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Arizona Weighs Income Tax Reform

By

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Introduction

On March 14, the Arizona House of Representatives approved HB 2636, a package that would ambitiously reform the state's individual income tax code.¹ The proposal, which now goes before the state Senate, would:

- Phase out the existing graduated income tax structure, replacing the current rates, which range from 2.59 percent to 4.54 percent, with lower rates between now and 2014, and with a flat 2.08 percent rate beginning in 2015.
- Eliminate standard and itemized deductions and personal exemptions; tax will be paid on federal adjusted gross income (AGI) with only a few permitted deductions.
- Retain existing credits.

The plan would be phased in through 2015, and sponsors say it is intended to be revenue-neutral. A special commission would be set up to establish the final single tax rate, with the parameters of remaining within the designed income tax base and not setting an income tax rate higher than 3 percent.

Sponsors argue the objective is to simplify the tax system by "avoiding numerous complex calculations reflecting multiple exemptions, deductions, additions, subtractions, and tax rates."² Opponents argue that a one-rate income tax will be unfair to many taxpayers.

Proposal Eliminates Deductions, Trading Them for Lower Rates

Arizona currently provides myriad deductions from state income tax. These include three major categories:

- *Federal itemized deductions* that are imported into the Arizona code, such as home mortgage interest and charitable contributions.
- *Standard deduction amounts* (currently \$4,677 for a single taxpayer; twice that for married filing jointly) and *personal exemptions* for each filer (currently \$2,100 for a single taxpayer; \$4,200 for married filing jointly; \$6,300 for married filing jointly with dependents).
- *Arizona-specific deductions* (such as deductions for Holocaust survivors, constructing energy-efficient residences, military pay taxed under federal law, and pension income up to \$2,500).

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¹ This proposal is separate from legislation signed into law last month by Gov. Jan Brewer (R), that phases in a corporate income tax reduction from 6.968 percent to 4.9 percent and single-sales factor apportionment, starting in calendar year 2014 and completing in four years; expands the Research & Development tax credit; creates a Quality Jobs tax credit and renews the Job Training tax credit; and adopts accelerated depreciation for business property expenses. That law is projected to be a net revenue reduction of \$538 million per year when fully phased in.

² HB 2636, <http://www.mygov365.com/legislation/view/id/4d53124b49e51bc11d5f3c00/tabcversions/>.

The proposed bill replaces these categories, instead subjecting a taxpayer's federal AGI to Arizona income tax after subtracting the following exclusions:

- *Interest income on United States government bonds*, which is required to be exempt from state taxation under federal law
- *Social Security and railroad retirement benefits* included in federal adjusted gross income
- *Federal deductions for bonus depreciation*, with benefits limited over time.
- *Unreimbursed employee trade or business expenses* that are allowed as an itemized deduction on the federal income tax return, above the 2 percent floor as specified in the federal return.
- *Damages awarded to the taxpayer as a court judgment*, not including attorney fees and court costs associated with the judgment. Since 1996, federal law permits a deduction for damage awards only if they are for physical injuries or sickness, and not, for example, for nonphysical injuries such as emotional distress. Recent proposals at the federal and state level have sought to address this exception.

Other than these exclusions, all income would be taxed at the new, lower rates.

New Income Tax Rates Would Be the Lowest of Any State with an Income Tax

Arizona's current rate structure and the proposed changes by year, for single persons, are listed in Table 1.

Table 1: Arizona Individual Income Tax Rates, 2011 (Current) and 2012-15 (Proposed)

Bracket	2011 & 2012	2013	2014	2015 and thereafter
>\$0	2.59%	2.08%		
>\$10,000	2.88%	2.25%	2.08%	
>\$25,000	3.36%	2.57%	2.25%	
>\$50,000	4.24%	3.65%	2.60%	
>\$150,000	4.54%	3.85%	2.95%	

Source: Tax Foundation *Facts & Figures*; Arizona H.B. 2636.

The 2.08 percent rate would be the lowest top individual income tax rate of any state with an income tax, lower than the current lowest top rates for Pennsylvania (3.07 percent) and Colorado (4.63 percent). Neighboring states' top rates are: California (10.3 percent), Colorado (4.63 percent), Nevada (none), New Mexico (4.9 percent), and Utah (5 percent).

The Proposal Retains Existing Tax Credits

The proposed legislation does not address Arizona's current income tax credits, so taxpayers would still be able to use them to reduce their tax liability. (A deduction is subtracted from income, while a credit is subtracted from tax.) The most significant of these credits (over \$250,000 in reduced revenue collection) are listed in Table 2.

