Fiscal Note

BILL # HB 2778

TITLE: taxation; omnibus

SPONSOR: Toma

STATUS: As Introduced

PREPARED BY: Hans Olofsson

Description

HB 2778, as introduced, would make several changes to individual and corporate income taxes. In addition, the bill would also repeal the Highway Safety Fee, beginning January 1, 2021. Please see attached detail for more information on the bill's provisions.

Estimated Impact

As shown in the table below, HB 2778 is estimated to have a General Fund cost of $161.8 million in FY 2021, $124.3 million in FY 2022, and $128.4 million in FY 2023.

General Fund Impact of HB 2778 [$ Millions]

Description of Provision	Tax	FY 2021	FY 2022	FY 2023
1) Repeals annual Highway Safety Fee as of January 1, 2021	Other	$(15.5)	$0.0	$0.0
2) Reduces marginal income tax rates from a range of 2.59% to 4.50% to a range of 2.53% to 4.45%, beginning in TY 2020	Individual Income	(100.0)	(100.0)	(100.0)
3) Exempts 50% of income attributable to long-term capital gains from assets acquired after December 31, 2019	Individual Income	0.0	(9.3)	(17.5)
4) Indexes to inflation the percentage of charitable contributions eligible for the additional standard deduction, beginning in TY 2020	Individual Income	(2.1)	(4.2)	(6.3)
5) Conforms state statutes to the federal bonus depreciation allowance for C Corporations, beginning in TY 2020	Corporate Income	(44.2)	(10.8)	(4.6)
Total General Fund Impact		**$(161.8)**	**$(124.3)**	**$(128.4)**

Description of Provisions in HB 2778

1) Repeal of Annual Highway Safety Fee

Laws 2018, Chapter 265 established a new highway safety fee charged on vehicle registrations. The highway safety fee, set at $32 per vehicle, went into effect January 1, 2019. Laws 2019, Chapter 268 eliminates the highway safety fee on July 1, 2021. The bill would repeal the highway safety fee on January 1, 2021, or 6 months earlier than under current law. The highway safety fee is primarily used to finance the Department of Public Safety's (DPS) highway patrol budget. However, a portion of the "excess revenue" in the Highway Patrol Fund that was scheduled to be transferred to the General Fund in FY 2021 would not occur as a result of the early repeal of the highway safety fee. Relative to the Baseline, this change is estimated to result in a General Fund revenue loss of $(15.5) million in FY 2021.

(Continued)

The highway safety fee has generated more revenue than anticipated. Given a higher annual revenue estimate, the early repeal of the highway safety fee would eliminate $108.5 million in highway safety fee revenue used to fund DPS Highway Patrol in FY 2021. The DPS Highway Patrol budget has $194.1 million in ongoing commitments in FY 2021. In December 2020, the anticipated Highway Patrol fund balance is approximately $74.8 million, which can be used to offset the loss of highway safety fee revenue for DPS Highway Patrol. Utilizing the balance in the Highway Patrol Fund, the revenues generated from the Highway Patrol Fund, along with eliminating the transfer to the General Fund, would cover the entire loss of Highway Safety Fee for DPS Highway Patrol in FY 2021.

2) Reduce Marginal Income Tax Rates

The bill would reduce each marginal individual income tax rate by (0.05) to (0.06) percentage points, beginning in TY 2020. Existing income tax brackets would be retained. Based on the Department of Revenue's (DOR) individual income tax microsimulation model, the rate reduction is estimated to reduce individual income tax collections by $(100.0) million annually, beginning in FY 2021. The tables below compare current marginal tax rates to those provided under the bill, by filing status.

Marginal Income Tax Rate Comparison - Single and Married Filing Separate Filers

Taxable Income	Tax Rates – Current Law	Tax Rates – HB 2778
$0 - $26,500	2.59%	2.53%
$26,501 - $53,000	3.34%	3.28%
$53,301 - $159,000	4.17%	4.11%
$159,001 and over	4.50%	4.45%

Marginal Income Tax Rate Comparison - Married Filing Joint and Head of Household Filers

Taxable Income	Tax Rates – Current Law	Tax Rates – HB 2778
$0 - $53,000	2.59%	2.53%
$53,001 - $106,000	3.34%	3.28%
$106,001 - $318,000	4.17%	4.11%
$318,001 and over	4.50%	4.45%

3) Exempt 50% of Long-Term Capital Gains on Assets Acquired after 12/31/2019 from Individual Income Tax

Under current law, 25% of long-term net capital gains derived from assets acquired after December 31, 2011 is exempt from the state individual income tax. The bill would increase the long-term capital gains exemption from 25% to 50% on assets acquired after December 31, 2019. This means that relative to current law, the bill would provide an additional capital gains subtraction of 25% on assets acquired after 2019.

