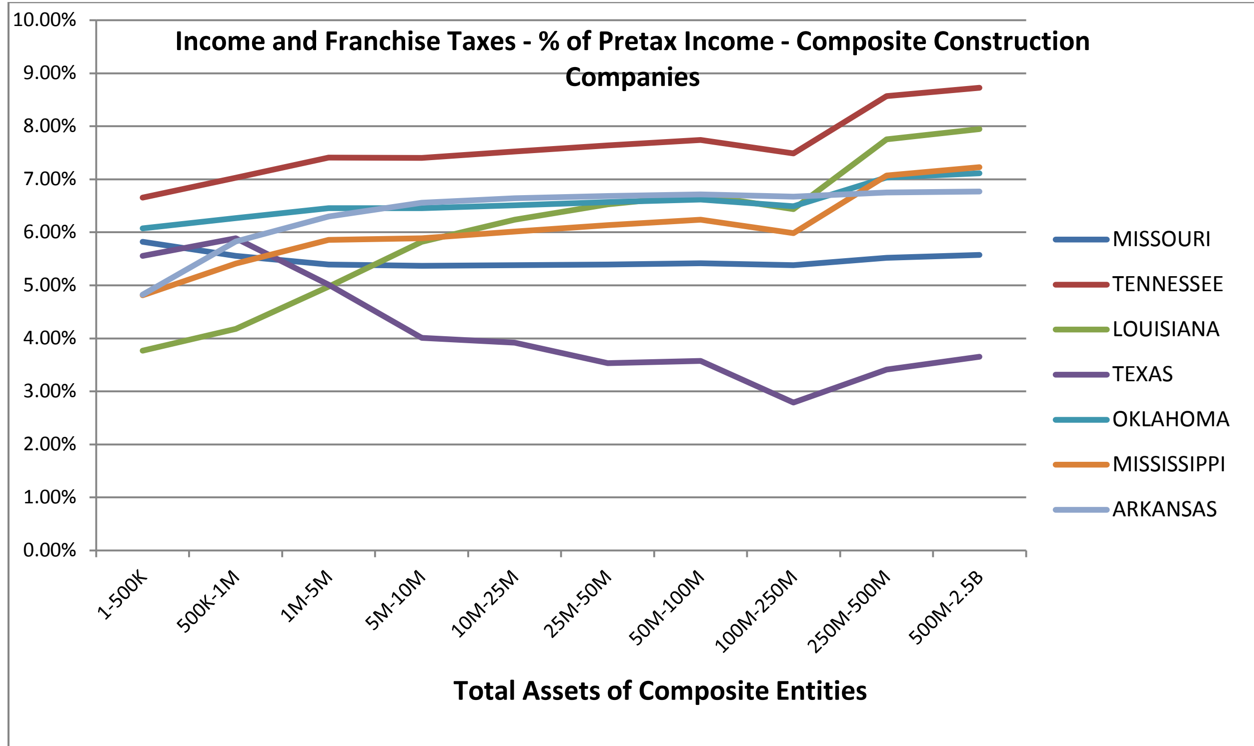
Industry: Information Services



Notes:

1. Tennessee is at the top of the graph for the reasons stated above.
2. Missouri is at the lower part of the chart due to its low (and disappearing) franchise tax rate.

