Leveraging Taxes to Facilitate Economic Development

(OR AT LEAST NOT THWART IT)

AEDCE ANNUAL CONFERENCE – FAYETTEVILLE – AUGUST 27, 2018

Overview

- Purpose: explain what Arkansas economic developers need to know about changes in the tax world
- Focusing today on two areas:
  - Qualified opportunity zones (QOZs)
  - Arkansas tax reform
- Ask questions at any time

Your Panelists

- Panel:
  - Leisa Cagle, Controller (McKee Foods)
  - Nicole Kaeding, Director of Special Projects (Tax Foundation)
  - Leslie Lane, Senior Vice President (Arkansas Capital)
- Moderator: Matt Boch, Dover Dixon Horne

Leveraging Taxes to Facilitate Economic Development

Part I

Qualified Opportunity Zones

ARKANSAS ECONOMIC DEVELOPERS

OVERVIEW: OPPORTUNITY ZONE PROGRAM

Opportunity Zone Tax Benefit

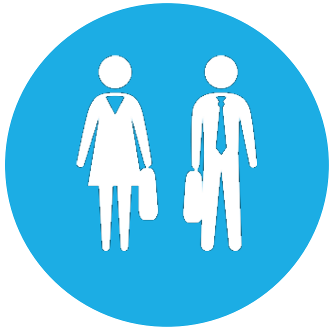
- Signed into federal law as part of the Tax Cuts and Jobs Act of 2017

- Investors currently hold over $2.3 trillion in unrealized capital gains and the Program has no appropriations cap.

- Encourages long-term **equity investments** into targeted low-income communities through Opportunity Funds, incentives are tied to the longevity of the investment.

Opportunity Zone Tax Benefit

Taxpayers can get capital gains tax deferral (& more)



for making timely investments in

Qualified Opportunity Funds (QOFs)

which invest in

Qualified Projects located in Opportunity Zones

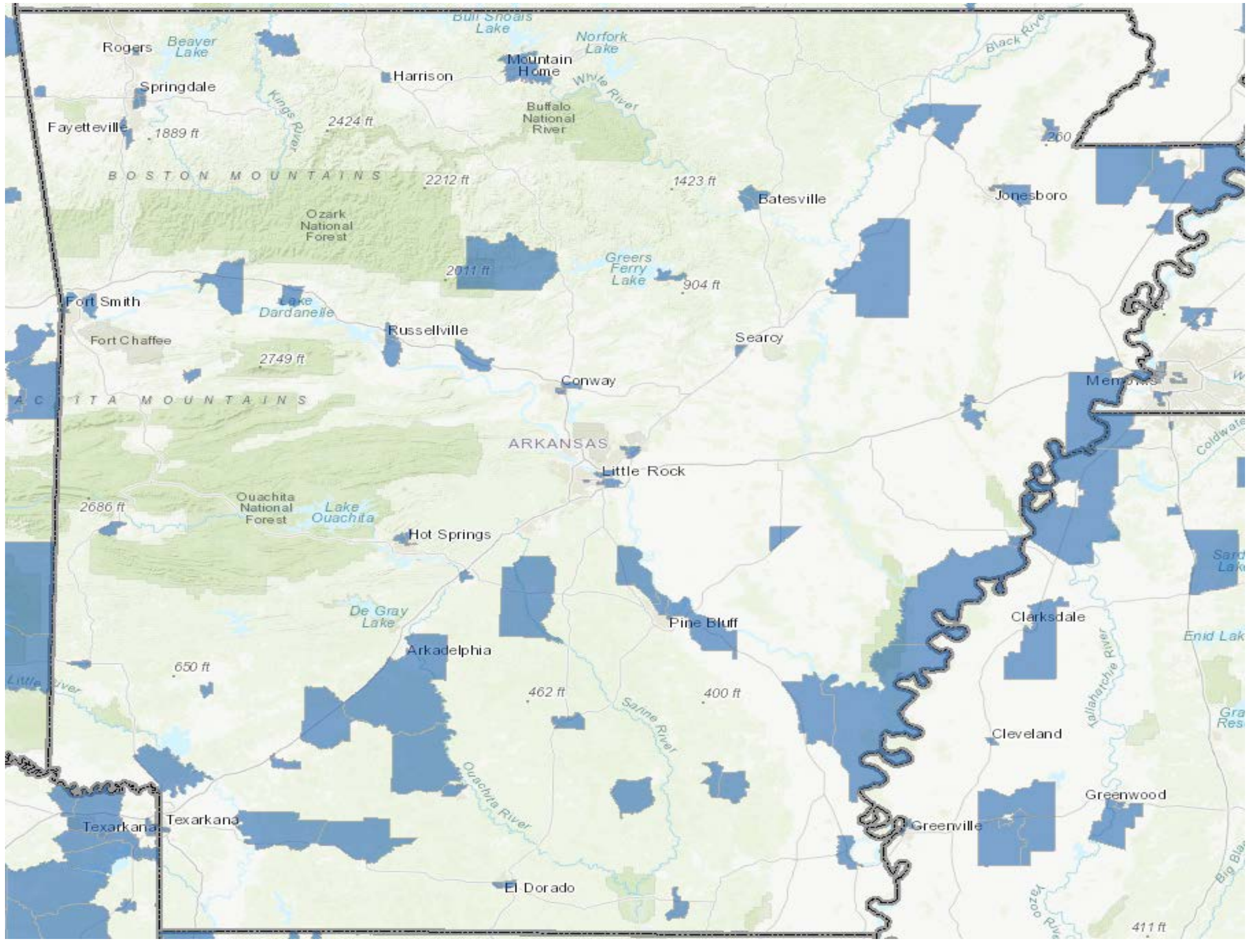
What Are Opportunity Zones?

