

## **Arizona Has Not Responded to Federal Tax Reform Measures**

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In this installment of SALT From My Saddle, Busby explains that Arizona may collect up to \$300 million in additional income tax revenue if it does not alter its tax rates or change its tax code in response to federal tax reform provisions.

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In Arizona, as in most states, corporations calculate their state income tax liability by using their federal taxable income as the starting point. Likewise, individual income tax liability calculations in Arizona begin with federal adjusted gross income as a starting point, and individual income tax payers who itemize use their federal itemized deductions as a starting point for state itemized deductions.

### Changes at the Federal Level

In 2017 Congress passed and President Trump signed two bills that, together, affect both federal income tax rates and the tax base

for federal income tax calculations.<sup>1</sup> Those bills will reduce the overall federal tax liability that many, but not all, taxpayers face.

### A Potential Tax Preparer Nightmare

This year in their annual Internal Revenue Code conformity bill, rather than respond to the changes at the federal level, Arizona's Legislature simply pointed to the provisions of the IRC in effect on January 1, 2017, as the starting point for Arizona individual and corporate income tax liability for tax year 2018.<sup>2</sup> Thus, unless the Legislature acts before January 1, 2019, millions of Arizona taxpayers could be forced to calculate their 2018 Arizona income tax liability using a radically different tax base than they use to calculate their federal income tax liability. Then if the Legislature acts after January 1, 2019, to alter the Arizona tax base for tax year 2018, many taxpayers may be forced to amend Arizona income tax returns that they already filed.

### The Impact on State Tax Collections

Surprisingly, the Legislature has not responded to the changes to the federal income tax code even though the Department of Revenue estimated that a failure to adjust the state's tax code in response may result in up to \$300 million annually in additional income tax revenue by the fiscal year beginning July 1, 2019.<sup>3</sup> That would amount to roughly a 5 percent

<sup>1</sup> Trump signed the Disaster Tax Relief and Airport and Airway Extension Act of 2017 on September 27, 2017, and the Tax Cuts and Jobs Act (P.L. 115-97) on December 22, 2017.

<sup>2</sup> Laws 2018, Ch. 142.

<sup>3</sup> See Arizona Department of Revenue Office of Economic Research and Analysis, "Estimated Impact on State Revenues of Conformity to Provisions in the Tax Cuts and Jobs Act and the Disaster Tax Relief and Airport and Airway Extension Act of 2017" (Jan. 10, 2018).

increase in overall income tax collections in Arizona.<sup>4</sup>

For individual income taxes, the primary drivers include the new federal limitations on itemized deductions and the limitations on active passthrough losses. Although the DOR says it believes that individual income tax payers will bear roughly 90 percent of the burden of that tax increase, corporations will be affected as well. For corporations, the primary drivers include the new federal limit on net interest deductions to 30 percent of adjusted taxable income and the repeal of the federal domestic production income deduction.<sup>5</sup>

### **Will Arizona's Lawmakers and Governor Stop the Stealth Tax Increase?**

Given Arizona's constitutional provision<sup>6</sup> requiring that its Legislature pass any legislation that would provide for a net increase in state revenue through some changes in taxes by a two-thirds vote, conventional wisdom in Arizona is that its Republican-leaning Legislature generally does not enact measures that would increase taxes.

But in this case, in which no action is required to increase state income tax revenue by roughly 5 percent, many are beginning to wonder whether the Legislature and Gov. Doug Ducey (R) will act to prevent that stealth \$300 million tax increase.

And if they do act, what will they do? Will they reduce tax rates across the board, or in a targeted fashion? Will they adjust the tax base? Or maybe they will adjust rates as well as the base. How will the changes be allocated between individual income tax payers and corporate income tax payers? Will they include triggers in the legislation so that some or all of the changes will go into effect only when revenue increases by a specific amount? If triggers are included in the legislation, will additional taxes that already were collected be

refunded, or will the tax code be adjusted only in the future?

Finally, many also are wondering whether Ducey will convene a special session after the election in November to address this important issue before the Legislature convenes as usual in January. Or will Arizona taxpayers and tax return preparers be forced to guess how to prepare, and then possibly amend, millions of tax returns? ■

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<sup>4</sup>Based on the DOR's total collections for withholding, individual, and corporate income taxes according to its annual report for fiscal 2017.

<sup>5</sup>*Id.*

<sup>6</sup>Arizona Const., Art. 9, section 22.