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Tax Policy

Criss-crossing the country, Crowell & Moring's state tax team meets regularly with state tax commissioners and their counsel to bring Bloomberg BNA's readers candid and timely observations from the country's top state tax decision-makers. Well into this 50-state journey, Don Griswold, Walt Nagel, and Jeremy Abrams spoke this month with Tim Leathers, the Arkansas Commissioner of Revenue. In this column, Leathers discusses major changes in tax policy, sales tax break litigation, and other developments in Arkansas.

Crowell's Conversations: An Interview With Tim Leathers, Arkansas Commissioner of Revenue



TIM LEATHERS, INTERVIEWED BY DON GRISWOLD,
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Major Changes in Tax Policy

CROWELL: It's great to see you again, Tim. What are some of the themes or changes you have seen in the Arkansas tax environment during your long tenure with the Department?

LEATHERS: One obvious difference is the technology and its impact on processing returns. It's totally different now compared to my early years here when we were using typewriters, where one lawyer had one secretary sitting there typing all day. Obviously, that's completely different from what we have today. The dramatically improved communications technology has made things easier, but in some respects it has also

made it harder because it doesn't give you as much time to stop and think things through. Technology and electronic filing have sped things up. We used to have filing seasons, for example, where we would have rooms full of temporary people doing data entry; handling all the paper—with the errors that can go along with that—and things of that sort. Processing has changed dramatically.

In terms of our tax laws, when I started out, I got a lot of the corporate income tax work to do and that was the more complicated area of tax, whereas sales tax was kind of the simpler area. Well, as years have gone on, the sales tax has become much more complicated in Arkansas. We've got the jurisdictional issues and the loading on of new exemptions, and credits. Each of those things has its own particular set of laws. Plus, we have local taxes that we collect and administer; that has its own set of jurisdictional and other issues. All of our guys will tell you that. Sales tax is not what it used to be; it takes a lot more time and effort just because of those things.

Streamlined Sales Tax

CROWELL: Speaking of sales tax, what is your perspective on the Streamlined Sales Tax effort?

LEATHERS: Well, when we first started, my thought was that it will never happen in my lifetime! It still may not, but we are a lot closer than I thought we would ever get after a long period of time. Everyone said we were going to negotiate this. But I said we can negotiate until hell freezes over—and then we can negotiate on ice!—because I don't see that the industry has any advantage to do this. That's proven to be a little bit untrue because we have gotten some voluntary participation where businesses have seen that it's better for them than to run the risk of having subjected themselves to our jurisdiction's tax. In addition, we have picked up some tax money because of Streamlined.

It would be great if Congress would finally resolve the nexus issue. This problem has been going on for so long. I've heard personally about it for many years. Back in the day, even before there was the Internet, this was a big issue. Think, for example, of the local music store. People would come into a store and shop, then they'd go get it by mail order. Or they'd get their carpet from North Carolina, but if they have trouble with it they'll come shop in my Arkansas store and bring it to me for the warranty work. A friend of mine in my neighborhood, a guy who sold stuff to me over the years, asked, "Why can't you guys do something about that?" "Well," I'd tell him, "you need to contact your Congressman about that." Our entire congressional delegation from Arkansas, I think except for one, is supportive of resolving this issue with federal legislation. If we can do it, it would be great for those merchants that are out there having to compete without having a level footing; also, it would indeed be great to simplify things to some degree. We have WalMart here that's been behind Streamlined as you know, and for years the message I've heard is, "Hey, we've been collecting sales tax all over the country at our stores and it's just not that complicated. If we can do it all across the country, all these other businesses can, too. The 'too complicated' argument is all a smoke screen."

Background and the Department of Revenue

CROWELL: You've been Commissioner of Revenue for quite a long time. Can you share with our readers your earlier background?

LEATHERS: I was attending the University of Arkansas at Little Rock, School of Law. When I started it was only a night law school. I was working my way through school at the local grocery store and one of the little old ladies who knew I was in law school approached me while she was shopping and said, "We have a law clerk's job open in our legal office, and you ought to apply to work in our legal office in Revenue." I started as a legal clerk . . . and the "little old lady" was probably about the same age I am now. After I passed the bar, there was an attorney's position that came open in Revenue, so I moved into that role, and then I progressed to become Chief Counsel, and then Revenue Commissioner, and then the current director of the Department of Finance and Administration also made me Deputy Director. So, I kind of grew up in the business and in the Department.

