Joint Legislative Budget Committee
Staff Memorandum

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DATE: June 19, 2019

TO: Senator Vince Leach

FROM: Hans Olofsson, Chief Economist
Sam Beres, Fiscal Analyst

SUBJECT: HB 2757 (TAX PROVISIONS; OMNIBUS)

This memo is in response to your request for a fiscal analysis of HB 2757, as enacted, which makes the following changes to the individual income tax, corporate income tax, and transaction privilege tax (TPT) codes:

- Conforms Arizona income tax statutes to federal tax law changes under the federal Tax Cuts and Jobs Act for tax year (TY) 2018 and TY 2019.
- Adopts new provisions, effective October 1, 2019, which allow Arizona to begin collecting TPT from out-of-state retailers in response to the 2018 landmark decision by the United States Supreme Court in *South Dakota v. Wayfair Inc.*
- Enacts other changes to the state individual income tax code to offset additional revenues generated by conformity and Wayfair, beginning in TY 2019.

These changes are described in greater detail in the *Analysis* section, below.

Estimated Impact

The JLBC Staff estimates that the bill will increase General Fund revenue by $155.0 million in FY 2019 due to conformity to the federal tax code for TY 2018. In future tax years, the state will gain additional revenue from both conformity and Wayfair, which will be offset by other tax law changes. In FY 2020, the bill is expected to reduce General Fund Revenue by $(52.0) million. In each year thereafter, the bill will reduce General Fund revenue by $(24.0) million. The estimated impact of the bill by fiscal year is summarized in *Table 1.*

These estimates are based on a Department of Revenue (DOR) individual income tax model, as well as national estimates that have been prorated to reflect Arizona's share of the economy. Estimates derived from either source are speculative.

Analysis

As stated above, the JLBC Staff estimates that HB 2757 will reduce General Fund revenues by $(24.0) million on an ongoing basis. The estimated ongoing fiscal impact of each provision of the bill is displayed in *Table 2.*

<u>Internal Revenue Code Conformity</u>
The federal Tax Cuts and Jobs Act (TCJA) 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 became effective January 1, 2018 and sunset January 1, 2026. In part, the state tax code is tied to the federal tax code. For example, Arizona uses the federal definition of income for calculating state individual and corporate income taxes.

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Table 1

HB 2757 Revenue Impact Summary
($ in Millions)

FY 2019	**Impact**
Conformity	$155.0
Total	**155.0**
FY 2020	
Conformity	$217.0
Wayfair 1/	57.0
Other Tax Law changes	(326.0)
Total	**(52.0)**
FY 2021	
Conformity	$217.0
Wayfair	85.0
Other Tax Law changes	(326.0)
Total	**$(24.0)**

1/ Due to the effective date of the Wayfair provisions, FY 2020 revenues are expected to only represent a portion of the full $85 million of new revenue expected due to Wayfair

Table 2

HB 2757 Ongoing Revenue Impact
($ in Millions)

Revenue Additions	**Impact**
Conformity	$217.0
Wayfair	85.0
Eliminate Personal/Dependent Exemptions	353.9
Eliminate Lottery Winning Subtraction	0.1
Total, Additional Revenue	**$656.0**
Revenue Subtractions	
Increase Standard Deduction	$(404.0)
Dependent Tax Credit	(144.0)
Bracket/Rate Reduction	(108.0)
25% Charitable Deduction	(24.0)
Total, Reduced Revenue	**($680.0)**
Net Ongoing Impact	**($24.0)**

The JLBC Staff estimates that conforming to these changes will generate $155.0 million of additional General Fund revenue in FY 2019 and $217.0 million in each year thereafter. These estimates used the following sources:

- **Department of Revenue Tax Simulation Model**: DOR utilizes a tax simulation model, which is currently based on actual Arizona tax returns from tax year 2015, to simulate the impact of tax law changes. The results from this model are then adjusted by DOR for tax liability growth to represent the current tax year. The JLBC Staff utilized these estimates where available and reduced the DOR model estimates by 10% to reflect uncertainty. Not all provisions of TCJA can be modeled by DOR.

