Arizona Lowers Corporate Income Tax Rate, Increases Weight of Sales Factor in Optional Apportionment Formula, Adds Credits and Updates Federal Conformity

Arizona Governor Jan Brewer has signed business incentives legislation that will lower the corporate income tax rate and increase the weight of the sales factor in the optional apportionment formula beginning in the 2014 tax year.1 Also, the legislation includes a new credit to encourage job creation, a new research credit and enhancements to the credit for investments in qualified small businesses. In an effort to improve Arizona’s business climate, the Arizona Commerce Authority is created to assume many of the functions and responsibilities previously performed by the Arizona Department of Commerce. Additionally, separate legislation has been enacted that adopts the Internal Revenue Code (IRC) as in effect on January 1, 2011 (previously, January 1, 2010).2

Corporate Income Tax Rate Reduced
The new law provides for the incremental reduction of the corporate income tax rate starting in the 2014 tax year.3 For taxable years beginning through December 31, 2013, the tax rate remains at 6.968 percent of net income. The rate subsequently decreases as follows:

- For taxable years beginning on or after January 1, 2014 through December 31, 2014, the rate is 6.5 percent;
- For taxable years beginning on or after January 1, 2015 through December 31, 2015, the rate is 6.0 percent;
- For taxable years beginning on or after January 1, 2016 through December 31, 2016, the rate is 5.5 percent; and
- For taxable years beginning on or after January 1, 2017, the rate is 4.9 percent.4

Optional Apportionment Formula
Arizona law allows taxpayers to elect to apportion income by using either (1) a standard apportionment formula that has a property factor, payroll factor and double-weighted sales factor or (2) a formula with a heavily weighted (enhanced) sales factor.5 Currently, a

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3 ARIZ. REV. STAT. § 43-1111.
4 Id.
5 ARIZ. REV. STAT. § 43-1139.
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taxpayer may elect to use the enhanced sales factor formula, which consists of a 10 percent property factor, 10 percent payroll factor and 80 percent sales factor. Under the legislation, the sales factor in the enhanced sales factor formula gradually will increase as follows:

- For taxable years beginning on or after January 1, 2014 through December 31, 2014, the property factor is 7.5 percent, the payroll factor is 7.5 percent and the sales factor is 85 percent;
- For taxable years beginning on or after January 1, 2015 through December 31, 2015, the property factor is 5 percent, the payroll factor is 5 percent and the sales factor is 90 percent;
- For taxable years beginning on or after January 1, 2016 through December 31, 2016, the property factor is 2.5 percent, the payroll factor is 2.5 percent and the sales factor is 95 percent; and
- For taxable years beginning on or after January 1, 2017, there is a single sales factor.6

Credit for New Employment

Historically, Arizona offered an enterprise zone incentive program that provided a credit for net increases in qualified employment positions of Arizona residents by a business located in an enterprise zone. Effective June 30, 2011, a new quality jobs program replaces the former enterprise zone incentive program.7 The new program provides corporate income tax, personal income tax and insurance premium tax credits equal to $3,000 for each full-time employee hired in a qualified employment position in each of the first three years of employment.8 The credit is limited to 400 employees in any taxable year. Excess credits, however, can be carried forward for up to five taxable years.

To be eligible for this credit, the taxpayer must invest at least $5 million of capital investment and create at least 25 new qualified jobs within a city that has a population of at least 50,000 that is located within a county that has a population of at least 800,000.9 Also, the taxpayer must invest at least $1 million of capital investment10 and create at least five qualified employment positions11 in any other location. No more than 10,000 jobs for

