

Two important changes went into effect this year that are affecting many Arizona residents: a flat tax and the Pass-Through Entity Tax.

“Flat” tax for individuals

For the 2022 tax year, individuals will be subject to only two tax rates in Arizona - 2.55% and 2.98% - reduced from the previous four rates/brackets: 2.59%, 3.34%, 4.17%, and 4.5%. This change had a long, strange journey to travel to get here, but the dust has finally settled and the two new rates are in place. **These two rates collapse into one, even lower rate, in 2023: 2.5%.**

What does this mean for Arizona taxpayers? A lower overall tax burden and more than likely, an overpayment/refund for the year.

Why? Due to the time it took for the rates to become a reality, all of us who earn a wage as an employee have been withholding Arizona income tax under the old, four-rate scheme for all of 2022. Previously, the higher withholding rates reached a peak of 5.1%. If you are in a situation where you don't have significant amounts of income from other sources, you've likely over withheld by at least 2.12%.

Thankfully, the Department of Revenue has (finally) released an updated A-4 for 2023. If you haven't already completed a new A-4 and given it to your employer, [here is a link to the new form.](#)

Pass-through entity tax

The other major change for 2022 is the pass-through entity tax (PTET). What is this and why is it important? In short, the PTET is a workaround for the \$10,000 cap on personal tax deductions.

Prior to the passage of the Tax Cuts and Jobs Act (TCJA) in December of 2017, individuals who itemized their deductions, could deduct all of their income, real estate and personal property taxes. If you lived in a high-tax state, this was a material and meaningful deduction. For example, if you paid \$30,000 in state income taxes, \$5,000 in real estate taxes and \$1,000 in vehicle license taxes, you would have claimed a tax deduction of \$36,000 on Schedule A of your individual income tax returns. If you were in the highest tax bracket (currently 37%), this would have meant a reduction in your federal taxes of approximately \$13,000. But, under the provisions of the TCJA, you are limited to deducting \$10,000 in taxes which means you'd be sitting on \$26,000 of nondeductible taxes. That's a federal tax hit of \$9,000.

Shortly after the passage of the TCJA, state governments began implementing strategies to work around this cap. Allowing taxpayers to claim a credit against state income taxes for certain charitable donations? The IRS, with the Internal Revenue Code on their side, nixed that. Some states even sued over the legislation. Finally, when the IRS issued Notice 2020-75, states received their blessing to adopt a pass-through entity tax as a workaround.

So, what is the PTET?

This workaround allows pass-through entities (such as partnerships and S corporations) to pay income taxes on the respective share of each partner's/shareholder's income and take a business deduction for the payment of those taxes.

Pass-through entity tax (continued)

Example: Let's assume we have an S corporation with one shareholder. Further, let's assume that the shareholder lives in a state with a flat tax rate of 2% (Ha!). Let's also assume that the year is 2016 and the S corporation has taxable income of \$1,000,000. In that year, which is prior to the passage of the TCJA, this shareholder would pay \$20,000 of taxes on that income on their state return. But, they would have also been allowed a deduction of \$20,000 on Schedule A of their federal income tax return.

As mentioned previously, after 2017, this shareholder would be limited to deducting half of those taxes on their federal return (\$10,000), losing half of the federal benefit. Under a PTET regime, this shareholder could elect to have the S corporation pay taxes on that income and claim a business deduction for the payment of those taxes.

The end result? Instead of passing through \$1,000,000 of taxable income to the shareholder, the S corporation is now passing through \$800,000 of taxable income to the shareholder.

Under the rules implemented by the TCJA of 2017:

- Without PTET – Taxable income is \$990,000
- With PTET – Federal taxable income is \$980,000

Again, assuming a 37% tax rate, federal taxes are:

- Without PTET – Taxes = \$366,300 ($\$990,000 * 37\%$)
- With PTET – Taxes = \$362,600 ($\$980,000 * 37\%$)

That is a federal tax savings of \$3,700 for simply electing to pay taxes on that income a bit differently.

We hope that this (simple?) explanation can help you understand why we recommend that you pay your state taxes in this manner, in certain cases. If you have more questions, please let us know. We are here to help!

Small Business Income Tax (SBI)

Wait a minute, what about the SBI tax you recommended that we pay last year (2021)?

Technically, this volunteer tax is still with us in 2022 and beyond but, unless you want to pay more than you are required to the state of Arizona, this tax was one-and-done in 2021.

This is due to the statutory SBI tax rate, which is 3.5%. If the top tax rate in Arizona is 2.98%, why would anybody elect to pay these taxes?

So, unless you want to know all of the details behind this tax and how it fits into the landscape, simply know that you won't have to deal with it this year. Or, any future year.

That is, unless laws change again.