- **Prorated national estimates:** The federal Joint Committee on Taxation (JCT) produced national estimates for each of the provisions included in the TCJA. In instances where the DOR model could not simulate the impact of a specific provision, the JLBC Staff relied on prorating the JCT's national estimates to reflect an Arizona impact. For each of these provisions, we reduced the prorated national estimate by 25% to reflect uncertainty.

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For more detail, please see our full Tax Conformity Report published on our website.

Other Income Tax Law Changes

Beginning in FY 2020, the bill makes numerous changes to the individual income tax code in order to offset additional revenues generated by conformity and Wayfair. These changes are as follows:

- Reduces the number of individual income tax brackets from 5 to 4, and adjusts the rates as shown in *Table 3.* These changes are expected to reduce General Fund revenues by $(108.0) million.

Table 3

Marginal Income Tax Rate/Bracket Comparison
Single/Married Filing Separately

Brackets – Current	**Rates – TY 2018**	**Brackets – Enacted**	**Rates – TY 2019**
$0 - $10,600	2.59%	$0 - $26,500	2.59%
$10,601 – 26,500	2.88%	Collapsed	2.59%
$26,501 - $53,000	3.36%	$26,501 - $53,000	3.34%
$53,001 - $159,000	4.24%	$53,001 - $159,000	4.17%
$159,001 and over	4.54%	$159,001 and over	4.50%

- Removes the Arizona subtraction for lottery winnings. The elimination of this subtraction is expected to result in a small revenue gain of about $0.1 million.

- Increases the standard deduction to the federal levels as shown in *Table 4,* and indexes it to the same inflation measure used to calculate the federal standard deduction. The increased standard deduction is expected to reduce General Fund revenue by $(404.0) million.

Table 4

Standard Deduction Comparison

Filing Status	**Standard Deduction - Prior Law**	**Standard Deduction - Enacted**
Single/Married Filing Separate	$5,312	$12,200
Single Head of Household	$10,613	$18,300
Married Filing Jointly	$10,613	$24,400

- Eliminates the state personal and dependent exemptions, as shown in *Table 5.* The elimination of these exemptions is expected to increase General Fund revenue by $353.9 million.

Table 5

Eliminated Exemptions

Personal Exemption, No Dependents	$2,200
Personal Exemption, Married with Dependents	$6,600
Dependent Exemption	$2,300

- Allows taxpayers that take the standard deduction to increase their standard deduction by 25% of their charitable contributions that otherwise would have been deductible had they itemized their tax returns. This provision is expected to reduce General Fund revenues by $(24.0) million.

- Establishes a dependent tax credit of $100 for each dependent under 17 years old and $25 for each dependent age 17 and above. This credit is phased out for singles with over $200,000 of adjusted gross income and $400,000 for married couples filing jointly. This credit is expected to reduce General Fund revenue by $(144.0) million.

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The fiscal impact estimates for each of these provisions are based on DOR's individual income tax model, which is described in the *Internal Revenue Code Conformity* section, above.

As a number of the provisions in the bill interact with one-another, scoring the impact of the provisions on an individual basis is challenging. As a result, the estimates for each of the provisions of the bill are approximate.

Wayfair

In June 2018, the United States Supreme Court overruled in *South Dakota v. Wayfair Inc*. a 1992 ruling made by the same court in *Quill Corp v. North Dakota*, which had held that only out-of-state ("remote") businesses with a physical presence ("nexus") inside a state could be required to collect and remit sales tax in that state. As a result of the Wayfair ruling, the physical presence requirement was effectively replaced by an economic nexus requirement.

Beginning October 1, 2019, the bill establishes the economic nexus thresholds under which an out-of-state business is required to collect and remit tax on retail sales in Arizona, which are as follows:

- If the out-of-state business is a remote seller (which means that it does not conduct sales through a marketplace facilitator), economic nexus applies if sales in Arizona exceed $200,000 in calendar year (CY) 2019, $150,000 in CY 2020, and $100,000 in CY 2021 and thereafter.
- If the out-of-state business is a marketplace facilitator, economic nexus applies if sales in Arizona from the marketplace facilitator's own business or on behalf of at least one marketplace seller exceed $100,000 in the calendar year.

