

**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**

**Prepared by the  
Arizona Department of Revenue  
Office of Economic Research and Analysis  
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Pursuant to A.R.S. §42-1005(A)(5), the Arizona Department of Revenue is directed to "prepare and submit to the legislature a report containing a summary of all the revisions made to the internal revenue code during the preceding calendar year." This report for calendar year 2017 addresses the Disaster Tax Relief and Airport and Airway Extension Act of 2017 signed by President Trump on September 29, 2017 and the Tax Cuts and Jobs Act signed on December 22, 2017. Many provisions of the Tax Cuts and Jobs Act, the most significant federal tax reform in more than three decades, have an impact on Arizona tax liability.

For corporations, a change in the calculation of federal taxable income becomes an automatic conformity issue because the calculation of Arizona corporate income tax liability begins with federal taxable income. Similarly, changes in the calculation of Federal Adjusted Gross Income (FAGI) automatically become a conformity issue because the starting point for calculation of Arizona individual income tax liability begins with FAGI. Additionally, Arizona law mandates that individual income tax filers who itemize must primarily use their federal itemized deductions; therefore a change in federal itemized deductions for individuals becomes an automatic conformity issue.

The current definition of internal revenue code in A.R.S. §42-1001 and §43-105 includes those changes to the internal revenue code that became effective on January 1, 2017 along with all federal retroactive effective dates, but excluding any change to the code enacted after January 1, 2017. However, there is one provision where Arizona did not previously conform to the federal changes. For the special bonus depreciation, Arizona taxpayers filing corporate returns must make an adjustment to add back all federal depreciation and then use a subtraction as if the taxpayer had opted out of the increased expensing (Arizona conforms to bonus depreciation for individual and partnerships).

This report covers all of the provisions in the 2017 acts with tax revenue implications. **Table 1** presents the total estimated amount of revenue expected to be gained/(lost) by Arizona from the most significant provisions of the federal acts.

**Table 1**

**ESTIMATED STATE REVENUE IMPACTS OF CONFORMITY**  
**FY 2018 - FY 2020**  
(Millions)

	<b>FY2018</b>	<b>FY2019</b>	<b>FY2020</b>
Total Impact of Conformity	\$0 - \$20.0	\$50.0 - \$250.0	\$250.0 - \$300.0

**Table 1** displays a range of estimates that are indicative of the expansiveness of the Tax Cuts and Jobs Act, which requires individuals, businesses, tax preparers and others to assess the federal law, make microeconomic decisions and plan tax strategies accordingly. The timing and magnitude of changes to taxpayer behavior are uncertain, particularly in the first few years of implementation of the federal law. Among those factors that will take some time to flow through from the federal level to the state level are changes to estimated payments, withholding patterns and selection of itemized deductions relative to the standard deduction. Many of the determinations made by taxpayers and tax preparers will be predicated on the timing and clarity of administrative guidance furnished by the Internal Revenue Service and policy decisions pertaining to conformity made by the Arizona Legislature and Executive.

**Table 2** and **Table 3** in this report presents point estimates of the impact of the major provisions. **Table 2** presents the major provisions by Individual and Business Tax Reform; some of the business provisions impacts occur at both the individual and corporate level. The point estimates of these revenue impacts are apportioned by Arizona tax type in **Table 3**. These tables of point estimates are

computed based on the assumption that Arizona will conform to the internal revenue code as of January 1, 2018, thereby adopting the federal provisions, except for extensions of provisions for which Arizona previously did not conform. For a few provisions there was either no impact from the anticipated change to federal revenues provided or the impact is negligible at the federal level. Additional provisions with minimal impacts on both the federal and state levels are grouped as “miscellaneous.”

**Attachment I** provides a brief explanation of the major provisions. **Attachment II** provides a list of those provisions in which the revenue impact to the state is negligible or unknown.

For the reasons stated above these point estimates are subject to a great degree of uncertainty, particularly in the first few years of implementation. As taxpayer behavior is revealed by when and how they choose to respond to federal tax law changes, further clarity is provided by the Internal Revenue Service, and conformity decisions are made by the Arizona Legislature and Executive, the revenue impacts will become clearer.

