JLBC Staff – April 2015 Income Tax Collections

Highlights

- *April 2015 individual and corporate income tax collections increased by over 30% compared to last April.*
- *The revenue surge was part of a nationwide trend - April federal income tax revenues increased by 19%.*
- *Capital gains and dividend payments may help explain the individual growth, while the corporate receipts may reflect a delay in filing for tax reductions.*
- *The state's more stable "core" revenues - sales tax and withholding - continue to grow much more slowly. Withholding is only up 2.8% this year.*
- *Preliminary year-to-date revenues are $228 million above forecast, but there are more outstanding income tax refunds than normal.*
- *If sustained for the entire year, the forecast overage will offset the $132 million FY 2015 shortfall – which would otherwise be covered by the Rainy Day Fund.*
- *Predicting any possible ongoing net revenue increase would be premature -- especially in light of pending K-12 litigation.*

April can be a significant month for state General Fund revenues with the filing of both individual and corporate income tax returns. Prior Aprils resulted in both significant windfalls (such as in 2006) and shortfalls (2009). This year, individual and corporate income tax posted unexpectedly large gains. The state collected $517 million in individual income taxes (IIT), a 31% increase above April 2014. Corporate income tax (CIT) receipts grew by 43% to a total of $126 million for the month.

April income tax receipts were $141 million above the enacted budget forecast. Preliminary year-to-date General Fund revenues are $228 million above the enacted budget forecast.

April Income Tax Collections
$ in Millions

	April 2014	April 2015	% Change
Individual Income	$394	$517	31%
Corporate Income	$88	$126	43%

The forecast overage, however, does not yet translate into "available" funds. The longer term implications of the April revenue surge will only become clearer as additional data is received over the next several months. For example, there are more pending IIT refunds than in prior years, which has the potential to offset some of the April growth in May. In addition, the state's K-12 inflation litigation has yet to be resolved, which has the potential of costing $262 million on an annual basis.

Individual Income Taxes

In terms of IIT, the gains occurred primarily in higher final payments and lower refunds. While there is currently insufficient data to determine the reasons for the growth, the primary factors may include:

- Taxpayer capital gains from the stock market. Over the last 3 calendar years, the stock market values as measured by the Standard and Poor (S&P) 500 index have grown by 60%. As taxpayers cashed in some of these gains in Tax Year 2014, they generated higher final tax payments in April 2015. The actual growth in taxable capital gains will not be known, however, until more detailed Tax Year 2014 data is released in 2016.

- As corporations accumulate large cash balances, some of them have increased their dividend payouts. Nationwide dividend payments of large corporations increased by 12.6% in Tax Year 2014.

- The “low” FY 2014 capital gains base. The potential as well as actual federal tax increases at the beginning of Tax Year 2013 (otherwise known as the “fiscal cliff”) incentivized taxpayers to shift income into Tax Year 2012 and out of Tax Year 2013. As a result, the April 2014 final payments associated with Tax Year 2013 may have been lower than normal. In April 2014, for example, income tax payments fell by (10)%. This lower base facilitated the 18% growth in payments in April 2015.

- The decline in capital loss carry forwards. As with capital gains, a taxpayer may generate a capital loss if stocks are sold for less than their original price. If taxpayers had capital losses during the Great Recession, they could use those losses to offset profits in subsequent years. These “loss” offsets may be declining, thereby increasing the amount of net capital gains subject to taxation.

Two other factors in prior April revenue surges do <u>not</u> appear to be at play this year:

- Employment and Wage growth. As measured by withholding, employment and wage growth continues to be slow. During the first 10 months of FY 2015, withholding has only increased by approximately 3%. Annual withholding growth has not been above 3.5% since FY 2011.

- Real estate profits. While real estate transactions can also contribute to capital gains, this does not appear to be a significant issue this year. Investment firms purchased numerous single family residences during the Great Recession and then rented them. Their sell-off of these properties could generate substantial profits. Real estate experts, however, have not found evidence of this occurring.

Arizona’s growth in April 2015 income tax collections appears to be part of a wider phenomenon. At the federal level, April IIT collections grew by 19% compared to a year earlier. California saw similar growth as its April IIT revenues increased by 26% over April 2014. These nationwide results lend support to the idea that broader influences – like stock market gains and the low FY 2014 base – play a more significant role in Arizona's gains than local factors.

Corporate Income Taxes

The April corporate gain of 43% was also surprising. CIT collections had been expected to decline by (13)% as previously enacted tax reductions were phased in. This impact, however, may be delayed due to the timing of CIT filing.

