



MULTISTATE INCOME/FRANCHISE TAX

Arizona enacts elective Arizona small business tax and pass-through entity level tax Tax Alert

Overview

On July 9, 2021, Arizona Governor Doug Ducey signed into law [Senate Bill 1783](#) (SB 1783) and [House Bill 2838](#) (HB 2838), which respectively provide for an elective income tax filing for Arizona small businesses and an elective entity level tax for certain pass-through entities, including partnerships and S corporations.

This Tax Alert provides a summary of some of the more relevant provisions in these bills.

Arizona small business tax election

For tax years beginning from and after December 31, 2020, SB 1783 provides for many changes to Arizona's income tax system relating to Arizona small business taxpayers, including but not limited to:

- Arizona small business taxpayers may elect annually to file an Arizona small business income tax return. This election may be revoked on a timely filed amended Arizona small business income tax return and a corresponding Arizona individual income tax return.
- "Small business taxpayer" is defined as any individual taxpayer who reports on the taxpayer's federal income tax return any income that constitutes Arizona small business gross income.
- "Arizona small business gross income of a resident taxpayer" is defined as the sum of the amounts, whether positive or negative, that are included in a taxpayer's federal adjusted gross income for the reported taxable year, computed pursuant to the Internal Revenue Code ("IRC"), and that are reported on the following schedules and forms or on equivalent successor schedules and forms:
 - (i) schedule B, interest and ordinary dividends;

- (ii) schedule C, profit or loss from business;
 - (iii) schedule E, supplemental income or loss;
 - (iv) schedule F, profit or loss from farming;
 - (v) form 4797, sale of business property;
 - (vi) form 4835, farm rental income and expenses;
 - (vii) includes any amount reported on Schedule D, capital gains and losses, that is recognized with respect to either the taxable disposition of an ownership interest in any entity other than a publicly traded entity or the taxable disposition of capital assets used in connection with a trade or business activity, including goodwill and going concern value.
- For individuals who are not Arizona residents, “Arizona small business gross income” is defined as that portion of federal adjusted gross income that represents income from sources within Arizona.
 - The tax rate for Arizona small business taxpayers that make the election to be taxed at the entity level is as follows:
 - For taxable years beginning from and after December 31, 2020 through December 31, 2021, an amount equal to 3.5%;
 - For taxable years beginning from and after December 31, 2021 through December 2022, an amount equal to 3.0%;
 - For taxable years beginning from and after December 31, 2022 through December 31, 2024, an amount equal to 2.8%; and
 - For taxable years beginning from and after December 31, 2024, an amount equal to 2.5%.
 - The election allows for certain additions and subtractions provided in sections 43-1021 and 43-1022 of the Arizona Revised Statutes to the extent that additions and subtractions directly relate to Arizona small business gross income.
 - The election provides for a credit for income taxes paid to other states with certain limitations.
 - Estimated tax payments may be required for certain electing small business taxpayers.

Pass-through entity tax election

For tax years beginning from or after December 31, 2021, HB 2838 provides for many changes to Arizona’s income tax system related to certain pass-through entities that are treated as a partnership or S corporation for federal income tax purposes, including but not limited to:

- Partners or shareholders of a business that is a partnership or S corporation may elect to be taxed at the entity level at a rate of 4.5% on the entity’s Arizona taxable income as discussed further below. The election is required to be made on or before the due date or extended due date of the entity’s return.
- The tax is levied on taxable income that is attributable to its resident partners or shareholders and the portion of its taxable income derived

from sources within this state that is attributable to its nonresident partners or shareholders for the taxable year.

- The portion of the taxable income attributable to a partner or shareholder that is not an individual, estate, or trust is not included in the entity level tax. Additionally, individual, estate, or trust partners or shareholders may opt out of the election to be included in the entity level tax.
- The amount deducted by a partnership or S corporation pursuant to the IRC for the amount paid to the state under the entity level tax election and for taxes the Arizona Department of Revenue determines are substantially similar must be reflected in the partner's or shareholder's Arizona gross income and the partnership's or S corporation's Arizona taxable income.
- The entity level tax provides for a credit for resident taxpayers for substantially similar taxes paid to other states for income received from a pass-through entity and taxes paid at the entity level.
- Estimated tax payments are required for electing taxpayers whose taxable income exceeds \$150,000 in the preceding tax year.

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