Arkansas has 85 certified Opportunity Zone Tracts effective until December 31, 2028.

Does not guarantee investment into any designated areas. Funds and investors make their own decisions based on the merits of each investment opportunity.

Department of Treasury - CDFI Fund has a national mapping tool online https://www.cdfifund.gov/pages/opportunity-zones.aspx

Arkansas Opportunity Zones



Opportunity Fund Investors

Any individual, corporation, or trust, whether foreign or domestic,

Can defer an unlimited amount of capital gain from the sale or exchange of any property (stock, business assets, personal assets, or any other property) to an unrelated person

Funds must be invested in a ‘‘qualified opportunity fund,’’ during the 180-day period beginning on the date of the sale or exchange.

Only capital gains realized in sales or exchanges on or before December 31, 2026, can be deferred under this program.

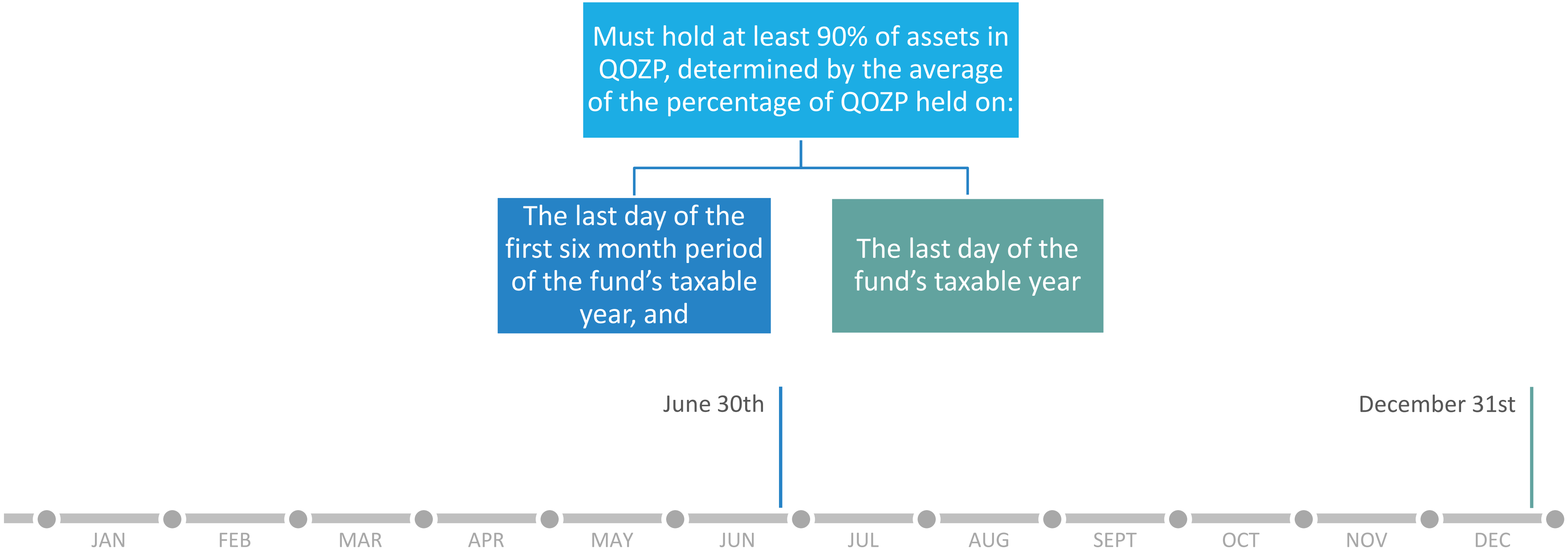
What are Opportunity Funds?

