

Fiscal Note

BILL # HB 2081

TITLE: income tax; subtraction; tipped wages

SPONSOR: Griffin

STATUS: As Amended by House WM

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Description

The bill would allow individual taxpayers to subtract income earned as tips from their Arizona gross income for tax filing purposes. The bill is effective beginning in Tax Year (TY) 2025.

Estimated Impact

We estimate the bill would reduce General Fund revenues by \$(31.0) million annually, beginning in FY 2026.

This estimate does not account for any potential dynamic economic impacts, such as behavioral changes that may arise as a result of the bill. These dynamic impacts may result in the total revenue impact being higher or lower than estimated.

Analysis

The starting point for filing the state individual income tax is the taxpayer's federal adjusted gross income. This is further adjusted by certain additions and subtractions provided by Arizona statutes, and the remaining balance is referred to as the Arizona adjusted gross income. Currently, earnings from tips are not included in the list of allowed subtractions and are therefore taxed at the same rate as earnings from wages and other sources.

The bill would add compensation received as tips to the list of allowed subtractions. As a result, tips would no longer be included in Arizona adjusted gross income and therefore would not be subject to Arizona's 2.5% flat income tax.

The Arizona Department of Revenue does not collect data delineating the different sources of income included in Arizona adjusted gross income, and we were unable to find an independent estimate of earnings from tips in Arizona. According to the Internal Revenue Service (IRS), however, U.S. taxpayers cumulatively reported earning \$38.3 billion in compensation from tips in 2018, which is the most recent year for which data is available. According to the Bureau of Economic Analysis (BEA), total wage and salary disbursements in the Accommodation and Food Service industry increased by 46.8% from 2018 to 2024. Therefore, after adjusting for this wage growth since 2018, we estimate that total compensation from tips will be approximately \$56.0 billion in 2025.

Arizona currently has a population of 7.6 million, according to the U.S. Census Bureau, which is 2.2% of the entire U.S. population. If we make the simplifying assumption that these tips are evenly distributed among all U.S. taxpayers, we can estimate that taxpayers in Arizona earn roughly 2.2% of all tips reported to the IRS, or \$1.2 billion. Under current law, Arizona's 2.5% tax rate on these earnings would generate \$31 million in revenues. Since the bill would allow these earnings to be subtracted from taxable gross income, the state would incur a revenue loss of \$(31.0) million relative to current law.

In addition to the direct revenue impact, there may be dynamic economic impacts attributable to the bill that may affect state revenue collections. The increase in after tax income, for example, could lead to increased consumer spending and therefore higher Transaction Privilege Tax (TPT) collections.



Alternatively, some taxpayers may attempt to reclassify other types of taxable income as earnings from tips, which could lead to a greater than anticipated loss in revenue collections. At the state's 2.5% tax rate, this incentive may not be that strong. If the federal government were to make tips exempt from federal income taxes, the incentive may be stronger.

Local Government Impact

Incorporated cities and towns 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. Since the bill would decrease statewide IIT revenue by \$(31.0) million in FY 2026, URS distributions would decrease by \$(5.6) million, beginning in FY 2028.

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