As an example, an asset acquired in 2020 and sold at gain in 2022 would essentially qualify for both the 25% subtraction allowed under current law and the additional 25% provided under the bill, for a total capital gains subtraction of 50%. By contrast, if the same asset was purchased in 2018 instead, and sold at gain in 2022, it would only qualify for the current 25% capital gains reduction.

The current capital gains exemption that applies to assets acquired after December 31, 2011 was phased in over 3 years, such that it allowed a 10% subtraction in TY 2013, followed by a 20% subtraction in TY 2014, and 25% subtraction in TY 2015 and subsequent years. Data provided by the Department of Revenue (DOR) indicates that the 10% subtraction provided in TY 2013 reduced General Fund revenue by $(2.6) million, whereas the 20% reduction in TY 2014 resulted in a

(Continued)

revenue loss of $(11.3) million. When the 25% subtraction was fully phased in the following year (TY 2015), the revenue impact was $(16.8) million. Thus, if the 25% subtraction had been in place in TY 2013 and TY 2014, the revenue impact would instead have been $(6.6) million in FY 2014 and $(14.1) million in FY 2015. Our analysis assumes a similar "impact trajectory" under the bill's additional 25% capital gains subtraction. However, since the level of capital gains is significantly higher now than in the period from TY 2013 through TY 2015, we have estimated the additional revenue loss under the bill to be $(9.3) million in FY 2022 and $(17.5) million in FY 2023. The revenue loss under the bill would continue to grow in the following years.

(As a technical note, the provision would have no revenue impact until FY 2022 as assets acquired in 2020 must be held for at least 1 year to qualify as long-term capital gains and to gain the additional 25% subtraction. As an example, an asset purchased in June 2020 and sold at gain in September 2021 would qualify as long-term capital gain on the individual's TY 2021 tax return. This return would be filed in the spring of 2022 and therefore the capital gains subtraction would not affect General Fund revenue until FY 2022.)

4) Inflation-Indexing of the Percentage of Charitable Contributions Eligible for Additional Standard Deduction

Under current law, state individual income tax filers who elect to use the standard deduction rather than itemized deductions are allowed to deduct 25% of their charitable contributions from their taxable income. Under the bill, the percentage of charitable contributions allowed to be deducted would be indexed to the Metropolitan Phoenix consumer price index (CPI). The inflation adjustment would be raised to the nearest whole percent. The adjusted charitable contribution percentage would not be allowed to increase in excess of 100%.

The average annual CPI increase over the last 5 years is 2.3%. Our analysis assumes the same rate of inflation over the next few years. Under the bill, the 2.3% expected inflation rate would be rounded up to the nearest whole percent, which is 3.0%. While it is unclear from the current language in the bill whether the inflation adjustment of the charitable contribution percentage is additive or multiplicative (meaning, whether the current 25% charitable contribution percentage would be increased by 3 percentage points to 28% or multiplied by a factor of 1.03 to 25.75%), our analysis currently assumes that it is additive, as this is the stated intent of this provision. Therefore, under the bill, 28% of charitable contributions would be eligible for the additional standard deduction in TY 2020. The deduction percentages are assumed to increase to 31% in TY 2021 and 34% in TY 2022. This provision is estimated to reduce individual income tax revenue by $(2.1) million in FY 2021, $(4.2) million in FY 2022, and $(6.3) million in FY 2023. The derivation of our estimate is described below.

Taxpayers Who Take the Standard Deduction

Laws 2019, Chapter 273 permitted taxpayers taking the standard deduction to deduct their charitable contributions as well for the first time in TY 2019. Chapter 273 limited the deduction to 25% of their charitable contributions. For tax filers who used the standard deduction prior to Chapter 273, the JLBC Staff estimated last year that the additional 25% deduction for charitable contributions will reduce revenues by $(5.9) million in FY 2020. The revenue impact for other filers, including those that switched from itemized deductions to the standard deduction owing to the doubling of the standard deduction amount under Chapter 273, as well as those filers that switched specifically due to the 25% deduction, was estimated to be $(18.1) million. Therefore, the total impact for this provision in Chapter 273 was estimated to be $(24.0) million in FY 2020.

Since tax filing is only now beginning for TY 2019, we do not have any data on the actual impact of Chapter 273. As a result, this fiscal memo relies on the same methodology as last year. As noted above, at that time, the 25% deduction was estimated to result in a revenue loss of $(5.9) million for filers already claiming the standard deduction.

Assuming a proportional increase, adding 3% (to a total of 28% of charitable deductions in TY 2020, 31% in TY 2021, and 34% in TY 2022) is therefore expected to have a revenue loss of another $(0.7) million in FY 2021, $(1.4) million in FY 2022, and $(2.1) million in FY 2023. These estimates reflect the subset of approximately 2.1 million filers that used the standard deduction before it was doubled following the enactment of Chapter 273.