Besides establishing the state's economic nexus threshold requirements, the bill also adds new language in state statutes with respect to the municipal tax treatment of retail sales.

Based on our review of 2 different studies, described below, we estimate that the bill's Wayfair provisions will generate approximately $85.0 million in General Fund revenue annually, beginning in FY 2021. Due to the October 1, 2019 effective date, the impact in FY 2020 is estimated to be $57.0 million. This estimate is uncertain, however, and should therefore be interpreted with caution.

(1) Estimate by the U.S. Government Accountability Office (GAO)

In November 2017, GAO released a study, which indicates a potential revenue gain from taxing remote sellers of between $8.5 billion and $13.4 billion. This estimate represents the potential revenue gain in 2017 for all state and local governments nationwide.

GAO prorated its national estimates to produce state-specific estimates, which showed that state and local governments combined could gain an estimated $190 million to $293 million in Arizona. Based on an average combined Arizona state and local sales tax rate of 8.25% in 2017 (as estimated by the Tax Foundation), these figures represent actual sales of $2.30 billion to $3.55 billion on which no sales taxes were collected.

Taxing these sales at a rate of 5%, the state would have received $115 million to $178 million in total collections, of which $85 million to $131 million would have been retained by the General Fund.

The GAO study is comprehensive and includes several different data sources, including the Internet Retailer Top 1,000 Database, Forrester Research and the U.S. Census Bureau. GAO also provides a range of detailed estimates for both Business-to-Consumer (B2C) and Business-to-Business (B2B) remote sales. Due to a number of factors, we believe that the higher end of the GAO range may be overstated.

First, according to the GAO study, most of the potential revenue gain would not come from internet retailers and other remote sellers (such as mail-order companies and call centers) but from third-party sales facilitated by marketplaces. (Marketplace facilitators typically engage both in direct sales of their own products on their online marketplace as well as third-party sales on behalf of other vendors.)

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The authors of the study estimate that taxes on 78% to 86% of direct internet retail sales are already being collected compared to only 14% to 33% on third-party sales through marketplaces.

Table 6 below shows the potential state General Fund revenue gain by type of remote seller. These amounts are based on the prorating of GAO's national estimates by category of remote selling. GAO uses a low and high revenue scenario, which are also reflected in the table below. As displayed in *Table 6*, the prorating of GAO's national estimates indicates that the General Fund would potentially receive $39.0 million to $60.2 million from the taxation of marketplace sales.

The study's authors acknowledged that they had difficulties obtaining data on the extent to which marketplace facilitators, such as Amazon, Etsy, and eBay, currently collect and remit tax from their marketplace sellers. Considering the lack of data on sales tax collections from marketplace sellers and that so much of GAO's estimated revenue gain would come from such sales, we believe that this part of their analysis has the largest potential to overstate the actual impact.

Table 6

Potential General Fund Revenue Gain from Taxing Remote Sellers ($ in Millions)

Type of Remote Seller	Impact Low	Impact High
Business-to-Consumer (B2C):		
Internet Retailers	$32.0	$46.6
Marketplaces	39.0	60.2
Other Remote Sellers	15.0	17.5
Less Consumer Use Tax Compliance	(2.0)	(1.9)
B2C Total	**$84.0**	**$122.3**
Business-to-Business (B2B):		
B2B Sales Less Exemption for Intermediate Goods	$10.0	$28.2
Less Business Use Tax Compliance	(9.0)	(19.4)
B2B Total	**$1.0**	**$8.7**
Total Gain	**$85.0**	**$131.0**

A second reason to interpret GAO's figures cautiously is that their state-derived estimates, including Arizona's, were based on the prorating of national sales figures. Arizona's share of national B2C remote sales was based on the state's share of U.S. disposable personal income (1.8%) while the state's share of national B2B e-commerce and remote sales was based on Arizona's share of the U.S. gross domestic product (1.7%). Thus, to the extent that an out-of-state business' share of sales in Arizona relative to the nation differs from these assumed percentages, the GAO method will produce inaccurate estimates for the state. Therefore, a method based on the prorating of national estimates (as opposed to the use of state-specific data) has the effect of further increasing the uncertainty of the impact.

