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TO : All Clients
FROM : David Buterbaugh, CPA
DATE : February 2, 2022
SUBJECT : Arizona Small Business Income (SBI) Tax – Impact On Your 2021 Taxes

IMPORTANT: We have included a new question on page 3 of our tax organizer that we request you to answer. The question is for you to instruct us as to whether you would like us to analyze if the new Arizona tax law change will be beneficial to you this year. If you do not file an Arizona tax return, you do not need to read this memorandum. Simply go to page 3 of our tax organizer and check the “No” box regarding whether or not you would like to make the form 140-SBI election. For those clients of ours that file Arizona returns, we ask that you take the time to read this memorandum and determine whether you wish for our firm to do the additional work and incur the additional fees to analyze this important decision. For many of you, the overall tax savings could be fairly significant this year. The new law is complex. We have done the best we can to simplify the new law to allow you to make a well informed decision.

In 2021, Arizona enacted into law a “Small Business Income” (SBI) tax for tax years 2021 and forward. For tax year 2021, the SBI is a flat tax on small business income at a 3.5% rate. For clarification, although the name of the law is “Small Business Income”, you are not required to have a small business to qualify.

Taxpayers filing Arizona Form 140, 140NR or 140PY with “small business income” (SBI) reported on the Federal Schedules below and included in their federal AGI (adjusted gross income) may **voluntarily elect** to report their SBI income (defined below) on a new separate form (Form 140-SBI):

- Federal Schedule B (interest and dividend income)
- Federal Schedule C (self-employment income)
- Federal Schedule D (Capital Gains/Losses from non-publicly traded entity including capital gains from the sale of capital assets and goodwill of a trade or business activity you own.)
- Federal Schedule E (Rental net income and Royalty income)
- Federal Schedule E – Pg 2 (Flow through income or loss from S-Corps, Partnerships and Trusts)
- Federal Schedule F (Farm income and Farm rental income)
- Federal Form 4797 (Sale of certain Business Assets)

For 2021, Arizona filers can elect to have the above income taxed at the flat tax rate of 3.5% by reporting these items on form 140-SBI. Please note that this is a separate and **additional** individual filing apart from your Arizona Form 140/140NR/140PY. On your individual AZ tax return, you will

reduce your total AZ income by the income reported on Form 140-SBI and the net income remaining is taxed at the normal AZ tax rates (see below).

If all of your income is from the sources listed above, and you elect to file Form 140-SBI, you would still be required to file the “normal” AZ Form 140, but your income would be reduced by the amounts reported on the AZ Form 140-SBI. If you choose to make the election to report the SBI income above, ALL SBI income from ALL the SBI categories will be reported on Form 140-SBI. You cannot pick and choose which items of SBI income to report on Form 140-SBI.

In order to minimize our fees, we are allowing you the opportunity to let us know if you wish for us to allocate additional time to determine if you would benefit from filing form 140-SBI. We encourage you to review the following and then answer our Arizona Form 140-SBI question on page 3 of our tax organizer. Since you cannot later elect to file form 140-SBI, we ask that you sign the organizer page to accept responsibility for your decision. If you check the box “yes”, we will assume responsibility for filing the appropriate form so as to minimize your tax liability. This does take extra time and our fee will be increased based on the additional time that is required. The more complex your return, generally, the more time that is required. Our goal is to be as efficient as possible with the additional analysis.

Should I File Form 140-SBI?

Our goal is to make the analysis as easy as possible for you to make a good decision. Below, we have provided the main factors that would assist you in making a good decision. If your scenario does not lend itself to an easy answer, we encourage you to have us do the analysis on your behalf.

