

# Fiscal Note

**BILL #** SB 1559

**TITLE:** businesses; fees; income tax reduction

**SPONSOR:** Kaiser

**STATUS:** As Introduced

**PREPARED BY:** Benjamin Newcomb

## Description

SB 1559 requires the Arizona Department of Administration (ADOA) to award 5% of new state contracts each year to a new business starting on January 1, 2024. A new business is defined as one that has been operating for fewer than 5 years and whose principal place of business is in Arizona. The bill also requires ADOA to waive all applicable licensing and registration fees for a new business.

In addition, the bill provides an income tax subtraction to new businesses equal to 100% of the income received during its 1<sup>st</sup> year of operation, 50% in its 2<sup>nd</sup> year, and 25% in its 3<sup>rd</sup> year. The bill takes effect in Tax Year (TY) 2024.

## Estimated Impact

We estimate the General Fund impact of the new business income tax subtraction will be \$(34.3) million in FY 2025, \$(36.5) million in FY 2026, and \$(38.9) million in FY 2027. Due to a lack of detailed business income data, our estimates are speculative and should be interpreted with caution. The Department of Revenue has not yet provided an estimate of the impact of the bill.

Any fiscal impact associated with the 5% new business state contract provision cannot be determined in advance because it is dependent on the scope of each new contract. ADOA has not provided an estimate at the time of publication.

There is no fiscal impact for ADOA to waive application and licensing fees because ADOA does not charge fees to businesses. If the intent is to have ADOA waive application and licensing fees of other agencies, we do not have an estimate of that impact. The level of lost revenue will depend on the type of business and the fee structure of the relevant licensing agency.

## Analysis

*Income Tax Subtraction Impact*- The bill allows an income tax subtraction for new businesses, including C corporations and pass-through-entities, such as partnerships, limited liability companies, S corporations and sole proprietors. The subtraction is equal to 100% of the income received during the 1<sup>st</sup> year of operation, 50% of 2<sup>nd</sup> year income, and 25% of income in the 3<sup>rd</sup> year. For the purpose of the bill's income tax subtraction, Legislative Council interprets a "new business" to mean a business that has been in operation for under 5 years and has Arizona as its principal place of business. Additionally, Legislative Council interprets the bill to mean that out-of-state businesses opening in Arizona do not qualify for the subtraction, although it is not clear whether new franchisees would qualify. While the bill does not define what constitutes "received income from the business," based on our conversation with Legislative Council, we believe that this provision refers to a business' net income (i.e., gross income minus business expenses and other allowable deductions).

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The most recent Internal Revenue Service (IRS) data on business filers shows that over 95% of businesses qualify as Individual Income Tax (IIT) filers. For this analysis, we have made the simplifying assumption that all new businesses are IIT filers. To the extent C-corporations qualify for the subtraction, our analysis will be understated because the corporate income tax rate is 4.9% compared to the 2.5% IIT rate.

According to data from the U.S. Census Bureau's Business Formation Statistics, there were 7,919 business formations in Arizona in 2022. This measure is limited to those businesses that are required to apply for an Employee Identification Number (EIN). Since sole proprietors are not required to apply for an EIN, our analysis assumes that business formations represent new businesses that file as partnerships and S-corporations. Based on historic trends, we project the number of new businesses will grow to 8,523 in 2023, 9,173 in 2024, 9,872 in 2025, and 10,625 in 2026.

Using IRS Statistics of Income (SOI) data, we estimate there were 15,717 new sole proprietors in 2022. This figure is projected to grow to 16,159 in 2023, 16,613 in 2024, 17,080 in 2025, and 17,561 in 2026.

Based on the IRS SOI data, we estimate the annual average net income for partnerships/S-corporations in Arizona to be \$67,100. The average income for sole proprietors is estimated to be \$11,800. Both net income figures represent all businesses in these particular categories, not just those in existence for 3 years or less. We would normally expect the average net income to be lower in these first 3 years. As a result, this part of our methodology could overstate the impact of the bill.

Multiplying the average per-business net income (for partnerships/S corporations and sole proprietors, respectively) by the projected number of new businesses each year, we derived estimates for the total aggregate level of subtractions from TY 2024 through TY 2026. As shown in *Table 1* below, based on this methodology, the total level of subtractions under the bill is estimated to grow from \$1.37 billion in FY 2025 to \$1.56 billion in FY 2027.

Applying the 2.5% IIT rate to the aggregate amount subtracted each year, we estimated the General Fund revenue loss under the bill to be \$(34.3) million in FY 2025, \$(36.5) million in FY 2026, and \$(38.9) million in FY 2027, as displayed in *Table 1* below.

<b>General Fund Revenue Impact of SB 1559</b>			
<b>(\$ in Millions)</b>			
<b><u>Annual Subtractions from New Businesses formed in:</u></b>	<b><u>FY 2025</u></b>	<b><u>FY 2026</u></b>	<b><u>FY 2027</u></b>
TY 2022	\$179.2	--	--
TY 2023	381.3	\$190.7	--
TY 2024	811.6	405.8	\$202.9
TY 2025	--	864.1	432.0
TY 2026	--	--	920.3
Total Deductions	1,372.1	1,460.6	1,555.2
Dollar Value of Subtractions at 2.5% IIT Rate	34.3	36.5	38.9
<b>General Fund Impact of SB 1559</b>	<b>\$(34.3)</b>	<b>\$(36.5)</b>	<b>\$(38.9)</b>

**State Contracts Impact-** The State Procurement Office (SPO) serves as the state’s central procurement authority and is responsible for managing large statewide contracts and operating the state's online procurement system, the Arizona Procurement Portal (APP).

The fiscal impact would depend on the contracts the state entered into and whether state agencies would incur costs to transfer services to new contracts. The bill does not require ADOA to enter into contracts without a competitive bid process. Therefore, we assume the cost would be minimal but that it cannot be determined in advance.

**Impact of Waiving Fees -** ADOA does not charge registration and licensing fees to businesses and the bill does not grant ADOA the authority to waive fees at other state agencies including the Arizona Corporation Commission, the Department of Revenue, and the Arizona Secretary of State. Therefore, there is no cost to the state to waive fees for new businesses.

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**Local Government Impact**

Beginning in FY 2024, incorporated cities and towns will 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. Therefore, the bill would decrease overall URS distributions to cities and towns by \$(6.2) million in FY 2027, \$(6.6) million in FY 2028, and \$(7.5) million in FY 2029.

3/3/23