

# Fiscal Note

**BILL #** HB 2838

**TITLE:** income tax; partnerships; S corporations

**SPONSOR:** Chaplik

**STATUS:** As Amended by Senate FIN

**PREPARED BY:** Benjamin Newcomb

## Description

The bill, as currently amended, would create an optional entity-level income tax for partnerships and S corporations. If the partners or shareholders of such pass-through-entities (PTE) elect to be taxed at the entity level, the PTEs would be taxed at 4.5% of their Arizona taxable income. Such an election would allow PTEs to claim a full deduction on their federal partnership return for state taxes paid at the entity level. Currently, the amount of itemized deductions that can be claimed for state and local taxes paid by each partner or shareholder of a PTE on their federal individual income tax return is limited to \$10,000.

The bill would become effective retroactively from Tax Year (TY) 2018.

## Estimated Impact

The bill would have no impact on General Fund revenues. At the state level, partners and shareholders of PTEs would pay the same amount of state individual income tax under the bill as under current law. At the federal level, however, there would be a reduction of individual income tax revenues since the bill would effectively allow partners and shareholders of PTEs to claim their full deduction for state taxes.

## Analysis

The federal Tax Cuts and Jobs Act (TCJA) enacted in December 2017 includes a provision that limits the amount of itemized deductions that can be claimed by an individual filer for state and local taxes paid to \$10,000, beginning in TY 2018. Currently, PTEs are not directly subject to either federal or state income tax. Instead, each partner or shareholder transfers their pro rata share of the PTE's business income onto their federal individual income tax return. This means that the federal adjusted gross income (FAGI) of each partner includes their pro rata share of the PTE's business income. FAGI is the starting point for calculating Arizona adjusted gross income (AAGI), which in turn is used to determine Arizona individual income tax.

A PTE's business income (or loss) is calculated by subtracting various deductions allowed under federal law from its income (such as gross receipts from sales). A PTE can claim a deduction for "taxes and licenses" paid so long as they are imposed on the entity. However, since state income taxes under current law are imposed at the partner/shareholder level as opposed to the entity level, these taxes cannot be deducted on the federal partnership return. Instead, each partner or shareholder is allowed up to \$10,000 in itemized deductions on their federal individual income tax return for state and local taxes paid.

As noted above, HB 2838 would provide an optional state income tax at the entity level. By imposing the state income tax at the entity level, the PTE's business income would be reduced commensurately. Such deduction is not subject to a cap, such as the current \$10,000 limitation on itemized deductions for state and local taxes paid.

At the federal level, revenues would be reduced under the bill whenever the total deduction at the entity level exceeds the amount of itemized deductions for state and local taxes claimed by all the entity's partners combined. At the state level, however, the bill includes a set of statutory adjustments that are intended to ensure that each partner or

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shareholder pays the same amount of state income tax under the bill as under current law. For this reason, the bill would have no state revenue impact. (As a technical note, the bill requires that each partner adds back their pro rata share of the deduction for state income taxes paid by the entity claimed on the federal partnership return. This adjustment makes sure that the AAGI is the same under the bill as under current law. Moreover, the bill provides a state individual income tax credit that is equal to each partner's pro rata share of the state income tax paid by the entity. This adjustment is included to prevent the same income from being taxed twice – first at the entity level and then at the individual partner level.)

**Local Government Impact**

Incorporated cities and towns receive 15% of the individual income tax and corporate income tax from the two years prior from the Urban Revenue Sharing Fund (URSF) established by A.R.S § 43-206. Since the bill would not affect state income tax revenues, URSF distributions to cities and towns would also be unaffected.

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