## **ESTIMATION METHODS**

For the following provisions identified in **Table 2** and **Table 3** the Arizona Department of Revenue Individual Income Tax Model was used to estimate the impact of revenue loss or gain to Arizona:

- Repeal certain itemized deductions except up to \$10,000 state/local taxes, limitation on deduction for qualified interest, repeal limit on overall itemized deductions, and increase charitable contribution limit

The Individual Income Tax Model used data from tax year 2014 grown to tax year 2018 liability, applied 2017 state law with 2017 federal tax rates, exemptions and deductions. To estimate the impact of the limit of state and local taxes itemized deduction, a \$10,000 cap was applied to married filing joint, head of household and single filers, \$5,000 for married filing separate filers. The limitation on deduction for qualified interest was estimated by adjusting the home mortgage interest deduction to 78% of current value to estimate the removal of the home equity deduction and cap on mortgage interest. The 78% assumption was derived from the Board of Governors of the Federal Reserve System (US), Real Estate Loans data. The impact, calculated for tax year 2018, was then adjusted for timing to arrive at the estimates for the listed fiscal years.

The model estimates assume that the impact would start in FY 2019 rather than FY 2018. Because the federal provisions become effective in tax year 2018, fiscal year 2018 would only be impacted if taxpayers actively seek to adjust their state income tax withholding, estimated payments and itemization decisions in the period of January to June of 2018. Given the fact that taxpayers would have little guidance from the Internal Revenue Service and the state’s conformity status, it is assumed they would not alter their behaviors right away, pushing the impact to FY 2019 and beyond.

Additionally, the model assumed no liability growth for the tax years, thus the impact to the fiscal years listed in the tables assume no revenue growth. The reason for this assumption is even though some revenue growth is to be expected, different forecasting methods and assumptions tend to result in different growth rates.

For all other provisions, the Federal Joint Committee on Taxation’s (JCT) analysis<sup>1</sup> of the major provisions with estimates of the gain or loss at the federal level was used. The portion of federal impacts attributable to Arizona taxpayers was determined using the relationship between U.S. and Arizona statistics as reported in:

- Internal Revenue Service, Statistics of Income Bulletin for individuals and corporations

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<sup>1</sup> Estimated Budget Effects of the Conference Agreement for H.R.1 Dec 18, 2017 - [Report](#)

- U.S. Department of Commerce, Bureau of the Census, Population Division
- Arizona Department of Economic Security, Population Statistics Unit

In order to generate impacts to the state given federal revenue impacts on individual taxpayers, an estimate of the Arizona portion of the change in FAGI is derived. The average state individual income tax rate is then applied to the estimate. In order to estimate the corporate provisions, the state corporate tax rate of 4.9% was applied. For the most part, the timing of impacts is derived by following the compliance and payment schedule estimated at the federal level, adjusted for the state fiscal year.

There are some instances where the federal revenue impacts for a provision cannot be apportioned to the state level using the above method without taking into consideration certain economic conditions that are distinct to Arizona. In these cases, the revenue impact may be further adjusted to account for these differences.

It should also be noted that the JCT analysis used by the Department is based on the conference version of the bill. The JCT communicated to the Department that an analysis based on the signed version of the Tax Cuts and Jobs Act will not be forthcoming. Should a new JCT analysis become available, the Department will evaluate the JCT analysis and adjust its estimates accordingly.

## **CONFOMIRTY IMPLEMENTATION CONSIDERATIONS**

As in any other year, the Arizona Legislature and Executive decide whether, how and when to conform to the federal tax law changes. The Arizona Department of Revenue implements and taxpayers and tax preparers comply with those decisions.

From an implementation and compliance standpoint, Full conformity allows taxpayers to rely on federal adjusted gross income (individuals) or federal taxable income (corporations) as the starting point on Arizona income tax returns.

Partial conformity that conforms to the federal changes for purposes of Arizona's starting point and then creates specific additions or subtractions to counteract changes to the federal tax code have the following characteristics:

- Taxpayers would be able to rely on federal adjusted gross income (individuals) or federal taxable income (corporations) for the starting point of the Arizona return.
- Taxpayers would also be able to rely on the federal itemized deductions from the federal return as a starting point for the Arizona return.
- The 2017 Arizona return would only be impacted if specific Arizona additions or subtractions to the federal code are created and applied to 2017. The complexities and costs of implementation would depend on the specific adjustments created.

