Fiscal Note

BILL # SB 1143 **TITLE:** conformity; internal revenue code; rates

SPONSOR: Mesnard **STATUS:** As Introduced

PREPARED BY: Sam Beres

Description

This bill would do the following:

- Conform Arizona's tax code to the 2018 Federal Internal Revenue Code for tax year 2018.
- Reduce each marginal individual income tax rate by 0.11 percentage points for tax year 2018.
- Both changes would only be effective for tax year 2018. In subsequent years, Arizona would conform to the 2017 Internal Revenue Code, and the reduction to the individual income tax rates would be reversed.

Estimated Impact

The bill would result in an estimated one-time General Fund revenue decrease of $(2) million. The intent of the rate reduction is to fully offset the revenue generated from conformity. Eliminating the $(2) million revenue loss would require that each new tax rate have 3 or more decimal points, while the current tax system is based on 2 decimal point tax rates.

The JLBC Staff estimates that simply conforming to recent federal tax law changes would generate additional General Fund revenues of $155 million, while the bill's corresponding temporary tax cut would reduce revenues by $(157) million.

The $155 million simple conformity estimate is higher than the JLBC Staff's prior $133 million projection due to recent Department of Revenue (DOR) model revisions.

These changes are effective only for tax year 2018. Most of the impact will occur in FY 2019, but some will occur in FY 2020 for individuals and entities filing extended returns.

Based on our prior 2018 analysis, DOR's conformity estimate was approximately $100 million higher than the JLBC Staff's ($236 million vs. $133 million). We believe that the differential would remain under SB 1143.

Analysis

Internal Revenue Code Conformity

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.

The JLBC Staff had previously estimated that conforming to these changes would generate $133 million of additional General Fund revenues in FY 2019. This estimate used the following sources:

- **Department of Revenue Tax Simulation Model:** DOR utilizes a tax simulation model, which was based on actual Arizona tax returns from tax year 2014, 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.

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- **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.

DOR has updated its tax simulation model in the last week, which now uses tax returns from tax year 2015 (rather than tax year 2014) to simulate the impact of tax law changes. The more recent model projections increased DOR's estimate for the revenue gains associated with conforming by $24 million. As a result of this updated model run, we have increased our own conformity estimate. After discounting this increase by 10% to reflect uncertainty, the overall JLBC Staff estimate for conformity increased by $22 million, or from $133 million to $155 million.

This $155 million estimate reflects a net impact on all taxpayers. Of this amount, $195 million of additional revenues would be generated from individuals, while businesses would pay an estimated $(40) million less.

For more detail, please see our full tax conformity report published on our website. As discussed above, recent changes to DOR's tax simulation model have resulted in our staff updating our conformity revenue estimate. Our staff is currently working to update this report, which does not yet reflect the recent changes.

Tax Rate Reduction

The bill would temporarily reduce each marginal individual income tax rate by 0.11 percentage points for tax year 2018. These adjusted tax rates can be seen in Table 1.

Table 1

Marginal Income Tax Rates

Taxable Income (Married Filing Jointly/Head of Household)	**Rates** Current Law	SB 1143
$0 - 21,202	2.59%	2.48%
21,203 - 53,000	2.88%	2.77%
53,001 - 105,998	3.36%	3.25%
105,999 - 317,990	4.24%	4.13%
317,991 and Over	4.54%	4.43%

To estimate the impact of this temporary rate cut, the JLBC Staff relied on the DOR tax simulation model. Based on the model run, the estimated revenue impact would be a $(157) million revenue loss in FY 2019. This revenue would offset $155 million in revenue gains associated with conformity, for a net impact of a $(2) million revenue reduction.

Local Government Impact

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. The bill therefore would reduce URSF distributions to cities and towns by an estimated $(300,000) in FY 2021.