CROWELL: You lived and breathed tax from the beginning. That's fabulous. Tell us more about your Department.

LEATHERS: We have some great people in Revenue. We need to clone your friend John Theis; he's that good. We have Walter Anger and Glenn Reynolds over there now, and Tom Atchley in Sales Tax. Lynne Reynolds is the new Administrator for the Office of Income Tax. Paul Gehring has replaced Martha Hunt as our new chief counsel. We have a solid group of people over there.

The scope of our responsibilities is worth talking about, too. This department has more different duties and responsibilities than any other financial or revenue department that I know of in the country. We have the revenue side where I started. We also have responsibility for all the taxes, motor vehicles and driver's licenses; child support has been added over the years, with all that goes along with that. Then on the other side of the agency we have the state budget office, the state accounting office which functions more or less as the controller in this day, we have the office of personnel management and alcoholic beverage controls, and we even have the racing commission. I'm leaving out a bunch of stuff, but that just goes to show you how broad we are. There is no agency I know of in the country that has all the financial elements of state administration all tied in to one department.

Importantly, this means that when we are looking at a revenue forecast or the fiscal impact of a proposed tax bill, we are looking at it through a broader lens than some revenue agencies, and this, I believe, helps us understand the ramifications better.

CROWELL: Let me take you back to your team again for a moment. Has Arkansas experienced the "brain drain" phenomenon that many departments around the country are facing?

LEATHERS: We have experienced some of that, and we know our staff is aging, but we have people that we've entrusted with more responsibility coming up . . . like Paul Gehring, our new chief counsel. We had several really excellent candidates who we interviewed for that job. They were internal people who we trusted, and who we had developed within the department. We've

tried to do that internal development of talent. There is, of course, no guarantee that we will continue to be successful at doing this, but we have always tried to have a solid replacement player already on the staff for certain positions. We give people room to grow. Within all those areas we try not to micro-manage what any of those folks do. We give them the responsibility to manage their areas and just hold them accountable on the back end, and treat them like I think high level professionals need to be treated—like I was. I give them the latitude to try and do what's right, and I think that approach has paid off for us. We haven't been in the situation very often over the years where we were told to hire a person for political reasons. We haven't had that. Maybe because we are kind of thin at the top, we don't have a lot of those types of patronage jobs laying around like some agencies might. We don't have a lot of duplication in those higher level jobs in Revenue.

CROWELL: We see a lot of bright young lawyers emerge from the Georgetown LL.M. program where we teach a state tax course, and more and more of them are interested in going into government. This surge of talent is fabulous for the practice of state tax, whether they go into industry, law and accounting firms, or the government side.

LEATHERS: I teach state and local tax here at the University of Arkansas at Little Rock, School of Law as well. I've taught for 6 or 7 semesters over the years. Sometimes I think teaching helps me even more than it helps the students! We've had some great students come here to work at Revenue. Some have come here, and then gone to industry or private practice over the years. Some of them had offers and chances to go into industry or private practice, but chose to stay with us. We don't pay a lot, but we give our folks lots of opportunity and responsibility.

The level of opportunity for young tax lawyers here is very real. When I started out as a young lawyer here in Revenue, it wasn't like I was sitting in the back room just drafting regulations every day or something. I was litigating. Here in Revenue, our law office is just different than other states' offices; we have our own litigators on staff for all the tax and licensing issues. Right off the bat I was trying lawsuits, writing briefs, arguing cases in the Arkansas Supreme Court as a young lawyer. The other guys I went to law school with? They might be in a big law firm but they weren't getting great work. I started with the attitude that I needed to learn as much as I could because this might not be a lifetime job, but it turned out to be that, and I'm very happy about that.

Sales Tax Break Litigation

CROWELL: You mentioned litigation. We understand there's some litigation in which taxpayers are challenging the constitutionality of sales tax breaks for sand used in oil and gas drilling.¹ It involves a peculiar feature of Arkansas law. What's that all about?