No conformity to the federal provisions would require more complex tax forms, significant implementation tasks for the Arizona Department of Revenue and compliance challenges for taxpayers and tax preparers, including the following:

- For 2017, taxpayers that are impacted by any portions of the federal bills that were retroactive to 2017 would have to amend their 2017 returns to back out the impact of the federal retroactive changes. This includes business taxpayers that claim depreciation deductions and taxpayers that were impacted by various natural disasters in 2016 and 2017.
- For 2018, the Arizona tax base would be based on the internal revenue code that was in effect on January 1, 2017. Therefore, taxpayers that file their 2018 federal return would not be able to rely

on the amount determined on their federal return for the starting point of their state return. This would create the following complexities:

- The Department would need to create a form that lists all of the adjustments necessary to convert the 2018 federal adjusted gross income (individuals) or federal taxable income (corporations) shown on the taxpayers federal return to the amount based on the federal code as of January 1, 2018. This would be a large project by the department that will involve a significant investment of Department resources to identify every adjustment made to the federal code and determine how to back the adjustments out for Arizona purposes.
- A similar project would need to be done to adjust federal itemized deductions to the amount that would have been determined under the prior internal revenue code.
- Taxpayers and tax preparers would need to complete schedules that contain hundreds of adjustments simply to determine Arizona's starting point. This would make the completion of Arizona returns much more complex and time consuming.
- Major changes would need to be made to the Department's tax system to incorporate all of the new schedules.
- Each year that goes by without conformity would exacerbate the complexities described above by adding more adjustments that need to be made in order to arrive at Arizona's starting point.
- Because none of the adjustments would be specific additions or subtractions in the Arizona statutes, any discussions with taxpayers or the courts will be much more complicated to explain.

The Department will implement any decisions made by the Arizona Legislature and Executive. This section merely describes implementation and compliance considerations that major conformity options entail.

Questions about this analysis can be fielded by Bill Ritz at 602.716.6132.

**Table 2**  
**ESTIMATED IMPACT ON STATE REVENUES OF CONFORMITY**  
**TO THE PROVISIONS IN THE**  
**Tax Cuts and Jobs Act**  
**BY SECTION OF FEDERAL ACT**  
**Year over Year Change**

**Provisions from the Individual Tax Reform Subsection - Sunset 12/31/2025**

<b>Individual Tax Reform (\$ in millions)</b>	<b>FY 2018</b>	<b>FY 2019</b>	<b>FY 2020</b>
Disallow active pass-through losses excess of \$500,000 for married joint, \$250,000 other	\$21.5	\$52.5	\$58.4
Repeal certain itemized deductions except up to \$10,000 state/local taxes, limitation on deduction for qualified interest , repeal limit on overall itemized deductions & increase charitable contribution limit*	\$0.0	\$170.8	\$179.8
Repeal employer-provided moving expense reimbursements deduction	\$0.9	\$2.0	\$2.0
Remove moving expenses deduction	\$1.4	\$2.8	\$2.9
Repeal alimony payments deduction	\$0.0	\$0.2	\$0.6
<b>Individual Tax Reform Total</b>	<b>\$23.7</b>	<b>\$228.4</b>	<b>\$243.7</b>

**Provisions from the Business Tax Reform Subsection – Permanent**

<b>Business Tax Reform (\$ in millions)</b>	<b>FY 2018</b>	<b>FY 2019</b>	<b>FY 2020</b>
Increase and expand Section 179 depreciation expensing	(\$5.2)	(\$12.1)	(\$8.8)
Simplify small business accounting	(\$8.5)	(\$14.6)	(\$6.8)
Extension, expansion and phase-down of bonus depreciation for 5 years	(\$14.7)	(\$27.4)	(\$18.1)
Limit net interest deduction to 30% of adjusted taxable income	\$10.6	\$30.1	\$37.5
Treatment of S corp conversion into C corp	(\$0.4)	(\$0.7)	(\$0.7)
Modify Net Operating Loss deduction	\$2.9	\$6.7	\$7.3
Repeal domestic production income deduction	\$4.8	\$13.5	\$16.0
Limit employee fringe benefit deduction	\$3.1	\$6.5	\$6.4
Miscellaneous Business Tax Reform provisions	\$1.4	\$5.9	\$9.0
<b>Business Tax Reform Total</b>	<b>(\$6.0)</b>	<b>\$7.8</b>	<b>\$41.8</b>
<b>GRAND TOTAL</b>	<b>\$17.7</b>	<b>\$236.2</b>	<b>\$285.5</b>

Figures may not add to total due to rounding. Estimates expressed as revenue gained/(lost)

\*Estimate used the Individual Income Tax Model

**Table 3**  
**ESTIMATED IMPACT ON STATE REVENUES OF CONFORMITY**  
**TO THE PROVISIONS IN THE**  
**Tax Cuts and Jobs Act**  
**BY TAX TYPE**  
**Year over Year Change**

