State Revenue Estimates of Federal Tax Legislation Conformity

If the state conforms to recently enacted federal tax law changes, we estimate that the state would generate $133.5 million in FY 2019 state General Fund revenue. This estimate, however, is highly speculative. The state already does not conform with several federal tax laws. Our analysis assumes that we continue to decouple from those existing provisions.

Federal Tax Legislation

- The federal tax legislation enacted on December 22, 2017 includes over 100 provisions and represents the largest revision to the Internal Revenue Code (IRC) in more than 30 years. Many provisions were effective January 1, 2018 and sunset January 1, 2026.
- Federal estimates suggest the law will reduce federal tax revenues by $(1.5) trillion over a decade. This overall reduction is primarily achieved by lowering federal individual and corporate income tax rates. A portion of the revenue loss from lower rates is offset by added revenue from expanding the overall base of income subject to tax.
- The state revenue impact will depend on the extent that Arizona chooses to conform to federal changes.

Conformity

- For purposes of calculating state individual and corporate income taxes, Arizona must annually decide whether to conform with any changes in the federal tax code during the prior year. With some exceptions, Arizona currently conforms to the federal IRC in effect January 1, 2017.
- Arizona tax statutes use IRC definitions of federal adjusted gross income and federal taxable income as the starting point for calculating individual and corporate income tax liability, respectively. The state additionally conforms to most IRC definitions of Individual Income Tax itemized deductions. Conforming to the recently expanded federal income tax base would similarly increase the state's income tax base and revenues.
- Arizona tax rates are set in statute and do not equal federal tax rates. As a result, reductions to federal income tax rates will not result in a state conformity impact.
- To conform, the state would need to enact new legislation by referencing the IRC in effect after the passage of federal tax changes.
    - The Arizona Legislative Council has issued guidance that indicates conformity legislation that increases state revenues is not subject to the two-thirds voting requirement under Proposition 108. The policy decisions resulting in revenue increases are argued to be made at the federal level while conformity represents the state’s passive adoption of those policies. If the state increases its revenues by "deconforming", however, those provisions would be subject to Proposition 108.

Estimated Impact

- Conforming to the recent federal tax legislation is estimated to result in a $133.5 million net increase to state General Fund revenues in FY 2019. *Attachment 1* of this report displays estimates by conformity provision. The official federal scoring of the bill separates the provisions affecting individuals versus businesses. Our analysis provides the same delineation for consistency. The individual/business split does not equate exactly to individual and corporate income taxes. Some businesses are "pass-through" entities in which business income is "passed through" and reported as taxable income on the individual income tax form.