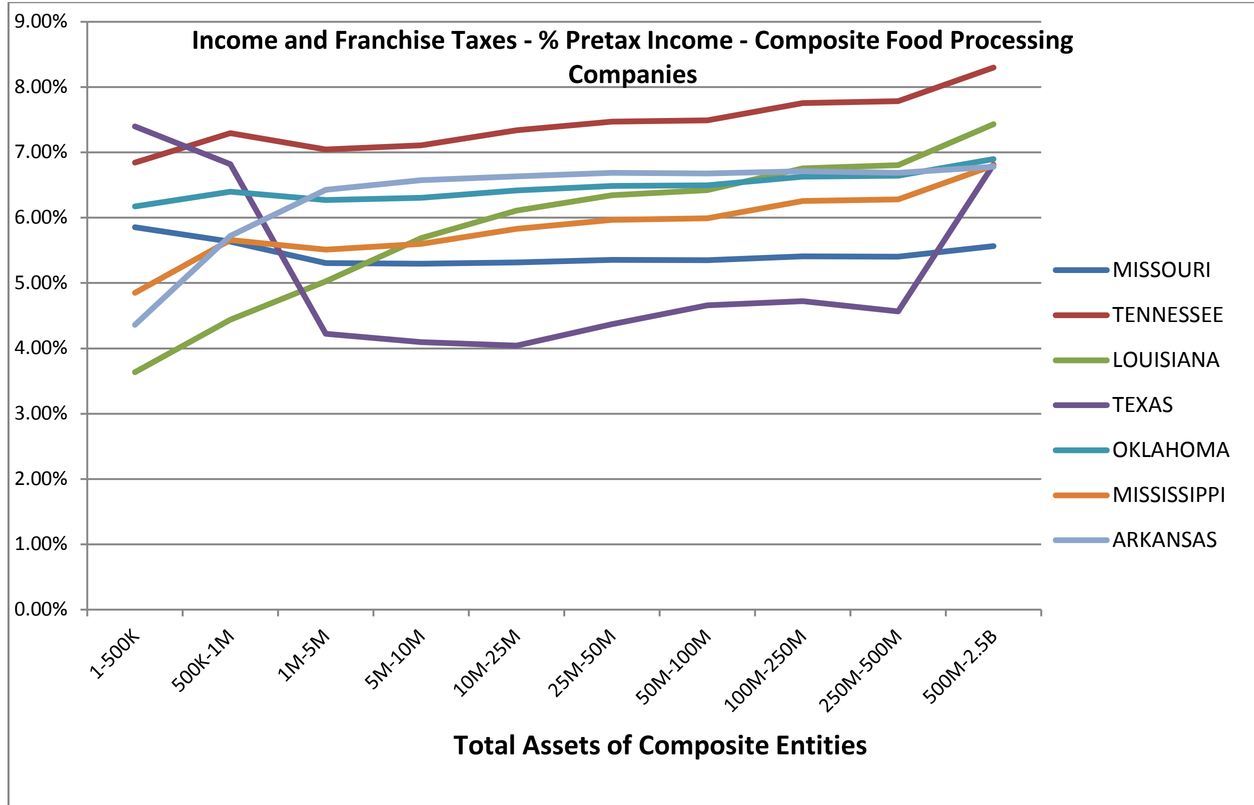
Industry: Construction



Notes:

1. Tennessee is at the top of the graph for the reasons stated above.
2. Texas is at the bottom of the graph due to reporting option that allows the deduction of cost of construction costs from gross revenue. The entities in the sample had costs that ranged from 53% to 84% of revenue. Caveat: The Texas rules define these costs somewhat differently than the IRS or, for that matter, most conventional accounting systems. Again, the limited detail of the IRS data does not allow the adjustment of these amounts.
3. Missouri is at the lower part of the chart due to its low (and disappearing) franchise tax rate.