Any corporation or partnership organized for the purpose of investing in qualified opportunity zone property

Opportunity Fund self certifies (no approval or action by the IRS is required.) by completing a form and attaches that form to the taxpayer's federal income tax return for the taxable year.

Fund must invests at least 90% of its assets into eligible Opportunity Zone property. Financial penalties for not meeting 90% test

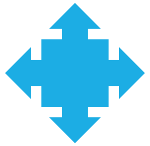
Qualified Opportunity Fund – Assets Test



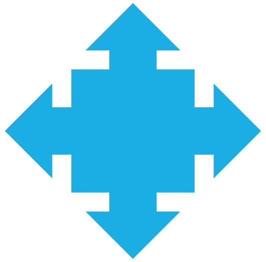
Investment in Opportunity Zones

Commercial Real Estate Development and Renovation in Opportunity Zones

Opening New Businesses in Opportunity Zones



Expansion of Existing Businesses into Opportunity Zones



Large Expansions of Businesses already within Opportunity Zones

Opportunity Zone Business

To qualify as an Opportunity Zone Business:

- substantially all of the tangible assets of the business must be used in an Opportunity Zone,
- at least 50% of the gross income earned by the business must be from the active conduct of a business in the Opportunity Zone,
- and the business can hold only a limited amount of investment assets.

Ineligible Opportunity Zone Businesses

Apart from the exclusion of a few “sin” businesses, the activities and projects Opportunity Funds can finance are broad.

A Qualified Opportunity Zone Business cannot engage in any of the following “sin” businesses: any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Note: It is also assumed by many third party professionals that medial marijuana related facilities would be included in this definition.

Qualified Opportunity Zone Property

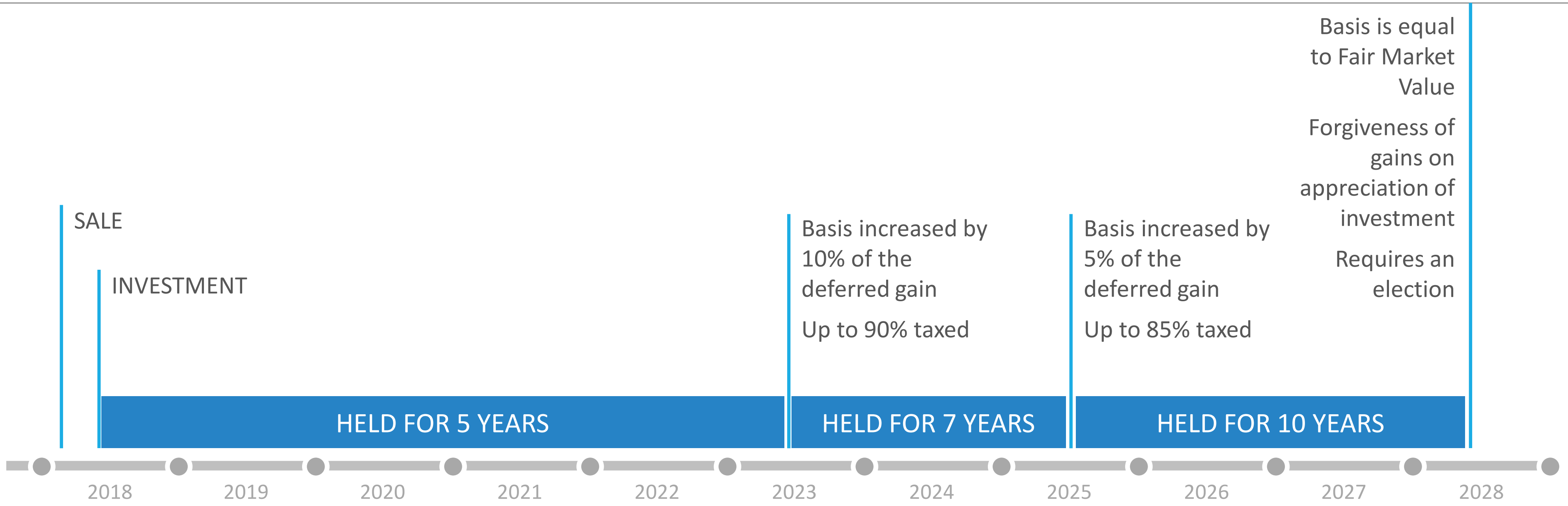
Tangible property used in a trade or business if such property