<b>Individual Income Tax (\$ in millions)</b>	<b>FY 2018</b>	<b>FY 2019</b>	<b>FY 2020</b>
Disallow active pass-through losses excess of \$500,000 for married joint, \$250,000 other	\$21.5	\$52.5	\$58.4
Repeal certain itemized deductions except up to \$10,000 state/local taxes, limitation on deduction for qualified interest, repeal limit on overall itemized deductions & increase charitable contribution limit*	\$0.0	\$170.8	\$179.8
Repeal employer-provided moving expense reimbursements deduction	\$0.9	\$2.0	\$2.0
Remove moving expenses deduction	\$1.4	\$2.8	\$2.9
Repeal alimony payments deduction	\$0.0	\$0.2	\$0.6
Increased and expand Section 179 depreciation expensing	(\$2.1)	(\$4.9)	(\$3.6)
Simplify small business accounting	(\$3.4)	(\$5.9)	(\$2.8)
Extension, expansion and phase-down of bonus depreciation for 5 years	(\$14.7)	(\$27.4)	(\$18.1)
Limit net interest deductions to 30 percent of adjusted taxable income	\$5.7	\$16.2	\$20.2
Modify Net Operating Loss deduction	\$2.9	\$6.7	\$7.3
Repeal domestic production income deduction	\$1.9	\$5.5	\$6.5
Limit employee fringe benefit deduction	\$1.3	\$2.7	\$2.6
Miscellaneous Business Tax Reform provisions	\$0.3	\$1.2	\$2.0
<b>Individual Income Tax Total</b>	<b>\$15.6</b>	<b>\$222.4</b>	<b>\$257.9</b>

  

<b>Corporate Income Tax (\$ in millions)</b>	<b>FY 2018</b>	<b>FY 2019</b>	<b>FY 2020</b>
Increase and expand Section 179 depreciation expensing	(\$3.1)	(\$7.2)	(\$5.2)
Simplify small business accounting	(\$5.0)	(\$8.7)	(\$4.1)
Limit net interest deduction to 30% of adjusted taxable income	\$4.9	\$13.8	\$17.2
Treatment of S corp conversion into C corp	(\$0.4)	(\$0.7)	(\$0.7)
Repeal like-kind exchanges except for real property	\$0.3	\$0.8	\$1.2
Applicable recovery period for real property	(\$0.1)	(\$0.1)	(\$0.2)
Amortization of research and experimental expenditures (impact starts 2022)	\$0.0	\$0.0	\$0.0
Repeal domestic production income deduction	\$2.8	\$8.0	\$9.5
Limit employee fringe benefit deduction	\$1.9	\$3.9	\$3.8
Repeal rollover of publicly traded securities gain	\$0.1	\$0.2	\$0.2
Certain special rules for taxable year of inclusion	\$0.8	\$1.9	\$2.3
Limit FDIC premiums deduction	\$0.4	\$1.5	\$2.0
Limit excessive employee remuneration	\$0.0	\$0.8	\$1.4
Partnership provisions	\$0.1	\$0.4	\$0.6
Tax-exempt organizations provisions	\$0.3	\$0.7	\$0.6
Other provisions	(\$0.8)	(\$1.5)	(\$1.1)
<b>Corporate Income Tax Total</b>	<b>\$2.1</b>	<b>\$13.8</b>	<b>\$27.5</b>

  

<b>GRAND TOTAL</b>	<b>\$17.7</b>	<b>\$236.2</b>	<b>\$285.5</b>
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Figures may not add to total due to rounding. Estimates expressed as revenue gained/(lost)

\*Estimate used the Individual Income Tax Model

## Attachment I

### SUMMARY OF MAJOR CONFORMITY PROVISIONS

#### Tax Cuts and Jobs Act

##### Individual Tax Reform

###### **Limitation on losses for taxpayers other than corporations**

Disallows active pass-through losses, defined as the deductions for the taxable year for the trades or businesses over the sum of the gross income from the trade or businesses, in excess of \$500,000 for joint filers, \$250,000 for all others.

- Effective Date: *Tax years beginning after 12/31/2017 and before 1/1/2026.*
- Revenue Impact: Increases tax revenue.

###### **Limitation on deduction for state and local taxes**

Limits the itemized deduction for state and local income taxes (or sales tax in lieu of income tax) and state and local real and personal property taxes to a net of \$10,000. Does not include foreign income or property taxes. Prepayment in 2017 of 2018 or later income taxes will not be allowed as a deduction in 2017.

- Effective Date: *Tax years beginning after 12/31/2017 and before 1/1/2026.*
- Revenue Impact: Increases tax revenue.

###### **Limitation on Deduction for Qualified Residence Interest**

Limits interest on home acquisition indebtedness, debt incurred in acquiring, constructing, or substantially improving any qualified residence to debt of up to \$750,000 (was \$1 million) for joint filers, half the amount for a single filer. Home acquisition debt incurred on or before 12/15/2017 is grandfathered in at \$1 million limit. Disallows interest on home equity indebtedness (previously limited to \$100,000).