¹ *Nunn v. Weiss*, No. 60 CV-14-2403 (Arkansas Pulaski County Circuit Court, 13th Division) (challenging the constitutionality of the enactment during the state's 2014 fiscal session of a sales tax exemption under Ark. Code Ann. §26-52-402(c)(2)(B) for the purchase of sand used for gas or oil drilling).

LEATHERS: That's more of a constitutional procedural case than a sales tax case. Basically our legislature has certain procedures it must follow with respect to revenue laws. Appropriation bills are supposed to be limited to budget issues and the legislature simply didn't follow procedure in this case. Of course we didn't bring the lawsuit. The taxpayers brought the lawsuit, but we had to admit that the legislature didn't follow the proper procedure, which we told them they weren't doing during the session, and they didn't listen. This is a bit strange, and it's another case where things have changed over the time I've been here. The environment's changed; once upon a time, we could tell legislative leadership that a tax proposal they were considering was unconstitutional and the majority would say, "We need to back off this and try it another way," but now we're told things like, "Well, until the court rules specifically on this issue, we're not going to worry about that."

CROWELL: That does change the dynamic then, doesn't it?

LEATHERS: Yeah, and it's because we've had term limits. We get a lot of new people in the legislature, and a lot of folks that want to have their own agenda, and it almost seems that the whole environment has changed legislatively. It seems like they don't really grasp or care about those kind of issues sometimes. That's kind of where we are with this. So now we're in court. If the legislature had followed the procedure up front, everything would've been fine. Of course, if they had followed that procedure, well then there might have been a lot more opposition to the bill, and there would have been 100 other proposed tax bills waiting in line.

CROWELL: Is the Department at odds with the Attorney General on this issue?

LEATHERS: Not really. They have to defend the laws and we have an excellent relationship with the Attorney General, same as all of them in the past that we've worked with. And we do our own litigation so if we have a falling out, it's not like their lawyers are representing us in court on something else. Our lawyers are on our payroll. The Attorney General does not represent us. Will Keadle, who is on our staff, argued the cable TV case in the United States Supreme Court.² There's some old case law where the Attorney General contended long ago that they should be representing the Department, but our Supreme Court said "no" to that, and ever since then it's been clear that they don't represent us in the tax cases.

CROWELL: Tell us about the *Lion Oil* case.³

² *Leathers v. Medlock*, 499 U.S. 439 (1991) (Arkansas sales tax statute did not unlawfully target cable companies in violation of First Amendment).

³ *Lion Oil Co. v. Richard Weiss*, No. CV2012-0021-4 (Ark. Union County Circuit Court) (whether purchases of machinery and equipment by Lion Oil Company qualify for the exemption for machinery and equipment required by state or federal law or regulations to prevent or reduce air or water pollution. Legislation enacted in 2013 exempts the equipment at issue in this case, but the department will argue that the law does not apply retroactively to this equipment). See Arkansas Tax Advisory Council, 2013 Year-Ending Report (<http://www.dfa.arkansas.gov/offices/policyAndLegal/Documents/2013AnnualReport.pdf>).

LEATHERS: That's in the discovery phase right now. The case bears on whether the taxpayer should get the retroactive benefit of a law passed by the legislature. But we simply defer to the legislature; we don't make or choose what the effective date of that is. That's the main issue there.

Retroactive Taxation

CROWELL: It can be viewed as the flip side of the issue that's getting some nationwide press now in some other states. Michigan has been in the news in particular because, with IBM's victory in the MTC compact litigation, its legislature passed a law that purports to retroactively change the tax result, right? For them it's a way of trying to plug a projected billion dollar revenue hole.

LEATHERS: In my view, the rule is that if you don't violate contracts or some other constitutional provision then you can do that, but it has to be specifically stated in the law. We participate directly in the legislative process, even on many of the bills that we don't draft from the outset. We always try to make sure that we have the effective date specified; just from an administrative standpoint, we want to know exactly when to apply the new rules. That doesn't mean that we don't miss some technicalities sometimes, but we do pretty well with the effective dates.