Table 2: Arizona Tax Credits, Claimants, and Revenue Reduction

Credit	No. of Claimants	Revenue Reduction (FY 2008)
Credit for taxes paid to other states or countries	31,103	\$78.8 million
Private School Tuition Organization (STO) credit	78,434	\$55.2 million
Private School extracurricular activity credit	233,450	\$45.1 million
Credit for low-income residents to compensate for increased sales tax rate	605,599	\$32.3 million
Contributions to charities that provide assistance to low-income workers	36,568	\$11.0 million
Family tax credit for low-income families	501,013	\$5.8 million
Property tax credit for low-income elderly	15,675	\$5.7 million
Research & Development tax credit	160	\$2.9 million
Credit for purchase and installation of agricultural water conservation system	105	\$1.3 million
Credit for donations to the Military Family Relief Fund	2,361	\$0.8 million
Credit for donations made to the Clean Elections Fund	33,966	\$0.8 million
Credit for non-retail businesses located in Enterprise Zones	119	\$0.7 million
Small Business Investment Credit	111	\$0.4 million
Credit for donation of land or improvements for use as a school site	54	\$0.3 million
Film tax credit	9	\$0.3 million

Source: Arizona Department of Revenue, "The Revenue Impact of Arizona's Tax Expenditures FY 2009/10," (Nov. 15, 2010).

Note: Data for the solar energy tax credit was not available.

Dudley Criticism Relies on an Unrepresentative Sample

Walter Dudley, with the Arizona Society of Practicing Accountants, delivered a spreadsheet to members of Arizona's House Ways & Means Committee containing six different Arizona households and their tax liabilities.³ Each family in Dudley's sample, earning income ranging from \$17,784 to \$248,456 per year, would pay more under the Arizona tax reform plan analyzed here. For example, the low-income family earning \$17,784 per year would pay an additional \$370 under the plan; the wealthy family earning \$248,456 per year would pay more than \$5,274 more under the plan. Rep. Steve Farley (D-Tucson), citing the Dudley spreadsheet, stated that the bill is "a massive tax increase on every household in the state of Arizona according to the calculations."⁴

Assuming Dudley's calculations are correct, Farley's conclusion is not. Six contrived examples are unlikely to be representative of all households in Arizona. Addressing that point, Rep. Justin Olson (R-Mesa) responded that taxpayers most likely to see accountants are those "taking advantage of every deduction and every tax advantage that exists in the tax code."⁵ Because the plan trades eliminated deductions for lower tax rates, to the extent that a family relies heavily on deductions, they will see a higher tax bill. If a family does not rely heavily on deductions, they are likely to see a lower tax bill. Because the tax reform will be revenue-neutral, it is mathematically impossible for everyone to owe more.

The bill's requirement that a state commission set the final tax rate, and that they must use the base outlined in the bill and cannot set the rate higher than 3 percent, are adequate protections to ensure that total revenue does not exceed the amount that otherwise would have been collected.

Arizona Would Join Seven States with a One-Rate Income Tax

A likely point of contention over the bill is the desirability of having one single income tax rate. Rep. Steve Court (R-Mesa), the bill's sponsor, has argued that "there is no reason for those who are doing better to pay a higher percentage of their income to support government." Further, Court stated, "Even with a flat tax, if you make 10 times more than I do, you'll pay 10 times as much tax. I'm just trying to get everybody back down to a level playing field."⁶

A contrary position could be that higher-income individuals should pay a larger portion of their income as taxes than lower-income individuals. In evaluating whether Arizona residents will face sufficiently progressive taxes after this bill is enacted, one should also consider the distributional effect of spending programs and other taxes besides the income tax, the retained tax credits, and the interaction with the progressive federal income tax.

Having a one-rate income tax is neither unprecedented nor stereotypically "red state." Seven states currently have a one-rate income tax: Colorado (4.63 percent), Illinois (5 percent), Indiana (3.4 percent), Massachusetts (5.3 percent), Michigan (4.35 percent), Pennsylvania (3.07 percent), and Utah (5%). In addition, seven states do not have an individual income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming), and two states have a limited tax applying only to interest and dividends (New Hampshire, at 5 percent, and Tennessee, at 6 percent).

Conclusion

Although revenue-neutral, the elimination of most deductions will increase tax liability for those who currently take significant advantage of those deductions, and some will pay less. Notably, many items currently itemized on federal and Arizona taxes will no longer be deductible on Arizona taxes, such as home mortgage interest and charitable contributions. In exchange for eliminating those deductions, the bill would decrease the rate for all taxpayers to a level lower than any other state with an individual income tax. The net result would likely be a reduction in compliance costs associated with tracking deductions and calculating state income tax

³ See Phoenix Fox Channel 10, "Flat Income Tax Bill Clears Arizona House," (Mar. 15, 2011), http://www.myfoxboron.com/dpp/news/politics/state_politics/flat-income-tax-bill-clears-arizona-house-03152011?idx.

⁴ Howard Fischer, "Arizona House sends measure for flat income tax to state Senate," *East Valley Tribune* (Mar. 14, 2011), http://www.eastvalleytribune.com/arizona/politics/article_aa382fc4-4eb2-11e0-b6d8-001cc4c03286.html.

⁵ *Id.*

⁶ *Id.*

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