(i) was acquired by purchase after December 31, 2017,

(ii) the original use of such property in the QO Zone commences with the QO Fund or the QO Fund substantially improves the property, and

(iii) substantially all of the use of such property was in a QO Zone during substantially all of the QO Fund's holding period for the property. QOZBP will be treated as substantially improved by a QO Fund only if during the 30 month period beginning after the date of acquisition, the additions to the basis of such property in the hands of the QO Fund exceed the adjusted basis of such property at the beginning of the 30 month period.

Partial Forgiveness and Forgiveness of Additional Gains



Sample Investment

Jan. 2, 2018
Taxpayer enters into a sale that generates $1M of capital gain

June 30, 2018
(Within 180 days), Taxpayer contributes entire $1M of capital gain to a Qualified Opportunity Fund

- Taxpayer is deemed to have a $0 basis in its QOF investment
- QOF Invests the $1MM in Qualified Opportunity Zone Property

2018 2019 2020 2021 2022 2023 2024

Sample Investment

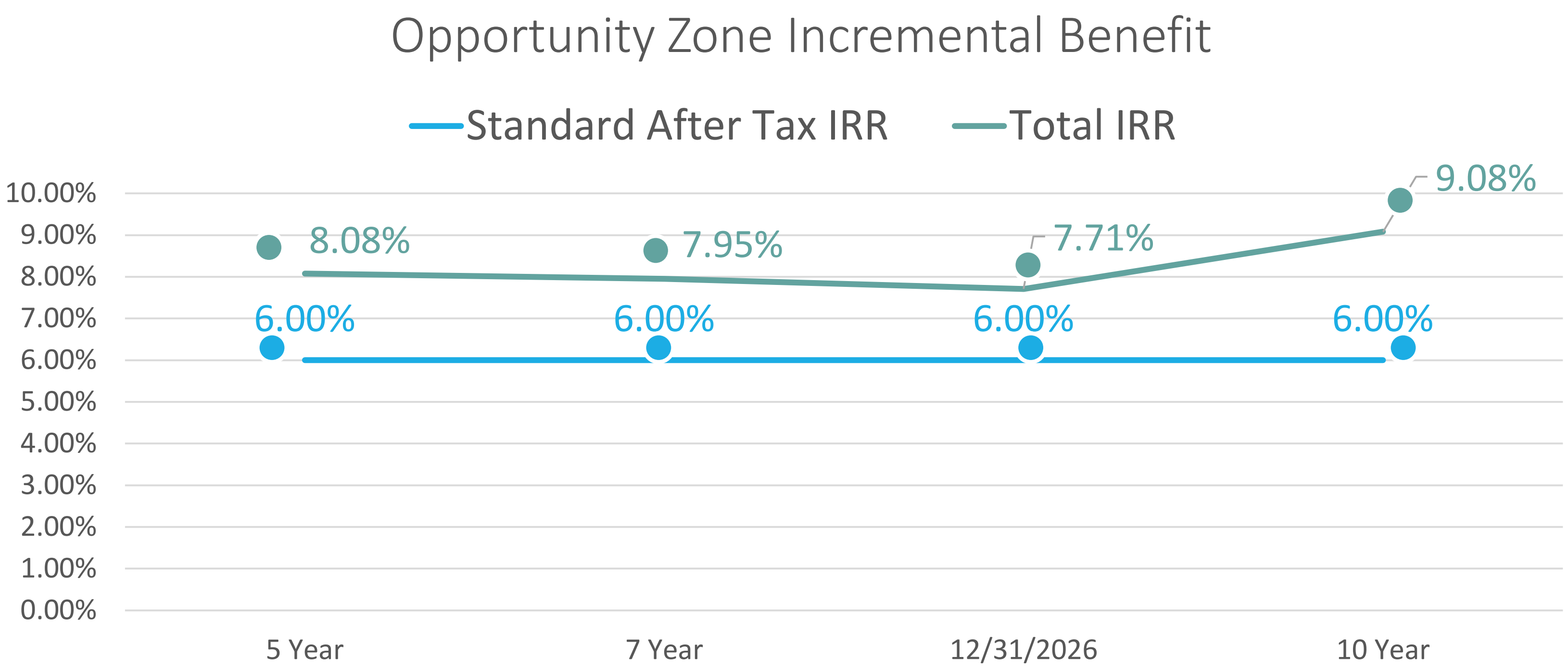
June 30, 2023
(After 5 years), Taxpayer's basis in investment in QOF increases from $0 to $100k

June 30, 2025
(After 7 years), Taxpayer's basis in investment in QOF increases from $100k to $150k

Dec. 31, 2026
$850K of the 1MM of deferred capital gains are taxed and the basis in QOF investment increases to $1MM.