CROWELL: There's this tension between the state's need to fix revenue leaks, if you will, and the taxpayers' expectation of some level of finality. How does the Department, when advising your legislature, come up with the maximum number of years that you feel is appropriate to go back retroactively, under the guidance the U.S. Supreme Court has given us in *U.S. v. Carlton*?⁴

LEATHERS: First of all, we try not to do anything retroactively. But that doesn't mean that some member wouldn't try to do that. In that case, what we tell them is that you have to be very specific about the retroactive period. They should also consider the old case law in this state that you can't forgive a corporate debt; that may be relevant in some of these situations. In *Federal Express I*, we won the lawsuit on a sales tax issue, but then the legislature stepped in and changed the result.⁵ Then in *Federal Express II*, the court said this was wrong; this is not what the law was; this involves changing the law retroactively; you can't forgive that state's tax debt retroactively.⁶ That sort of thing does arise at times, the issue of the legislature's power to undo tax laws that are already fixed or dead.

⁴ *U.S. v. Carlton*, 512 U.S. 26 (1994) (retroactive amendment limiting deduction did not violate due process because it was rationally related to a legitimate legislative purpose).

⁵ *Federal Express Corp. v. Skelton*, 531 S.W.2d 941 (Ark. 1976) (storing aircraft in Arkansas constitutes sufficient "use" to warrant the imposition of use tax).

⁶ *Federal Express Corp. v. Skelton*, 578 S.W.2d 1 (Ark. 1979) (the legislature can prospectively change the tax laws within constitutional limitations, but it does not have the power or authority to retrospectively abrogate judicial pronouncements of the courts by a legislative interpretation of the law).

Arkansas Tax Policy

CROWELL: Regarding tax policy, how is Arkansas doing in its efforts aimed at attracting business to the state?

LEATHERS: We don't have an energy base that we can live from like Texas, Oklahoma and Louisiana, so we don't have that situation where we can export our taxes to other states. That's what I keep telling our taxpayers. You're paying the Montana and the Wyoming taxes in your utility bills when you go buy gasoline here in Arkansas, and that's why those states can do some things differently with their taxes. We just don't have that opportunity essentially to export the tax burden.

We've had to look to other areas for our revenues, and we have as balanced a tax rate as any of the states around us have. There are groups that want to say our taxes are high, and they want to point to the statutory rate instead of properly pointed to the effective rates; sometimes, they also single out one tax instead of looking at the entire package. We passed some new taxes for education that has moved us up in the national education rankings, but we traditionally rated low to middle of the pack. We were very low in these rankings when I started before we had raised the taxes for education. These tax increases really helped. But we have also made progress on considering how some particular groups of taxpayers are impacted by our tax laws. For example, we've just now been phasing in exempting food from the sales tax. Our Governor has been a big proponent of that kind of state tax reform.

Returning to this concern about our inability to export our tax burdens the way some of the oil-producing states can do this: If you don't have that free money that comes from exporting your taxes to other states in terms of energy taxes and those sorts of things, then you have to look to other sources of revenue.

Perhaps it's easy for a critic to say, "If I were king, I'd start over on the Arkansas tax system," but that's just not practical and it's a really complicated system that we have in place. We spoke earlier about one of the unusual voting requirements for tax bills in the Arkansas constitution. Here's another one: We have an extraordinary vote requirement, enacted during the Great Depression, that the drafters probably intended to mean that we must have a three-fourths vote by the legislature to increase any tax. As the courts interpreted it, though, that law required only a three-fourths vote to increase any tax that was already in effect at the time this "extraordinary vote" law was passed. So we had income tax and we had tobacco tax, but the big one that we didn't have was sales tax. It has been easier to increase sales tax because it takes just a majority vote. You increase income tax and it takes a super-majority vote. So when the Governor sits down trying to determine how to raise revenues, or how do I replace revenues lost by enacting new exemptions and so forth, all those questions come into play.

CROWELL: What do you think about the idea of computing tax based on SEC-reported net income rather than Federal 1120?

LEATHERS: I can certainly see the advantages to it but I can also see where the corporate community might generally like what they have in the current system. In my view, though, this would simplify things. If we adopted that here, we would have to adopt that law as it existed on a certain date. If that ever changed, then we

would have to come back and adopt it again because of the law I just mentioned. So that's one of the reasons why Arkansas takes a provision by provision approach to IRC conformity. Otherwise we might trip up on an unconstitutional tax increase. We've had some constitutional amendments to look at requiring all taxes to re-

quire a three-fourths vote, but that would be really tough.

CROWELL: We're so grateful for your time this morning, Tim. Thank you.

LEATHERS: My pleasure.