State Conformity Revenue Estimates by Federal Provision

#	Provision 1/	Changes to Federal Law	Tax	Effective	General Fund Impact ($ in Millions) FY 2019 2/	Source
BUSINESS PROVISIONS CONTINUED						
28	Repeal technical termination of partnerships	• Repeals a rule that automatically terminates and reforms a partnership when 50% or more of ownership is sold.	IIT	TY 2018 and after	$ 0.4	JCT prorated 4/
29	Treatment of qualified equity grants	• Permits certain employees to defer income associated with stock transferred from the employer until the stock is considered tradable. Employers may not deduct any withholding associated with the deferred income until the employee is taxed on the amount.	IIT/CIT	TY 2018 and after	$ (0.3)	JCT prorated 7/
30	Require separate calculations of unrelated business income tax	• Gross income that is unrelated to the primary purposes of tax-exempt organizations under 501(a) is subject to the unrelated business income tax. Such income is taxed at the highest corporate tax rate. • The legislation requires that unrelated business income tax is calculated separately for each unrelated business in order to prevent losses being used to offset income in another unrelated business.	UBIT/CIT	TY 2018 and after	$ 0.3	JCT prorated 7/
31	Revision to exclusion of contributions to capital	• Repeals exclusion of contributions to capital by a government or civic group that is not in exchange for stock in the corporation.	CIT/IIT	TY 2018 and after	$ 0.2	JCT prorated 7/
32	Modify definitions of certain property for depreciation purposes	• Under federal legislation, qualified restaurant and retail improvement property are considered qualified improvement property subject to a 15-year recovery period.	CIT/IIT	TY 2018 and after	$ (0.2)	JCT prorated 7/
33	Repeal deduction of local lobbying expenses	• Repeals current deduction for lobbying expenses in connection with local government legislation.	CIT/IIT	December 22, 2017	$ 0.1	JCT prorated 7/
34	Modifications that effectively expand interest deduction for craft beverage makers	• Previously, interest paid by craft beverage producers could not be deducted during the production/aging period and must instead be incorporated into the value of inventory or other property. The legislation permits the interest expenses to be deducted during the production period.	CIT/IIT	TY 2018 and TY 2019	Minimal -	JLBC
35	Eliminate deduction for living expenses of members of Congress	• Eliminates the $3,000 a year deduction of living expenses incurred by members of Congress while traveling outside their district.	IIT	TY 2018 and after	Minimal +	JCT prorated 4/
36	Deny deduction of settlement payments for sexual harassment	• Prevents businesses from deducting expenses associated with settlement of sexual harassment or abuse allegations, when the settlement is subject to a non-disclosure agreement.	CIT/IIT	Date of enactment	Minimal +	JCT prorated 7/
37	Expands definition of qualifying beneficiaries of an electing small business trust	• Expands definition of beneficiaries of electing small business trusts that hold shares of S corporations to include non-citizens.	IIT	TY 2018 and after	Minimal -	JCT prorated 4/
38	Shorten depreciation schedule for farm property	• Reduces the number of years that certain farm equipment may be depreciated, from 7 to 5 years.	IIT/CIT	TY 2018 and after	Minimal -	JCT prorated 4/
39	Expands deduction for replacing damaged citrus plants	• Extends a deduction for costs of replacing damaged citrus plans to passive owners with at least a 50% stake in the business or to new owners that purchase an affected farm.	IIT/CIT	TY 2018 to TY 2027	Minimal -	JCT prorated 4/

State Conformity Revenue Estimates by Federal Provision

#	Provision 1/	Changes to Federal Law	Tax	Effective	General Fund Impact ($ in Millions) FY 2019 2/	Source
BUSINESS PROVISIONS CONTINUED						
40	Requires research and experimentation expenses to be depreciated over 5 years	• Currently, companies may deduct certain research and experimentation costs in the year of expense or depreciate the investment over time. • For research and experimentation expenses after 2022, repeals the option for full first year expensing and requires expenses to be depreciated over 5 years.	CIT/IIT	TY 2022 and after	-	JCT prorated 7/
	SUBTOTAL: BUSINESS PROVISIONS				**$ (40.4)**	
	TOTAL: INDIVIDUAL AND BUSINESS PROVISIONS				**$ 133.5**	

1/ Some provisions listed in this report are not listed in DOR's conformity report. The JLBC Staff is confirming with DOR whether any provisions listed in this table do not represent a conformity issue. If it is determined that some provisions materially affect our estimates, this report will be revised accordingly.

2/ The first full year of impact for most provisions will occur in FY 2019, though the initial impact of many provisions may begin in FY 2018. The impact of some provisions begins after FY 2019. The chart also includes the following estimates:
a) "Minimal +" = minimal revenue increase
b) "Minimal -" = minimal revenue decrease

3/ Using an individual income tax simulation model, DOR estimates that changes to itemized deductions under provision 1 would increase state revenues by a total of $170.8 million in FY 2019. The agency's estimate does not incorporate an exclusion provided for business taxes in calculating allowable deductions of state and local taxes under federal reforms. The JLBC Staff has reduced DOR's estimates by $(17.0) million to incorporate this exclusion. To produce a more cautious estimate, the results were further reduced (10)%. We have requested that DOR separately estimate the impact of major itemized deduction provisions.