June 30, 2028
(after 10 years) , Taxpayer sells its investment for $2.0MM. Basis in the investment is deemed to be FMV. The effect is no tax on appreciation in investment.

2022 2023 2024 2025 2026 2027 2028



23.8% Tax Rate	5 Year	7 Year	12/31/2026	10 Year
Standard After Tax IRR	6.00%	6.00%	6.00%	6.00%
Incremental OZ Benefit	2.08%	1.95%	1.71%	3.08%
OZ Investment IRR	8.08%	7.95%	7.71%	9.08%
Percentage Increase	35%	32%	29%	51%

Yield enhancements

Further yield enhancements may be realized when using Opportunity Zones in combination with other programs such as New Market Tax Credits, Low Income Housing Credits, Historic Tax Credits, Energy related Credits.

May be combined with state programs but need guidance from the programs on a case by case based upon the merits of the projects. Examples would include the 33 1/3% investment tax credit and the state capital gains deferral for certain equity investments.

Sample Guidance Issues

State Level

- Capital gains treatment
- Thoughts from State Securities Department

State Tax Implications

Opportunity Zone benefits increase if states conform to the Federal Law

Some states piggy-back off of the current Federal Law but could decouple from OZs
- New York decided not to decouple
- Hawaii decided to decouple
- North Carolina released a draft bill that would decouple

Some states (including Arkansas) do not conform to Federal Law but could add OZs at the state level
- Colorado is considering a bill to add the OZ benefit at the state level

Some states do not have a state income tax (e.g. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming).

State Tax Implications of an single OZ transaction may include multiple states
- State where original gain was realized
- State (s) where the opportunity fund has nexus

Some states are tying other State incentives to opportunity zones
- Missouri proposed increased cap for state historic credits for properties in OZs
- California introduced a bill to exempt projects in OZs from the CA Environmental Quality Act

Resource Providers

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Qualified Opportunity Zones – Q&A

QOZ Questions?

Leveraging Taxes to Facilitate Economic Development

Part II

Arkansas Tax Reform

Arkansas Tax Reform

- How do you make a poor state with a populist tax system competitive for economic growth?
- Starting point:
  - Low property taxes
  - Somewhat high income taxes
  - Very high sales taxes

Arkansas Tax Reform

- Discussion:
  - Practical perspective on tax competitiveness (Leisa Cagle)
  - The Tax Reform Task Force and policy perspective (Nicole Kaeding)

McKee Foods Corporation

August 27, 2018

Heartland®
Est. 1968
BRANDS

Drake's®

McKee
A FAMILY BAKERY

Little Debbie®

FIELDSTONE™
BAKERY

Sunbelt®
BAKERY

McKee Foods Locations

Gentry, AR

McKee Foods Corporation
Arkansas Operations

- Current FTE-1,584
- Average Pay--$46,553
- Investment Plans—5 Year Plan (2017-2022)
  - Large Shipping Expansion in works $40 million
  - Other Projects $70 million
- Contributions to State Economy - $88 million - Payroll, Supplies, Taxes
  - $77 million of that—is to local economy

Most Important Criteria for Site Selection

(ranking per siteselection.com/issues—Nov 2017 issue)

1. Workforce skills
2. Transportation Infrastructure
3. Utilities (Cost/Reliability)
4. State & Local tax structure
5. Land/Building Prices and Supply
6. Quality of Life
7. Workforce Development
8. Ease Of Permitting and Regulatory procedures
9. Incentives
10. Higher education resources

McKee's Scorecard

Manufacturing Location Scorecard			
	TN	AR	VA
Sales and Use Taxes--Cost per Case	2X	3X	X
Real Estate Property Taxes--per $1,000 of Cost	$16.55	$11.68	$5.80
Personal /Equipment Property Taxes--per $1,000 of Cost	$5.20	$7.12	$4.00
Corporate State Income & Franchise Taxes	1.5X	4.5X	X
Incentive Programs for Expansion	X	X	.5X
5 Year Planned Capital Spend	$155MM	$110 MM	$60MM