The first step is to determine your AZ taxable income and tax rate. Generally, if you believe you will be taxed at above a 3.5% AZ tax rate for 2021, you will most likely benefit from making this election. Below are the 2021 tax rate and income brackets for Arizona. Keep in mind these rates are based on AZ taxable income which is calculated after all deductions are claimed. If you filed a form 140 for tax year 2020, this is the amount on line 45 of form 140:

<u>Tax Rate</u>	<u>Taxable Income</u> Single/MFS	<u>Taxable Income</u> Married Filing Joint/Head of Household
2.59%	\$0 to \$27,272	\$0 to \$54,544
3.34%	\$27,273 to \$54,544	\$54,545 to \$109,088
4.17%	\$54,545 to \$163,632	\$109,089 to \$327,263
4.50%	\$163,633 and up	\$327,264 and up

If you are Single or Married Filing Separately and you anticipate your AZ taxable income will exceed \$ 54,545, you may benefit from the election. If you are Married Filing Jointly or Head of Household for 2021, you may benefit if your taxable income will exceed \$ 109,089. If, however, your income is under these limits, you can assume you will not benefit from the Form 140-SBI and can check the box “No” in our tax organizer page 3.

Bear in mind, this election is irrevocable. If you are claiming aggressive deductions on your tax return and are audited in the future and your income is adjusted higher, you will not be able to change your election at that time.

If your AZ taxable income is anticipated to exceed these amounts, you will now want to focus on your sources of income. If your income is primarily W-2, pension, social security or from capital gains from sales of publicly traded stocks or mutual funds, you may not benefit from the filing of Form 140-SBI. If, however, you have income from sources other than these items, you should consider making the election and filing of form 140-SBI.

Additional Factors To Consider

If you still believe you will benefit from filing Form 140-SBI, we now get to the more complex issues to consider.

Filing of the Arizona form 140-SBI is an annual **election** and requires an additional tax filing. The election is made by filing Form 140-SBI and it **must** be timely filed (including extension) or the election will be denied. There are some additional factors to keep in mind:

- If you extend your Arizona tax return, the extension for Form 140 will also extend your Form 140-SBI thus protecting your ability to make the election after April 15th. However, if you are planning on making the SBI election, any tax calculated must be paid separately on an extension form for 140-SBI. Any other tax owed on your “normal” individual AZ tax return, will need to be paid with the normal form 140 extension. The good news is that for tax year 2021, there is no underpayment of estimated tax penalty for SBI tax if payment for 90% of the SBI tax is made by 4/15/2022.
- Your itemized deductions cannot be used to reduce your SBI, itemized deductions remain on the “regular” Form 140. The same is true with AZ tax contribution credits, these are only claimed on the “regular” return.
- The credits for business contributions by an S Corporation to School Tuition Organizations and the Research and Development credits are allowed to reduce 140-SBI tax.
- Any estimates already paid into Arizona via form 140-ES or application from your 2020 form 140 cannot be utilized against the AZ SBI tax thus you could potentially have a large refund on your “normal” AZ return and owe a significant balance for the SBI tax. Bear in mind that the form 140-SBI came into existence late in the year and the state provided very few details until recently. Further, to date, AZ has chosen not to allow taxpayers to offset liability on the 140-SBI against an overpayment from form 140. This will likely lead to difficult cash flow decisions for those taxpayers that will benefit by filing form 140-SBI.
- If you make the SBI election, you may possibly have separate SBI tax estimates to pay for 2022 if you believe you will make the election for 2022 as well. We can help determine the estimates that will be needed if you make the SBI election for 2021.
- Finally, for 2022, S Corporations and Partnerships will have the option to elect to pay the AZ personal tax liability for K-1 income on behalf of shareholders and partners. This is a very favorable change in the law which will help taxpayers to claim a deduction for state taxes paid as a “work around” to the SALT limitations. We will be sending a separate informational memo on this subject to our clients with S corporation or Partnership interests.

- There will be additional costs involved for analyzing any potential savings and preparing the additional filings.

If you believe you may benefit from filing form 140-SBI, we encourage you to allow us to analyze your return so you can make the most beneficial decision. If this is the case, please check the “Yes” box on page 3 of our tax organizer.

In order for us to maximize your tax benefit, it will be necessary for us to spend more time developing the new information which will be required to properly reflect the tax reform changes relating to this new Arizona SBI tax which will result in higher fees. We are very sensitive to cost/benefit analysis and will do our best to get to the best result for you as efficiently as possible.

We look forward to assisting you in navigating these new changes in order to minimize your Arizona tax liability.