Third, we have some indications that at least a few out-of-state businesses that did not collect state and local sales taxes in Arizona prior to the *Wayfair* ruling, are voluntarily doing so now. This suggests that insofar as these companies were included in GAO's estimates, the impact would be overstated. We are not able, however, to determine to what extent GAO's estimates would have to be adjusted for such changes following the *Wayfair* ruling.

Fourth, the bill includes a remote seller and marketplace facilitator exemption for out-of-state businesses with sales in Arizona below a certain minimum amount, as described above. The GAO study was not adjusted for a small remote seller exemption. By itself, this factor would overstate their estimates slightly.

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Fifth, some taxpayers (primarily businesses) that currently remit use tax to the state would pay TPT under the bill. Since the state receives 100% of the use tax but only retains 73.8% of retail TPT, there would be some offsetting General Fund revenue loss under the bill, which is not reflected in GAO's estimates.

(2) Estimate by the League of Arizona Cities and Towns
The League of Arizona Cities and Towns estimates that the bill would generate $46.1 million to $82.3 million in state sales tax collections. After adjusting for state sales taxes shared with local governments, the JLBC Staff estimates that the General Fund would retain $34.0 million to $60.7 million.

To produce their estimate, the League used the Internet Retailer Top 1,000 Database, which reportedly account for more than 95% of the nation's e-commerce sales. (As noted earlier, GAO also used this data source along with several other data sources.) The League determined that 563 of the 1,000 remote sellers would be required to start collecting sales tax under the bill. The League then used the national sales data reported for these companies to estimate the amount of sales taxes that would be collected in Arizona under the bill.

As with the GAO study, there were certain data limitations that likely affected the League's estimates. First, the League's estimates were based on the prorating of national data. Specifically, the League apportioned sales to Arizona based on the state's share of the U.S. population (2.16%). Second, the sales figures reported for the top 1,000 remote sellers were not exact figures but rather ranges (between a lower and upper bound), which could result in further forecast errors. Third, the League's analysis did not specifically address other forms of remote sales, such as marketplace sellers, mail orders, call centers, or B2B e-commerce. Such sales could be at least partially included in their estimates, however, since many of these companies also provide sales over the internet.

Local Government Impact

Conformity and Other Income Tax Law Changes
Incorporated cities and towns and cities receive 15% of state income tax collections from 2 years prior from the Urban Revenue Sharing Fund (URSF) established by A.R.S. § 43-206. As a result of the bill, income tax collections are expected to increase by $155.0 million in FY 2019, and decrease by $(109.0) million in FY 2020 and each year thereafter. Therefore, the bill would increase URSF distributions to cities and towns by an estimated $23.2 million in FY 2021 and decrease URSF distributions by an estimated $(16.3) million in each year thereafter.

Wayfair
Under current law, incorporated cities and towns receive 10% of state TPT levied on retail sales. Since the bill is estimated to generate $115 million in total state TPT annually, beginning in FY 2021, municipalities are expected to receive 10% of this amount, or $11.5 million, beginning in FY 2021. Due to the October 1, 2019 effective date, the distributions to cities and towns are estimated to be $7.7 million in FY 2020. We have not attempted to estimate the impact on municipal taxes.

Under current law, counties receive 16.2% of state TPT levied on retail sales. Since the bill is estimated to generate $115 million in total state TPT annually, beginning in FY 2021, counties are expected to receive 16.2% of this amount, or $18.7 million, beginning in FY 2021. Due to the October 1, 2019 effective date, the distributions to counties are estimated to be $12.5 million in FY 2020. These estimates exclude the impact of Wayfair on county excise taxes.

Summary of HB 2757 Local Impacts
The fiscal impact of the bill on local governments with respect to state-shared revenue is summarized in *Table 7,* below.

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Table 7

HB 2757 Local Government Impact
($ in Millions)

	FY 2020	FY 2021	FY 2022
Incorporated Cities and Towns			
Wayfair	7.7	11.5	11.5
Conformity	0.0	23.2	(16.3)
Total	**7.7**	**34.7**	**(4.8)**
Counties			
Wayfair	12.5	18.7	18.7
Total, Local Governments	**20.2**	**53.4**	**13.9**

HO/SB:kp