Sales & Use Tax Recommendations

- Arkansas has already addressed in AR Act 465 (3/13/17) one key exemption issue
  - Exemption for manufacturers related to repair parts and services
  - Much needed exemption—made AR comparable to other 2 states where we have manufacturing operations
  - Being phased in over a 5 year period with a rate reduction of 1% each year until fully exempt beginning 7/1/22
- Exemption paid for by eliminating two sales tax incentives—Invest Ark and Major Maintenance and Improvements Incentive
- Rates still high compared to Virginia

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Property Tax Recommendations

- Consider not taxing inventories
- Add Property Tax Incentives—such as rebates of property taxes for increases in personal property taxes—similar to Virginia
- Modify PILOT Agreement process to simplify-constitutional change

Personal Property Tax—Inventory Tax

	TN	AR	VA	
	Personal Property Taxes-Inventory			Explanation
	Taxed %			
Parts Inventory	100%	100%	0%	
Small Tools	0%	0%	100%	
Raw Materials (Ingredient/Packaging)	100%	% Sold In AR	0%	Freeport Exemption in AR
Finished Goods	0%	% Sold In AR	0%	Freeport Exemption in AR
Racks and Displays	100%	% going in AR	0%	Freeport Exemption in AR
Ranking	X	.45X	.00X	VA doesn't tax Inventories

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State Income & Franchise Taxes

	TN	AR	VA	
	State Income Taxes			Explanation
	Costs & Rates			
Apportionment Formula	Single Sales Factor	3 Factor-2X Sales	Single Sales Factor	TN went to Single Sales Factor 7/1/17
Tax Rate	6.50%	6.50%	6%	
Apportionment Factor--Prior to 7/1/17	26%	12.4%	2.80%	
Apportionment Factor if Triple Weighted Sales.	22%	10.3%	2.80%	
Apportionment Factor if Single Sales Factor	4.7%	2.0%	2.8%	
Franchise Tax	X			
Ranking	1.5X	4.5X	X	
		Credits		
Industrial Machinery Exemption Tax Credit--1% of Investment	X			
Gross Premiums Tax Credit--Unemployment Comp	X			
Recommendation	Apportioned Property for Franchise	Single Sales Factor		

State Income Tax—Simplified

Federal Taxable Income	$10,000,000
Adjustment to Federal Taxable Income:	
AR Income Taxes Deducted	50,000
Bonus Depreciation Adjustment	1,000,000
Arkansas Apportionable Income	$11,050,000
Apportionment %	29.50%
Arkansas Taxable Income	$3,259,750
Arkansas Tax Rate	6.50%
Arkansas Income Tax	$211,884

How does apportionment work?

Arkansas--3 Factor, Double-Weighted Sales	Company A Manufacturer	Company B Manufacturer
AR Payroll %	50%	1%
AR Property %	50%	1%
AR Sales %	9%	9%
AR Sales %	9%	9%
Total %	118%	20%
Arkansas Apportionment (Total/4)	29.5%	5%

Tennessee--Single Sales Factor	Company A Manufacturer	Company B Manufacturer
TN Payroll %	1%	50%
TN Property %	1%	50%
TN Sales %	9%	9%
Tennessee Apportionment (Sales Only)	9%	9%