Due to the doubling of the standard deduction, beginning in TY 2019, many state income tax filers are expected to switch from itemized deductions to the new and higher standard deduction amount under Chapter 273. While the exact number of state filers that will switch from itemized deductions to the standard deduction is not currently known, some

(Continued)

inferences may be drawn from federal filers for TY 2018, the first year under which the doubled federal standard deduction amount was in effect. While the Internal Revenue Service (IRS) has not yet published TY 2018 tax filing data, microsimulations of tax-filing data by the Tax Policy Center and the Tax Foundation suggest that the share of itemized filers declined from 30% to 10% (or conversely, the share of filers using the standard deduction increased from 70% to 90%).

Assuming that state filing behavior for TY 2019 is similar to the federal filing behavior for TY 2018, we estimate that 20% of state filers, or approximately 600,000 filers, will switch from itemized deductions to the standard deduction during the current TY 2019 tax-filing season. Based on aggregate federal tax-filing data, we expect that most of these "switchers" have a federal adjusted gross income of about $150,000 or less. Using the same data source, we estimate that they made charitable contributions of $1.14 billion. For the purpose of this analysis, we have assumed the same level of charitable donations for this subset of filers under the bill. Under this set of assumptions, the revenue loss for this subset of filers would be an estimated $(1.1) million [$1.14 billion charitable donations x (28% - 25%) x 3.29% effective tax rate] in FY 2021. The revenue loss in FY 2022 and FY 2023 would be an estimated $(2.2) million and $(3.3) million, respectively.

Taxpayers Who Currently Itemize
Under the bill, a select group of taxpayers may find it advantageous to switch from itemization to the standard deduction for the first time in TY 2020. To estimate the revenue reduction resulting from such change in filing behavior, we typically rely on DOR's individual income tax model. To date, DOR has not provided any estimate of this provision in HB 2778. For this reason, we prorated the estimate from a similar tax policy change generated by DOR's model for doubling the deduction allowance from 25% to 50% of charitable contributions.

DOR's model showed a revenue impact of $(2.3) million for taxpayers who would switch from itemized deductions to the standard deduction as a result of increasing the threshold from 25% to 50%. To obtain an estimate of this provision for the subset of taxpayers who would switch to the standard deduction as a result of the changes under this bill, we prorated DOR's $(2.3) million estimate. This method generated an estimated revenue impact of $(0.3) million in FY 2021, $(0.6) million in FY 2022, and $(0.9) million in FY 2023.

In summary, the impact is as follows.

Revenue Impact of Inflation-Indexing of Charitable Contribution Percentage

Tax Filers	FY 2021	$ Millions FY 2022	FY 2023
Pre-TY 2019 Standard Deduction Filers	$(0.7)	$(1.4)	$(2.1)
New Standard Deduction Filers Attributable to Laws 2019, Ch. 273	(1.1)	(2.2)	(3.3)
New Standard Deduction Filers Attributable to HB 2778	(0.3)	(0.6)	(0.9)
Total General Fund Revenue Impact	**$(2.1)**	**$(4.2)**	**$(6.3)**

Given the rounded annual inflation increase of 3%, we estimate the General Fund impact to increase by $(2.1) million for each subsequent fiscal year.

5) Allow Bonus Depreciation for Corporations
The bill would conform state statutes to federal bonus depreciation allowance for C corporations, beginning in TY 2020. Under current law, the federal bonus depreciation deduction is limited to individual income tax filers, such as shareholders of S corporations or partners in Limited Liability Companies.

The federal Tax Cuts and Jobs Act (TCJA) was enacted in December 2017. TCJA increased the bonus depreciation allowance from 40% to 100% in TY 2018, from 30% to 100% in TY 2019, and from 0% to 100% in TY 2020 through TY 2022. Beginning in TY 2023, the bonus depreciation allowance is reduced by 20% each year until it decreases to 0% in TY 2027.

(Continued)

Based on the prorating of federal revenue estimates published by the federal Joint Committee on Taxation (JCT), we estimate that conforming state statutes to the federal bonus depreciation allowed under TCJA would reduce state corporate income tax revenues by $(44.2) million in FY 2021, $(10.8) million in FY 2022, and $(4.6) million in FY 2023.

Finally, we would note that our analysis does not reflect any potential behavioral responses of businesses and individuals to the changes under the bill. For example, all else equal, a decrease of individual and corporate income taxes can serve as an incentive for businesses to employ more capital and labor, and individuals, to spend and invest more than they would otherwise. Such "dynamic" effects may result in an increase in economic output, which in turn may generate more tax revenue dollars for the state General Fund than what a "static" analysis assumes.

2/11/20