- Effective Date: *Tax years beginning after 12/31/2017 and before 1/1/2026.*
- Revenue Impact: Increases tax revenue.

###### **Suspension of overall limitation on itemized deductions**

Suspends the limitation that reduced itemized deductions by 3% of the amount that their AGI exceeded a specified threshold (in 2017 the threshold is \$313,800 for joint filers and \$261,500 for single)

- Effective Date: *Tax years beginning after 12/31/2017 and before 1/1/2026.*
- Revenue Impact: Decreases tax revenue.

##### Business Tax Reform

###### **Section 179 expensing**

Expands section 179 expensing, the deduction on new and used equipment, as well as off-the-shelf software, from \$500,000 to \$1,000,000.

- Effective Date: *Years beginning from and after 12/31/2017.*
- Revenue Impact: Decreases corporate and individual income tax revenue.

###### **Extension, expansion and phase-down of bonus depreciation**

Increases bonus depreciation (depreciation on new equipment only) from current 50% to 100% for 9/27/2017 and before 1/1/2023 (longer production assets are before 1/1/2024). Beginning in 2023 (2024 for longer production assets) the bonus depreciation decreases by 20% each year.

Allows used property to qualify.

- Effective Date: Assets placed in service 9/27/2017.



- Revenue Impact: Decreases individual income tax revenue. No impact to corporate tax because Arizona currently adds back all federal depreciation and then allows a subtraction as if taxpayer had opted out of the increased expensing.

### **Simplify small business accounting**

Allows more small businesses corporations and some partnerships with corporate partners to use cash basis accounting. Small businesses (including individuals) that meet a less than \$25 million gross receipts test not required to use inventory accounting, and not subject to UNICAP rules.

Expands the exemption for small construction contracts from the requirement to use percentage-of-completion method.

- Effective Date: *Years beginning from and after 12/31/2017.*
- Revenue Impact: Decreases tax revenue.

### **Limit net interest deduction**

The interest deduction for a business averaging \$25 million or more of gross receipts for a three-year period for any year cannot exceed the sum of either the taxpayer's business interest income for the tax year or 30% of the taxpayer's adjusted taxable income for the year plus the taxpayer's floor plan financing interest for the taxable year.

- Effective Date: *Years beginning from and after 12/31/2017.*
- Revenue Impact: Decreases corporate and individual income tax revenue.

### **Repeal domestic production activities income deduction**

Repeals deduction for income attributable to domestic production activities. The Domestic Production Activities Tax Deduction, current maximum credit at 9% of the income, is intended to provide tax relief for businesses that produce goods in the United States rather than producing it overseas.

- Effective Date: *Years beginning from and after 12/31/2017.*
- Revenue Impact: Increases corporate and individual income tax revenue.

### **Modification of net operating losses**

Repeals the carryback rule except for 2 year in the case of farming trade or business. The carryforward is changed from 20 years to forever. Offset limited to 80% of the taxable income for any given year.

- Effective Date: *Years beginning from and after 12/31/2017.*
- Revenue Impact: Increases individual income tax revenue. The 80% adjustment will increase tax in the short term. The unlimited carryover period and increases to carryover amounts may decrease tax in the long term. No impact to corporate income tax as corporations add back their federal NOL deduction and then take a subtraction for an Arizona basis carryover which allows a 20 year carry forward without the 80% limitation.

## Attachment II

### NEGLIGIBLE OR UNKNOWN REVENUE IMPACTS

#### Tax Cuts and Jobs Act

##### International Tax Reform

Treatment of deferred foreign Income upon transition to participation exemption system of taxation. The previously deferred income that will be included is picked up as subpart F income.

- Effective Date: *Years beginning from and after 12/31/2017.*
- Revenue Impact: No impact on corporate income tax as Arizona allows corporations to subtract subpart F income. Individual income tax could increase but the impact is unknown and likely small because this applies to individuals who own at least 10% of the foreign entity.

#### Disaster Tax Relief and Airport and Airway Extension Act of 2017

Provides special disaster-related rules for use of retirement funds if principal place of abode was in disaster area and sustained economic loss from hurricane, disaster-related employment benefit, credit for retention of employees in disaster area and other tax relief measures.

- Effective Date: *In the case of: Hurricane Harvey – Distributions after 8/23/2017 and before 1/1/2019. Hurricane Irma – Distributions after 9/4/2017 and before 1/1/2019. Hurricane Maria – Distributions after 9/16/2017 and before 1/1/2019*
- Revenue Impact: Could decrease tax revenue but impact is likely negligible.