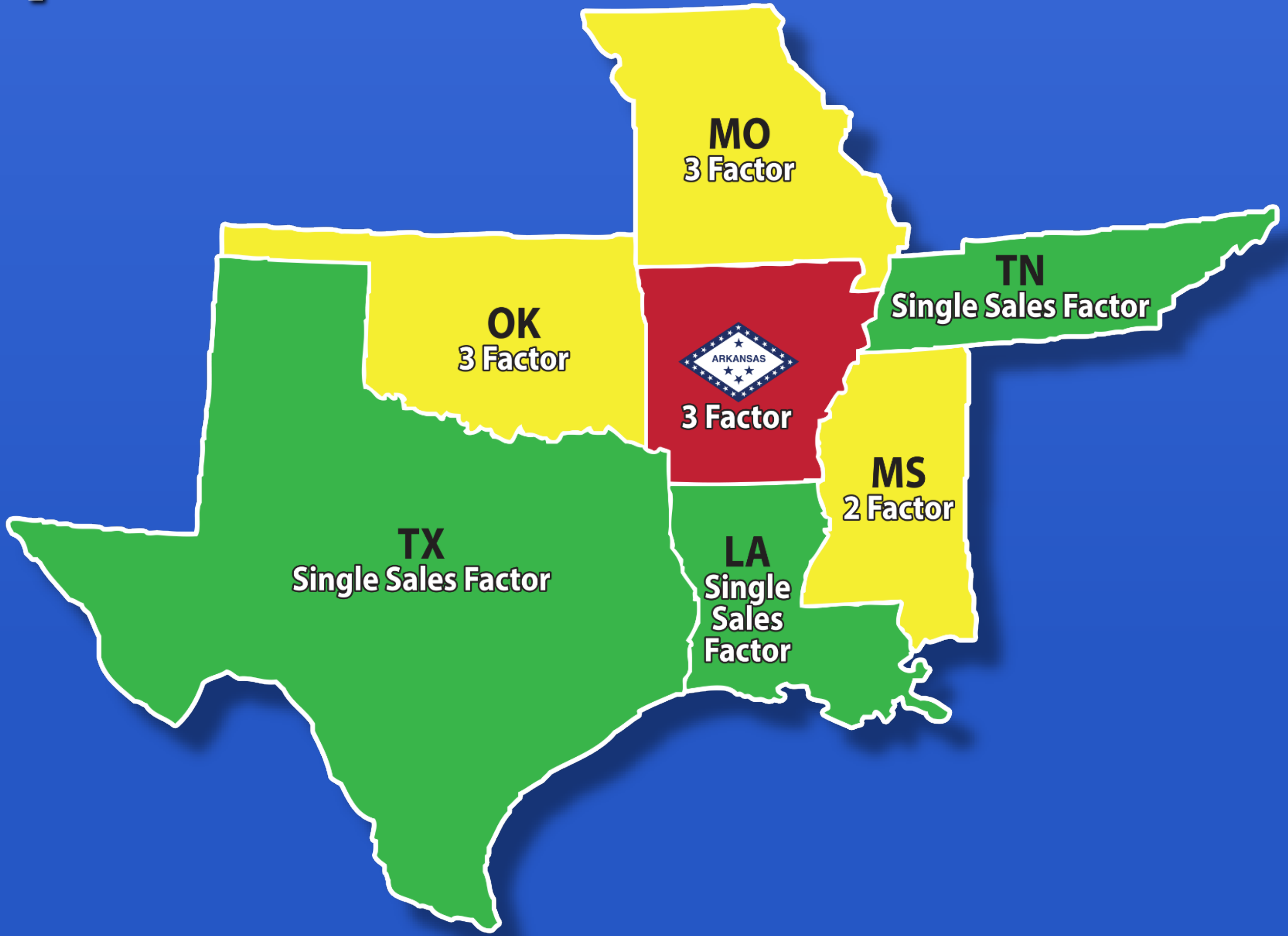
State Income Opportunities

- Move to single sales factor apportionment for manufacturers
- Apportionment factor more important than rate reduction

Single Sales Factor Apportionment

- 31 of 47 states have some form of single sales factor apportionment in place or being transitioned—66%
- In 2004, 7 states used single sales factor apportionment. This has more than quadrupled in 14 years.
- No repeal of single sales factor by the states adopting such factor to date.
- Of 3 states where MFC has plant operations, AR is the only one that does not currently have single sales factor apportionment.
- Of 6 states surrounding AR, 3 have single sales factor apportionment.