The 4-year phase-in of rate reductions and a higher sales factor started with Tax Year (TY) 2014. A business may begin its Tax Year any time between January and December. If a company has a January – December 2014 Tax Year, for example, its TY 2014 state taxes are due in April 2015. The JLBC Staff methodology has been to assume that the first year of the 4-year phase-in would fully occur in FY 2015.

Based on further research and discussions with the Department of Revenue (DOR), however, a majority of the first year impact of the phase-in may not occur until FY 2016. Many large corporations receive a 6-month extension to file their returns. If their Tax Years run concurrent with the calendar year, their TY 2014 returns will not be filed until October 2015 (FY 2016). To avoid a penalty, corporations must either have made estimated payments equal to their prior year liability or 90% of their current year liability.

While a corporation would reduce its tax bill more quickly if it filed in April than in October, the state tax filing may be largely driven by the much larger federal liability. If there is no incentive to file a federal return sooner, the state may not begin to experience most of the impact of TY 2014 CIT reductions until October 2015 (FY 2016). If a corporation's TY 2014 began after January 2014, the tax reduction revenue loss may occur post-October 2015 and could occur as late as FY 2017.

Forecast Implications

Given the unexpectedly high growth rates, April IIT and CIT collections were $141 million above the enacted budget's General Fund revenue forecast for the month. This gain would be in addition to the $87 million forecast gain for all revenue categories through the end of March. The implicit April year-to-date forecast gain would be the combination of these 2 estimates, or $228 million.

A more accurate year-to-date forecast projection, however, will ultimately depend on the following:

- April results for all non-IIT/CIT revenue categories. These estimates will take several weeks to finalize and will be reported in the May *Monthly Fiscal Highlights*.

- Final results for tax filing season. While almost all of the IIT payments associated with the April 15 tax filing deadline have been deposited to the General Fund, the state will continue to issue IIT refunds through May. The level of May refunds could be greater than in the past. The redesign of the state's IIT return may have increased filing error while taxpayers become accustomed to the forms. As a result, an estimated $69 million in refunds may have been delayed as more returns go through an error resolution process.

These additional pieces of tax information will provide a greater perspective on the actual year-to-date gain, beyond just the April income tax results.

The enacted budget had a projected FY 2015 shortfall of $132 million, as adjusted for the federal tax conformity legislation. The budget required a sufficient transfer of funds from the Budget Stabilization Fund (otherwise known as the Rainy Day Fund) to the General Fund to generate a $12 million ending balance. As a result, the enacted budget presumed a $144 million Budget Stabilization Fund transfer. If the current forecast trend holds, that transfer would no longer be required.

Sustainability of Gains

The additional FY 2015 revenues could also affect the FY 2016 base. This issue, however, will require more analysis to determine how much of the FY 2015 gain is ongoing versus one-time. For example, both capital gains collections as well as the corporate income tax are volatile revenue sources:

- During the last decade, estimated capital gains taxes ranged from a low of $142 million in FY 2010 to a high of $721 million in FY 2006.

- In that same period, corporate income tax hit its peak of $986 million in FY 2007 and fell to $413 million in FY 2010.

In contrast, the state's more stable "core" revenue sources – sales tax and withholding -- remain in slower growth mode. While withholding is only up 3% year to date, the sales tax is slightly better at 4.2%. Permanent revenue growth is more dependable if anchored in these sources rather than by capital gains and corporate collections.

The challenge moving forward will be to determine how much of the FY 2015 growth in these latter categories is sustainable and can be counted in the permanent revenue base.

Other Forecast Influences

The passage of time will also provide added perspective on this past week's Gross Domestic Product (GDP) release. In its initial estimate for the first calendar quarter of 2015, the federal Commerce Department estimated that real GDP grew by only 0.2%, compared to 2.2% in the fourth quarter of 2014. There is speculation that the lower-than-expected growth is due to harsh winter weather and the now-resolved West Coast port labor dispute.

There was a similar lull in the first quarter of 2014, when the (2.1)% contraction in GDP was again attributed to inclement weather. The economy, however, eventually recovered and GDP grew by 2.4% for the entire year. While most forecasters see a similar recovery in 2015, the additional data over the next 6 to 9 months will confirm this prognosis. In turn, that information will help determine whether the FY 2015 Arizona income tax gains can be maintained through FY 2016.

The state also faces uncertainty in terms of its spending level as a result of litigation. The primary example is the K-12 inflation lawsuit. In July 2014, the Maricopa Superior Court ruled that the state must "reset" the K-12 per pupil formula amount to adjust for inflation funding that was not provided during FY 2009-FY 2013. This "reset" would translate into increased K-12 spending of $336 million in FY 2016. The March budget did provide $74 million in "extra" per pupil funding over and above normal inflation. If this $74 million is counted toward the reset, the revised cost would be $262 million. The plaintiffs and the state have been in discussions to resolve the litigation.