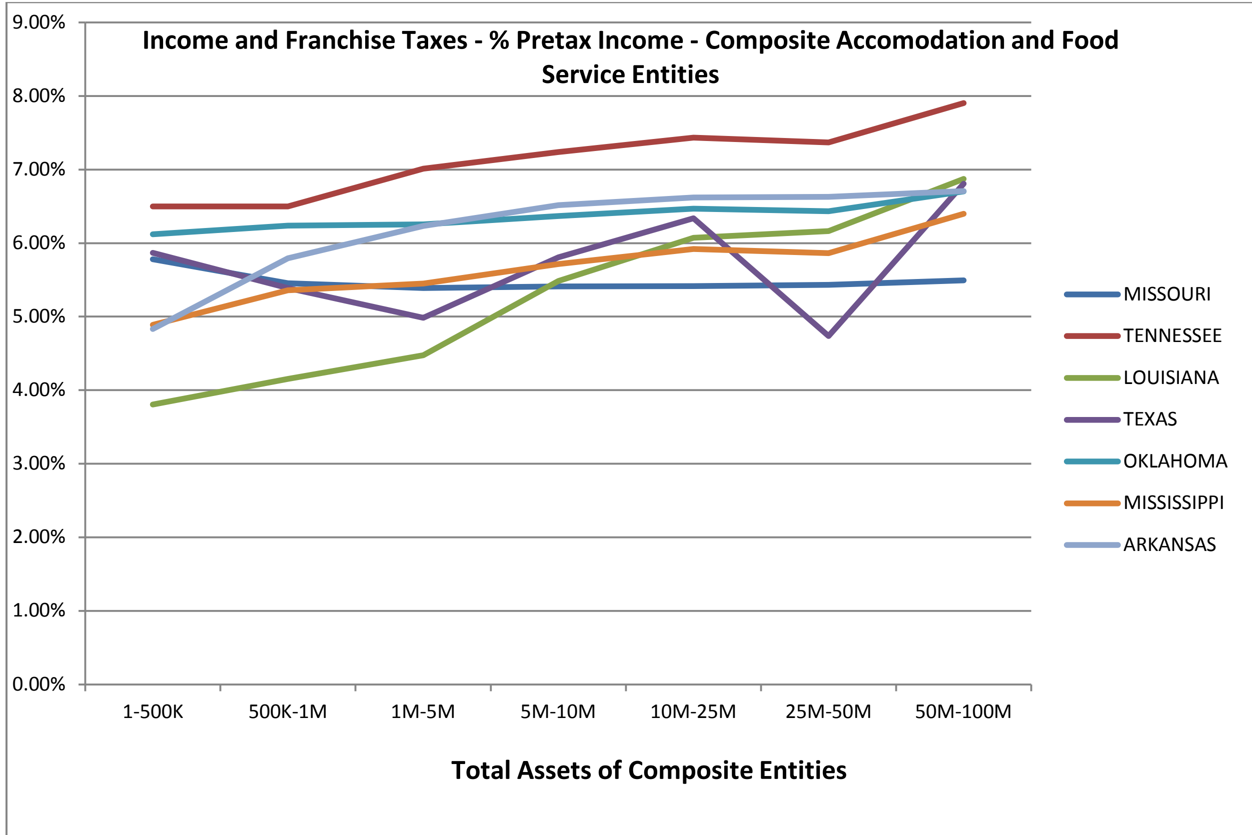
Industry: Food Processing



Notes:

1. "Food Processing" is synonymous with food manufacturing, a subset of the manufacturing industry presented above.
2. Tennessee is at the top of the graph for the reasons stated above.
3. Texas is at the bottom of the graph due to reporting option that allows the deduction of cost of manufacturing costs from gross revenue. The entities in the sample had costs that ranged from 60% to 79% of revenue. Caveat: The Texas rules define these costs somewhat differently than the IRS or, for that matter, most conventional accounting systems. Again, the limited detail of the IRS data does not allow the adjustment of these amounts.
4. Missouri is at the lower part of the chart due to its low (and disappearing) franchise tax rate.

Industry: Accommodation and Food Services



Notes:

1. Tennessee is at the top of the graph for the reasons stated above.
2. Missouri is at the lower part of the chart due to its low (and disappearing) franchise tax rate.
3. The top three asset size categories were excluded due to lack of representative data.

Conclusions:

1. Although Tennessee consistently showed the highest rate of combined taxes, the state's lack of a personal income tax would seem to more than compensate for this differential.
2. Missouri's ongoing phase-out of corporate franchise taxes gives that state a competitive advantage against the other states (excluding Texas) since all of the income tax rates are fairly competitive.
3. Arkansas' franchise tax system is easily manipulated as compared to the other states. It is, to some extent, a voluntary tax.
4. The tax effects of Texas' margin tax regime vary widely depending on the type of industry. The desirability of this as a matter of policy is an open question.
5. Of all eight industries presented, only one (trucking) showed the highest rates in Texas. Texas showed the lowest rates in many industries. Since Texas has no state income tax, this differential is very competitive against the other states.
6. Although Louisiana has the highest tax rates (on paper), the effective rates in that state are much smaller due to the deduction for federal income taxes.