AR apportionment and bordering states



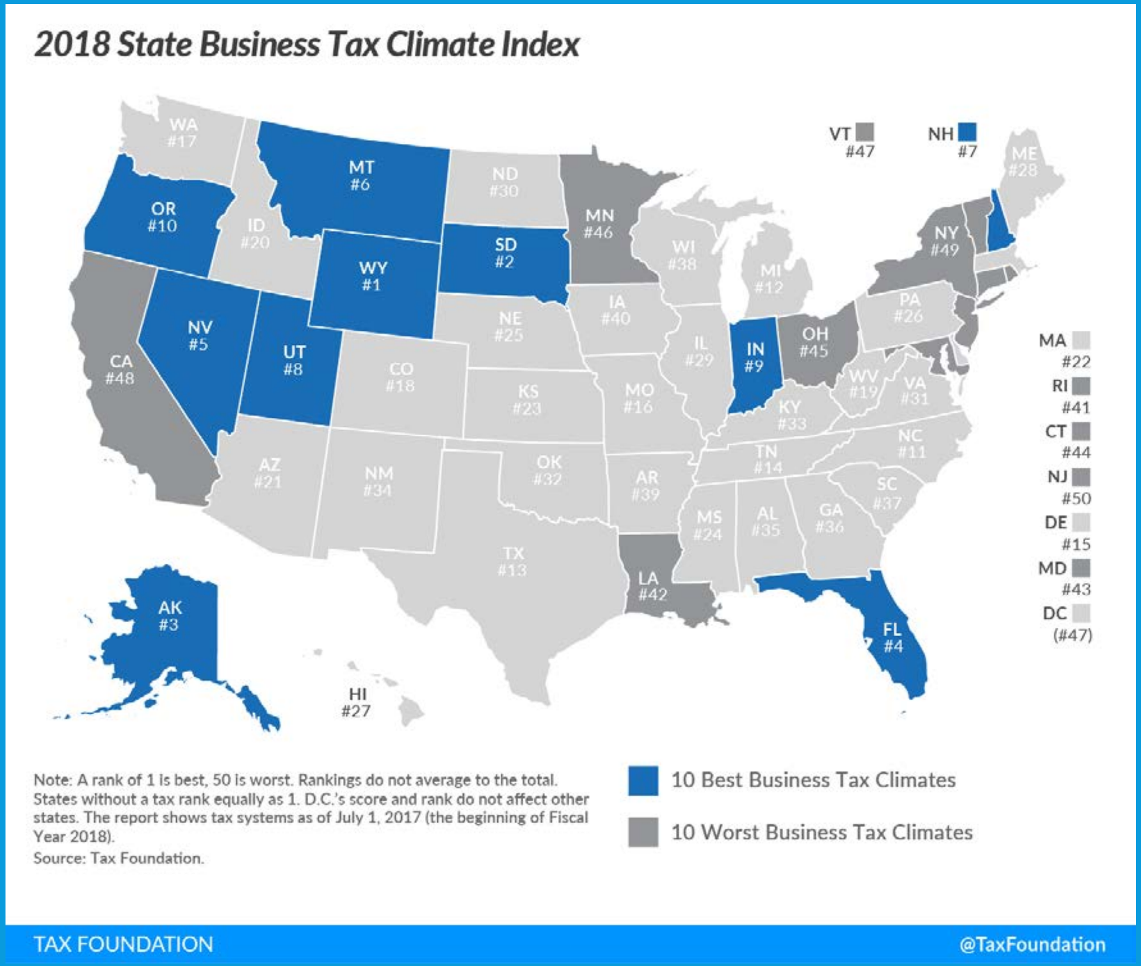
Arkansas Incentives Opportunities

- Simplify Advantage Arkansas
  - Labor-related incentive for new jobs created
  - Very difficult to administer—120 hours for $3,000 incentive
- Pilot Agreements—consider constitutional change to allow without bonds
- Update Training Incentives to allow for computer based training

McKee Foods Corporation

STATE BUSINESS TAX CLIMATE INDEX

TASK FORCE REPORT



STATE BUSINESS TAX CLIMATE INDEX
TASK FORCE REPORT

- We've projected Arkansas's score on the State Business Tax Climate Index using the task force's final recommendations.

Projected *State Business Tax Climate Index* Ranking

	Current	Proposed
Overall	**39**	**36**
Individual Income	30	30
Corporate Income	39	26
Sales	44	44
Property	22	22
Unemployment Insurance	32	32

TAX REFORM

TASK FORCE REPORT

- So what did the task force recommend?
- Individual Income:
  - Consolidate brackets and lower rates
  - Create a pass-through entity tax
- Corporate Income:
  - Repeal the throwback rule and move to single sales factor
  - Lower the corporate income tax rate
  - Expand net operating losses
- Property Tax:
  - Create an inventory tax credit
- Sales Tax:
  - Clarify remote collection post-*Wayfair*

TAX REFORM

TASK FORCE REPORT

- Next steps?
- The big remaining question is prioritization.
- The reforms cost approximately $400 million with $40 million in identified offsets.
- Their revenue target is $200 million in the first year.
- So which reforms go first, how are they phased in, and will they use tax triggers?

TAX REFORM
TASK FORCE REPORT

- Contact Information
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Key Arkansas Tax Reforms for Economic Development

Major potential reforms in pipeline:

1. Apportionment reforms (single sales factor and throwback repeal)
2. Individual and corporate rate cuts
3. NOL extensions
4. Business inventory property tax
5. Remote seller sales tax collection

Key Arkansas Tax Reforms for Economic Development

Other ideas

- Data center sales tax exemption
- Expand manufacturing exemption
- Market-based sourcing of services
- Expand freeport exemption
- Property tax abatement (const. amendment one day)

Arkansas Tax Reform – Q&A

Arkansas Tax Reform Questions?

(Or other questions….)

Panel Contact Information

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