

Fiscal Note

BILL # SB 1331

TITLE: income tax subtraction; capital gains

SPONSOR: Mesnard

STATUS: As Introduced

PREPARED BY: Benjamin Newcomb

Description

Under current law, 25% of the income derived from long-term capital gains on assets acquired after December 31, 2011 can be subtracted from an individual filer's taxable income. SB 1331 expands the 25% individual income tax subtraction to include all long-term capital gains irrespective of when the assets were acquired. Long-term capital gains are generally generated from assets held for longer than one year. The bill would become effective beginning in Tax Year (TY) 2026, affecting Fiscal Year (FY) 2027 revenues.

Estimated Impact

We anticipate that the expansion of the current 25% long-term capital gains subtraction under the bill would reduce annual General Fund revenue starting in FY 2027. While we are not able to determine the magnitude of the bill's impact with precision, the General Fund revenue impact is likely between \$(40) million and \$(60) million.

We have asked the Department of Revenue (DOR) for their estimate of the bill's impact but have not yet received a response.

Analysis

The most recent data from DOR shows that total net capital gains in Arizona were \$21.02 billion in TY 2023, of which \$11.52 billion were for assets acquired after December 31, 2011. We do not know what portion of the remaining \$9.5 billion comes from long-term or short-term gains, as such information was not included in DOR's data. However, federal tax-filing data published by the Internal Revenue Service's (IRS) Statistics of Income Division shows that, assets held for less than one year (referred to as short-term capital assets) often generate, in the aggregate, net capital losses. Therefore, it is unlikely that short-term gains alone could account for the \$9.5 billion gap.

In addition, capital gains distributions, which are payments made by a mutual fund (or other regulated investment company) or real estate investment trust from its net realized long-term capital gains are often reported to taxpayers without a date of acquisition. Federal data from the IRS suggests that well over half of all capital gains distributions do not have a reported acquisition date. This suggests that a significant portion of the \$9.5 billion gap could be long-term capital gains, if not all of it.

Based on the Congressional Budget Office's most recent U.S. capital gains forecast, we project that this gap will grow to \$14.11 billion in Arizona by TY 2026. If the entirety of this amount were for long-term gains, the maximum additional income subtraction under the bill would be \$3.53 billion. We expect that only a portion of this amount would be realized as taxpayers may only subtract an amount sufficient to offset their taxable income. Therefore, we estimate that \$2.45 billion of the total subtraction amount would be realized, based on historical data from DOR. Applying the state's 2.5% individual income tax (IIT) rate, we estimate that the General Fund revenue reduction from the bill could be as high as \$(60) million beginning in FY 2027. But based on our analysis of the current gap between total capital gains and post-2011 capital gains, we estimate that the impact is at least \$(40) million.



Local Government Impact

Incorporated cities and towns receive 18% of individual and corporate income tax collections from 2 years prior from the Urban Revenue Sharing (URS) Fund established by A.R.S. § 43-206. Since the bill would decrease statewide income tax revenue by an estimated \$(40) million to \$(60) million in FY 2027, overall URS distributions to cities and towns would decrease by between \$(7.2) million and \$(10.8) million in FY 2029.

2/19/25