

# Joint Legislative Budget Committee

## Staff Memorandum

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DATE: July 13, 2021

TO: Richard Stavneak, Director

FROM: Hans Olofsson, Chief Economist

SUBJECT: FISCAL IMPACT OF HOUSE ENGROSSED VERSION OF SB 1783

This memo responds to requests that we have received for the fiscal impact of the House Engrossed version of SB 1783, especially as it relates to our fiscal note on the Senate Engrossed version of the same bill released on March 15, 2021.

### Changes to SB 1783

While the House Engrossed version of SB 1783 includes several changes to the Senate Engrossed version of the bill, the main concept remains, which is that the legislation provides an option for individuals with certain types of income, such as interest and dividends, business profits, and capital gains from the sale of certain capital assets, to be taxed under either the regular individual income tax or the alternative income tax created by SB 1783. An individual who elects to be taxed under SB 1783's alternative income tax is not subject to the Proposition 208 3.5% surcharge. Instead, all taxes collected under the bill's alternative income tax will be deposited into the General Fund. Individual income tax filers will presumably elect the type of tax (regular income tax or the SB 1783 alternative income tax) that results in a lower overall tax liability.

### March 15 Fiscal Note

Our [fiscal note](#) on the Senate Engrossed version of SB 1783 from mid-March was based on the state's existing regular tax rates in combination with a tax rate of 4.5% on SB 1783 taxable income. As discussed in more detail below, the fiscal estimate issued on March 15 is no longer applicable for the following reasons: (1) The House Engrossed version of SB 1783 implements different rates for the alternative income tax and (2) SB 1783 now needs to be scored in the context of the recently enacted budget, as usage of SB 1783 interacts with the other significant tax policy changes made in the budget.

As noted above, under the Senate Engrossed version of SB 1783, the rate for the alternative income tax was set at 4.5%. When we issued our fiscal note in mid-March, we scored the bill relative to the existing regular rates, which range from 2.59% to 4.50%. Under the enacted Tax Omnibus bill (Laws 2021, Chapter 412), these rates are phased down to a single rate of 2.5% (when a specific General Fund revenue target amount has been exceeded). Moreover, the Revenue BRB (Laws 2021, Chapter 411) imposes a rate cap of 4.5% on regular taxable income above \$250,000 for single filers and \$500,000 for married couples filing jointly.

The fiscal impact of SB 1783 depends on the rate cap as well as the regular income tax rates. Therefore, since the March 15<sup>th</sup> estimate was based on a tax policy with different tax rates than in the enacted budget and without a 4.5% rate cap, that estimate cannot be applied to the House Engrossed version of the bill. Below, we discuss the potential impact of SB 1783 under the 4.5% max rate and the reduced regular individual income tax rates.

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**JLBC**

### Why SB 1783 Will Result in General Fund Savings

As noted earlier, SB 1783 establishes new tax rates for certain types of income that are lower than the maximum 4.5% income tax rate established by the Revenue BRB. Due to the lower rates, we assume that taxpayers will shift their SB 1783 taxable income from the 4.5% income tax rate, which is subject to the Proposition 208 surcharge, to the SB 1783 rate. The latter is not subject to the surcharge.

SB 1783 interacts with the 4.5% maximum income tax rate. Taxpayers with incomes above \$250,000 for single filers and \$500,000 for married couples filing jointly will pay no more than a 4.5% tax rate on income above that threshold. Since Proposition 208 requires 3.5% of the income to be paid into a separate education fund, the General Fund will only collect 1.0% of the income above \$250,000/\$500,000 from those households. This policy change will cost the General Fund an estimated \$836 million in FY 2022, as shown on page 1, line 26 of the following [FY 2022 Enacted Budget Summary](#) listed on our website.

As discussed in more detail below, SB 1783 makes the cost of the 4.5% max rate policy less expensive. The tax rates under SB 1783 start at 3.5% in TY 2021 and then decline to 3.0% in TY 2022, 2.8% in TY 2023 and TY 2024 and 2.5%, beginning in TY 2025. While the taxpayer benefits from the lower tax rate, the General Fund also benefits since all of SB 1783 income will be deposited into the General Fund compared to only 1% of regular income above \$250,000/\$500,000.

### FY 2022 Impact

The SB 1783 tax rate is 3.5% in TY 2021 (or FY 2022 for budget scoring purposes) compared to the regular tax rates, which range from 2.59% to 4.5%. The different rates for income taxed under SB 1783 compared to the regular tax will have 2 separate effects on the General Fund in FY 2022. First, individuals with taxable income above \$250,000/\$500,000 will choose the lower SB 1783 tax rate of 3.5% rather than the max rate of 4.5% under the regular income tax. This benefits the General Fund since it now receives 3.5% of the income taxes paid compared to 1% under the 4.5% rate cap. Second, for taxable income up to the \$250,000/\$500,000 threshold, the rate of 3.5% paid under SB 1783 is less than what would be paid under the regular tax. To provide some perspective, the average rate for taxable income between \$98,100 and \$250,000 for single filers (and twice those amounts for married couples filing jointly) ranges from 3.51% to 4.02%. This means that in that income range, the General Fund will receive less under SB 1783 than under the regular tax.

We do not have a good dataset to estimate the net impact on the General Fund of the 2 “countervailing effects” described above. As a result, we have attempted a very rough back-of-the-envelope calculation. Based on our methodology, the impact of the SB 1783 tax rate in TY 2021 could be a potential net savings of \$30 million in FY 2022. However, since our methodology is imprecise, we do not recommend scoring any impact in FY 2022.

### FY 2023 Impact

In FY 2023, the cost of the 4.5% maximum tax rate declines from \$836 million to \$488 million. We estimate that slightly less than 35% of income for \$250,000/\$500,000 households will qualify under SB 1783. As a result, those taxpayers will have the incentive to shift that income to the lower SB 1783 rate of 3.0%. Using the assumption that 35% of income tax liability for high-income earners will shift to SB 1783, we estimate that this shift will reduce the General Fund cost of the maximum tax rate policy by 35%, which results in savings of \$173 million. This is reflected on page 1, line 27 of [FY 2022 Enacted Budget Summary](#)

### Proposition 208 Impact

Proposition 208 is estimated to generate \$836 million annually from the 3.5% surcharge. As noted above, our analysis assumes that slightly less than 35% of this amount, or about \$292 million, is generated from taxable income as defined in SB 1783. Due to the lower rates, we assume that taxpayers will shift their SB 1783 taxable income from the regular income tax, which is subject to the Proposition 208 surcharge to SB 1783, which is not subject to the surcharge. This means that Proposition 208 revenues will be reduced by an estimated \$292 million.

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