

Fiscal Note

BILL # HB 2113

TITLE: charitable contribution; deduction; inflation adjustment

SPONSOR: Bolick

STATUS: As Introduced

PREPARED BY: Benjamin Newcomb

Description

The bill would increase the percentage of charitable contributions allowed to be deducted by indexing the deduction to the Metropolitan Phoenix's consumer price index (CPI), as determined by the Bureau of Labor Statistics (BLS). This change would become effective in tax year (TY) 2022.

Estimated Impact

We estimate that this bill would result in a General Fund revenue loss of \$(2.0) million in FY 2023 and \$(3.9) million in FY 2024. These estimates represent the amount of additional deductions that could be claimed in TY 2022 and TY 2023 by those who use the standard deduction as well as the cost from itemizers who shift to the standard deduction. As with any indexing proposal, the impact would continue to grow beyond FY 2024 relative to the current Baseline.

Due to uncertainty regarding the overall level of charitable donations as well as the change in tax-filing behavior following the enactment of Laws 2019, Chapter 273, this estimate should be viewed as speculative.

As of publication, the Department of Revenue (DOR) has not yet provided an estimate of HB 2113.

Analysis

Under current law, Arizona individual income taxpayers are eligible to deduct 25% of their charitable contributions. The bill would index Arizona's charitable contribution deduction to Metropolitan Phoenix's CPI, as determined by BLS. The inflation amount is to be rounded upward to the nearest whole percent. Based on data from BLS, inflation for Metro Phoenix has averaged 2.6% over the past 5 years.

Based on the interpretation of similar language in prior bills, we assumed that this inflationary amount would be added to the 25% that is currently deductible (rather than multiplied by the 25%). The application of rounding under the bill would result in a 3-percentage point increase to the eligible deduction amount. Based on the 5-year average increase of the CPI, the bill would allow 28% of charitable contributions to be deducted from taxable income in Arizona in TY 2022 and 31% in TY 2023, with similar increases in future years.

State Revenue Loss

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 additional 25% deduction for charitable contributions was estimated to have an impact of \$(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. The total impact for this provision in Chapter 273 was estimated during the 2019 session to be \$(24.0) million in FY 2020.

Due to the shift in the filing date from April 15 to July 15, 2020 in response to the pandemic, TY 2019 extension returns are still being filed, therefore we do not have any data on the actual impact of Chapter 273. As a result, this fiscal

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note relies on the Chapter 273 analysis 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 2022 and 31% in TY 2023) is therefore expected to have a revenue loss of another \$(0.7) million in FY 2023 and \$(1.4) million in FY 2024. 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 inferences may be drawn from federal filers for TY 2018, the first year under which the doubled federal standard deduction amount was in effect. According to the IRS, from TY 2017 to TY 2018 the number of federal filers itemizing their deductions fell from 30.6% to 11.4% (or conversely, the share of filers using the standard deduction increased from 69.4% to 88.6%).

Assuming that state filing behavior for TY 2019 is similar to the federal filing behavior for TY 2018, we estimate that 19.2% of state filers, or approximately 576,000 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 \$983.3 million. 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 \$(1.0) million [$\$983.3 \text{ million charitable donations} \times (28\% - 25\%) \times 3.29\% \text{ effective tax rate}$] in FY 2023. The revenue impact in FY 2024 is estimated at \$(1.9) million.

Taxpayers Who Currently Itemize

A select group of taxpayers may find it advantageous to switch from itemization to the standard deduction for the first time in TY 2022 because of this bill. To estimate the revenue reduction resulting from such change in filing behavior, the JLBC Staff typically relies on DOR's income tax simulation model. As noted earlier, to date, DOR has not provided any estimate of HB 2113. 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 HB 2113 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 2023 and \$(0.6) million in FY 2024.

In summary, the impact is as follows.

Fiscal Impact of HB 2113		
<u>Tax Filers</u>	[\$ Millions]	[\$ Millions]
	<u>FY 2023</u>	<u>FY 2024</u>
Pre-TY 2019 Standard Deduction Filers	\$(0.7)	\$(1.4)
New Standard Deduction Filers Attributable to Laws 2019, Ch. 273	(1.0)	(1.9)
New Standard Deduction Filers Attributable to HB 2355	<u>(0.3)</u>	<u>(0.6)</u>
Total General Fund Revenue Impact	\$(2.0)	\$(3.9)

Given the rounded annual inflation increase of 3%, we estimate the General Fund impact to increase by about \$(2.0) million for each subsequent fiscal year.

Local Government Impact

The bill would reduce Urban Revenue Sharing Fund distributions to cities and towns by an estimated \$(0.3) million in FY 2025 and \$(0.6) million in FY 2026. Subsequent years are expected to have additional \$(0.3) million decreases annually.