

Expect Seamless Transition To Controversial Ariz. Flat Tax

By **Karen Jurichko Lowell and Pat Derdenger** (November 28, 2022)

Arizona will implement its new 2.5% flat income tax rate on Jan. 1, 2023, a full year ahead of schedule. According to Gov. Doug Ducey, the accelerated implementation is the result of the state's continued economic growth and record surplus.

The flat tax was adopted as part of the 2022 fiscal year budget, signed June 30, and was originally scheduled to be phased in over three years, beginning Jan. 1, 2024.

However, a Sept. 29 memo prepared by the Joint Legislative Budget Committee and the Governor's Office of Strategic Planning and Budgeting determined that Arizona's general fund revenues exceeded the statutory threshold required to immediately implement the flat tax.

The flat tax eliminates Arizona's graduated income tax scale, which started at 2.59% and had a maximum tax of 4.5% for income over \$159,000 a year for a single person. Starting Jan. 1, 2023, all taxpayers will pay a maximum of 2.5%.

According to the Tax Foundation, Arizona will join 11 other states with flat income tax rates and will have the lowest rate among these states. The new 2.5% flat rate is the only change made to the individual income tax structure; there were no substantive changes made such as narrowing or elimination of deductions, exemptions or credits. Thus, it will be a fairly seamless implementation.

The flat tax's enactment was contingent on annual state revenues exceeding \$12.9 billion. Revenues for fiscal year 2022 exceed \$16.7 billion per the analysis of the Joint Legislative Budget Committee and the Governor's Office of Strategic Planning and Budgeting, allowing the accelerated implementation.

According to the governor's office, the average Arizona taxpayer will receive a 13% income tax reduction, saving families \$350 a year. However, the Legislature's budget analysis said the average savings would be lower. While taxpayers with adjusted income ranging from \$1 million to \$5 million are expected to see \$44,762 in tax savings, the analysis projected savings of only \$2 to \$8 for taxpayers making \$40,000.

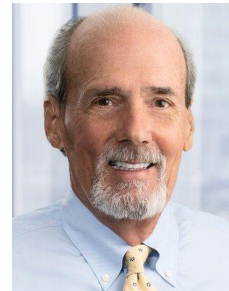
Contentious Path to the New Flat Tax Rate

The implementation of the new flat tax rate comes after two Arizona tax initiatives were found to be unconstitutional. In November 2020, Arizona voters passed a ballot initiative known as Proposition 208, which would have established a 3.5% income tax surcharge on single taxpayers with taxable income of \$250,000 or more — \$500,000 for married taxpayers filing jointly — effective Jan. 1, 2021.

Revenue collected from the Proposition 208 surcharge would have been deposited into a special fund for distribution to schools and teacher training programs. Proposition 208 was found unconstitutional by an Arizona court in March, and the 3.5% surcharge never took



Karen Jurichko
Lowell



Pat Derdenger

effect.

The 2.5% flat tax rate in the 2022 fiscal year budget also faced legal challenges. Following the governor's signing, opponents of the cuts collected enough signatures to block the 2.5% rate from taking effect until a referendum vote in the Nov. 8 election. The Arizona Supreme Court struck down that effort in April, holding that that tax legislation is not subject to the voter referendum process in the state constitution.

The flat tax rate remains controversial. Individual income tax collections represented 43.2% of total Arizona general fund revenue collections in fiscal year 2022, with a portion of those individual income tax collections being shared with incorporated cities and towns within the state. The flat tax will result in approximately \$1.5 billion in forgone revenue annually according to the Joint Legislative Budget Committee's fiscal year 2022 appropriations report.

Critics say this revenue is permanently lost given the legislative supermajority required to enact new taxes. Statutes imposing taxes require a vote of two-thirds of the Legislature to pass.

Officials representing Arizona cities and towns assert the flat tax will result in \$255 million in lost municipal revenue annually. Critics claim the surplus that enabled the flat tax's enactment was primarily the result of a one-time influx of federal stimulus dollars that is not sustainable in the future.

The Arizona Center for Economic Progress and the Institute on Taxation and Economic Policy, both tax policy think tanks, also estimate that the flat tax will increase tax inequity, with the top 20% of taxpayers receiving more than 90% of the tax cut's benefits.

On the other hand, proponents of the flat tax assert that the reduction in tax rates will make Arizona more competitive and economically appealing as compared to other states, particularly those with lower rates or no income tax at all.

The 2022 flat tax is not Arizona's first attempt at a flat tax. In 1987, a bipartisan plan passed in the Arizona House of Representatives with overwhelming support before being scuttled due to opposition from the governor, who instead wanted to roll back a temporary sales tax increase.

The 1987 plan would have cut taxes for approximately 70% of Arizona taxpayers while increasing taxes on the wealthiest 2% of Arizonans, largely through the elimination of various deductions and exemptions, including the charitable contribution deduction.

The 1987 plan featured two tax rates — 3% on income up to \$5,000, and 4% on income above that threshold. By contrast, the 2022 flat tax keeps existing deductions and exemptions in place.

The successful enactment of the new flat tax was the result of a convergence of several factors. During the first year of the COVID-19 pandemic, Arizona spent judiciously.

This was followed by a surprising economic rebound that left the state with a substantial budget surplus. The state also added to the surplus with increased retail transaction privilege — sales — tax collections on out-of-state online vendors following a 2019 change to the retail tax code.

As such, lawmakers had enough money in the state's coffers to keep the government funded and make some important spending increases, while still affording the reduction in future state revenues.

The new flat tax builds on the 2019 tax changes, which eliminated one of the tax brackets in place at the time — flattening from five brackets to four.

Flat income tax rates have become more common in the last few decades. In 1987, when Arizona first considered a flat tax scheme, only Colorado had such a policy according to the Tax Foundation.

Today, per information published by the Tax Foundation, Arizona joins Illinois, Indiana, Kentucky, Massachusetts, Michigan, New Hampshire, North Carolina, Pennsylvania, Washington and Colorado as states with flat income tax rates.

An additional seven states — Alaska, Florida, Nevada, South Dakota, Tennessee, Texas and Wyoming — have no state income tax.

What Taxpayers Need to Know

While the fiscal impact of the new flat tax rate may be subject to debate, its implementation should be painless and welcome for individual taxpayers. In November, the Arizona Department of Revenue issued an updated individual income tax withholding form — Form A-4 — that includes withholding options reflective of the new flat tax rate.

The updated Form A-4 has seven new withholding election rate boxes, ranging from 0.5% to 3.5%. Taxpayers still have the option to elect to withhold an additional, flat dollar amount, or to elect zero withholdings if they anticipate no tax liability for the current tax year. If a taxpayer does not fill out a new Form A-4, the default withholding rate is 2.0%.

Employers are required to make Form A-4 available to their employees by Jan. 31, 2023, but can begin distributing the form immediately.

While the merits of a flat income tax rate and its impact on state finances may be in the eyes of the individual taxpayer, Arizona's move to a flat tax should prove to be a seamless transition.

Arizona residents subject to withholding should review their elections and submit a new Form A-4 if they would like to withhold at a rate other than 2.0%. Employers should make their employees aware of the new forms in advance of the Jan. 31 deadline.

Karen Jurichko Lowell is an associate and Pat Derdenger is a partner at Lewis Roca Rothgerber Christie LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.