4/ Arizona prorated estimate is 0.26% of FFY 2019 nationwide federal revenue estimate prepared by the Congressional Joint Committee on Taxation. The state share is the ratio of state/federal individual income tax liability (TY 2015 data). Estimates derived from this proration method are speculative. To produce a more cautious estimate, negative revenue impacts were increased 25% while positive impacts were reduced 25%.

5/ DOR reports in their FY 2013/2014 tax expenditure report that the moving expense subtraction reduced General Fund revenues by $(1.3) million in TY 2012. The average growth in subtractions was 10.5% from TY 2007 to TY 2012. The JLBC Staff grew DOR's TY 2012 estimate to TY 2018, assuming a 10.5% annual growth rate.

6/ Estimate is based on prior-year staff estimates that increasing the bonus depreciation allowance for individual taxpayers to 50% of qualifying investments would reduce revenues by $(18.0) million. The JLBC Staff assumes that further increasing the allowance for bonus depreciation to 100% would further reduce state revenues by $(18.0) million. To produce a more cautious estimate, this negative revenue impact was increased 25%.

7/ Arizona prorated estimate is 0.12% of FFY 2019 nationwide federal revenue estimate prepared by the Congressional Joint Committee on Taxation. The state share is the ratio of state/federal corporate income tax liability (TY 2013 data; adjusted for subsequent Arizona corporate income tax rate reductions). Estimates derived from this proration method are speculative. To produce a more cautious estimate, negative revenue impacts were increased 25% while positive impacts were reduced 25%.

Attachment 2

DOR and JLBC Conformity Estimates by Major Provision

Federal Provision	FY 2019 General Fund Impact ($ in Millions) DOR	JLBC 1/	DOR - JLBC
INDIVIDUAL PROVISIONS			
Repeal or modify select itemized deductions (primarily $10,000 cap on state and local taxes deduction and repeal of miscellaneous expenses deduction)	$ 170.8	$ 138.4 2/	$ 32.4
Limit pass through of a business loss to offset other individual income	52.5	31.6	20.9
Repeal subtraction of unreimbursed moving expenses	2.8	1.7	1.1
Repeal exclusion of employer-reimbursed moving expenses	2.0	1.2	0.8
Repeal subtraction of alimony payments made and provide exclusion of alimony payments received from income	0.2	0.2	0.0
Other Individual Provisions	NA	0.8	(0.8)
SUBTOTAL: INDIVIDUAL PROVISIONS	**$ 228.4**	**$ 173.9**	**$ 54.4**
BUSINESS PROVISIONS			
Expand eligibility of small businesses to use simplified cash accounting	$ (14.6)	$ (24.4)	$ 9.8
Increase business expensing allowance	(12.1)	(24.1)	12.0
Increase bonus depreciation allowance	(27.4)	(22.5)	(4.9)
Limit interest expense deduction to 30% of earnings	30.1	16.5	13.6
Repeal deduction for domestic production activities	13.5	8.3	5.2
Limit net operating loss deduction	6.7	3.9	2.8
Repeal deductions for expenses of certain fringe benefits	6.5	3.5	3.0
Modify treatment of S corporation conversions to C corporations	(0.7)	(1.6)	0.9
Other Business Provisions	5.9	-	5.9
SUBTOTAL: BUSINESS PROVISIONS	**$ 7.8**	**$ (40.4)**	**$ 48.3**
TOTAL INDIVIDUAL AND BUSINESS PROVISIONS	**$ 236.2**	**$ 133.5**	**$ 102.7**

1/ Due to uncertainty about the accuracy of estimated impacts, initial calculations made by the JLBC Staff were adjusted to produce more cautious estimates. Except where otherwise noted, negative revenue estimates were increased 25% while positive estimates were reduced 25% from initial JLBC Staff estimates.

2/ The JLBC Staff estimate adopts the Department of Revenue (DOR) amount, but makes adjustments to incorporate a provision not estimated by the agency's tax simulation model for state and local tax deductions. The modified estimate was then reduced 10% to recognize the uncertainty involved in projecting FY 2019 impacts using TY 2014 taxpayer data.