

ARIZONA TAX ALERT: THE STATE OF ARIZONA CONFORMS TO THE TAX CUT AND JOBS ACT FOR INCOME TAX; RETURNS WINDFALL TO TAXPAYERS STARTING IN 2019

07/31/2019

On May 31, 2019, Governor Doug Ducey signed Arizona H.B. 2757, which updated Arizona's income tax code to conform to the 2017 federal Tax Cuts and Jobs Act (TCJA). The bill, beginning in 2019, also reverses the effective state tax increase imposed on Arizona taxpayers as a result of the Legislature's failure to take action in 2018 to return the TCJA windfall to taxpayers.

ARIZONA FINALLY CONFORMS TO THE TCJA AND CUTS 2019 INDIVIDUAL RATES; KEEPS 2018 WINDFALL

H.B. 2757 adopted conformity with the federal tax code but also cuts personal income tax rates, increases the standard deduction, and replaces the dependent exemptions with a new child tax credit for the 2019 tax year. On the corporate side, H.B. 2757 makes clear that Arizona will not follow the federal government in imposing a new tax on global intangible low-taxed income (GILTI), but does not address full expensing and the net interest limitation.

The changes are designed to neutralize the effect of the TCJA, which resulted in an effective tax increase for Arizona taxpayers in 2018. Arizona must adopt conformity to the federal income tax code annually, unlike some states, where such adjustments are automatic. Because the TCJA expanded the tax base, and most states—including Arizona—use federal adjusted gross income as the starting point for state tax calculations, updating the state's conformity date without making any other changes would have resulted in a net tax increase. In 2018, the Arizona Department of Revenue's income tax forms assumed that the legislature would adopt updated federal conformity for that year, even though the legislature failed to actually do so – resulting in an estimated \$155 million in additional tax collected. H. B. 2757 allows the state to keep this windfall and use it to pay down state debts. The changes to the income tax code taking effect for the 2019 tax year reverse the impact the TCJA had on Arizona taxpayers in 2018 but going forward only.

A. Personal Income Tax

Professionals

- Pat Derdenger
- Karen Jurichko Lowell

Practice Areas

- Tax

Offices

- Phoenix

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The bill reduces Arizona's income tax brackets from five to four by eliminating the second-lowest bracket, instead taxing individuals who were in this bracket at the lowest rate. The remaining three brackets also see modest rate reductions.

Individual and Married Filing Separate*Income Bracket**2018 Marginal Tax Rates**Income Bracket**2019 Marginal Tax Rates*

\$0 – \$10,000

2.59%

\$0 – \$26,500

2.59%

\$10,001 – \$25,000

2.88%

\$25,001 – \$50,000

3.36%

\$26,501 – \$53,000

3.34%

\$50,001 – \$150,000

4.24%

\$53,001 – \$159,000

4.17%

\$150,001 +

4.54%

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\$159,001+

4.50%

Married Filing Joint and Head of Household

Income Bracket

2018 Marginal Tax Rates

Income Bracket

2019 Marginal Tax Rates

\$0 – \$20,000

2.59%

\$0 – \$53,000

2.59%

\$20,001 – \$50,000

2.88%

\$50,001 – \$100,000

3.36%

\$53,001 – \$106,000

3.34%

\$100,001 – \$300,000

4.24%

\$106,001 – \$318,000

4.17%

\$300,000+

4.54%

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\$318,000+

4.50%

H.B. 2757 increases the standard deductions available to taxpayers to mirror the federal standard deductions adopted in the TCJA, and repeals the personal exemptions found in A.R.S. § 43-1043.

Filing Status**2018 Standard Deduction****2019 Standard Deduction****2018 Personal Exemption****2019 Personal Exemption**

Single

\$5,312

\$12,200

\$2,200

N/A

Married Filing Separate

\$5,312

\$12,200

\$2,200 – \$3,300

N/A

Head of Household

\$10,613

\$18,350

\$3,300 – \$4,400

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N/A

Married Filing Joint

\$10,613

\$24,400

\$4,400 – \$6,600

N/A

Finally, H.B. 2757 adopts a new dependents tax credit in A.R.S. § 43-1073.01. Unlike a deduction, the credit reduces the tax owed by an Arizona taxpayer dollar-for-dollar in the following amounts:

Filing Status**Federal Adjusted Gross Income****Dependent Under 17 (Each)****Dependent Over 17 (Each)**

Single, head of household, and married filing separate

\$0 – \$200,000

\$100

\$25

Married filing joint

\$0 – 400,000

\$100

\$25

Single, head of household, and married filing separate

\$200,000+

\$100 minus \$5 for each \$1,000 of income over \$200,000

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\$25 minus \$1.25 for each \$1,000 of income over \$200,000

Married filing joint

\$400,000+

\$100 minus \$5 for each \$1,000 of income over \$400,000

\$25 minus \$1.25 for each \$1,000 of income over \$400,000

B. Corporate Income Tax

H.B. 2757 also conforms to the TCJA for corporate income tax purposes, but with several key differences. First, it makes clear that GILTI and Subpart F income are treated as foreign dividends, which are fully deductible from Arizona gross income. This clarification ensures that Arizona is not making an unwarranted expansion into international taxation at the state level.

However, the bill does not address two other key provisions of the TCJA: full expensing and the net interest limitation. Arizona automatically conforms to Internal Revenue Code (IRC) § 163(j), which increases business investment costs, but does not conform to IRC § 168(k), which eliminates a tax penalty on investments. The changes adopted in the TCJA are designed to counterbalance each other, with § 168(k) permitting businesses to deduct the full cost of machinery and equipment in the first year instead of depreciating them over time, and § 163(j) limiting the deductibility of interest for business debts with a goal of reducing the tax code's bias for debt financing over equity financing. H.B. 2757 does not address this disparity.

For more information on H.B. 2757, please contact Karen Lowell at klowell@lrrc.com and Pat Derdenger at pderdenger@lrrc.com.