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6 Id.
7 ARIZ. REV. STAT. § 41-1525.
8 ARIZ. REV. STAT. §§ 20-224.03, 43-1074, 43-1161.
9 ARIZ. REV. STAT. § 41-1525(B).
10 For purposes of the program, “capital investment” means an expenditure to acquire, lease or improve property that is used in operating a business, including land, buildings, machinery and fixtures. ARIZ. REV. STAT. § 41-1525(K)(1).
11 “Qualified employment position” means employment that meets the following requirements: (1) the position consists of at least 1,750 hours per year of full-time permanent employment; (2) the job duties are performed primarily at the location or locations of the business; (3) the employment provides health insurance coverage for the employee for which the employer pays at least 65 percent of the premium or membership cost and (4) the employee pays compensation at least equal to the median wage of the county. ARIZ. REV. STAT. § 41-1525(K)(3).
all employers qualify for first-year credits each year. To claim a credit, the taxpayer must certify to the Arizona Department of Revenue or the Arizona Department of Insurance, as applicable, specified information for the taxpayer and each employee in the location.13

**Additional Research Credit**

For taxable years beginning on or after January 1, 2011, the legislation encourages increased research activities by offering an additional corporate income tax and personal income tax credit for payments made to Arizona universities for basic research.14 The credit amount is equal to 10 percent of the basic research payments that constitute excess expenses for the taxable year over the base amount.15 The annual amount of the additional corporate income tax credit and personal income tax credit is limited to $10 million per calendar year. Excess credits are not refundable, but may be carried forward for up to five years.

**Investment in Qualified Small Businesses**

The legislation extends and expands the personal income tax credit for investments in qualified small businesses, commonly called the Angel Investment Program.16 The Arizona Commerce Authority may authorize tax credits under this program until June 30, 2016 (previously, June 30, 2011).17 The credit may be claimed in tax years beginning through December 31, 2019 (previously, December 31, 2014).18 The definition of “qualified small business” is amended to increase the limit on total assets from $2 million to $10 million beginning in 2012. The definition of “qualified small business” is amended by eliminating the exclusion for taxpayers principally engaged in sales or distribution of retail goods or food or restaurant services; real estate; professional services; health care services; banking, brokerage, insurance or other financial or investment services; personal services; mining, forestry and other natural resource exploitation or extraction businesses; agricultural operations; and operating an investment company or fund.19 Thus, taxpayers engaged in these businesses are now eligible to claim the credit. Finally, the definition of “rural county” is expanded by increasing the population designation from 400,000 to 750,000 or fewer persons.20

For taxable years beginning after December 31, 2013, there is a subtraction from Arizona gross income for the amount of any net capital gain included in federal adjusted gross income for the taxable year derived from investment in a qualified small business.21

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12 ARIZ. REV. STAT. § 41-1525(C).
13 ARIZ. REV. STAT. § 41-1525(D), (E).
14 ARIZ. REV. STAT. §§ 43-1074.01, 43-1168.
15 The base amount is defined by IRC § 41(c).
16 ARIZ. REV. STAT. §§ 41-1518, 43-1074.02.
17 ARIZ. REV. STAT. § 41-1518(F).
18 ARIZ. REV. STAT. § 43-1074.02.
19 Former ARIZ. REV. STAT. § 41-1518(K)(6)(c).
20 ARIZ. REV. STAT. § 41-1518(K)(7). This definition is significant because qualified small businesses in rural counties receive a larger credit amount.
21 ARIZ. REV. STAT. § 43-1022(36).
IRC Conformity Updated

For taxable years beginning after December 31, 2010, Arizona adopts the IRC as in effect on January 1, 2011, including provisions that became effective during 2010 with the specific adoption of all federal retroactive effective dates, but excluding any change enacted after January 1, 2011.22 Previously, Arizona adopted the IRC in effect on January 1, 2010 for taxable years beginning after December 31, 2009. For the 2010 tax year, the conformity statute is amended to specifically adopt significant federal legislation enacted in 2010, including provisions of the Small Business Jobs Act of 201023 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 201024 that are retroactively effective during the 2010 tax year.25 However, Arizona decouples from significant provisions contained in this federal legislation such as bonus depreciation.26 Also, for purposes of IRC Section 179 expensing, Arizona requires an addback of amounts in excess of $25,000.27

Commentary

Many of the provisions contained in this legislation are intended to attract businesses to Arizona. The reduced corporate income tax rate and option of using an apportionment factor that is more largely skewed towards the sales factor should appeal to some businesses with significant Arizona presence. However, these incentives will not provide immediate benefits because they do not begin until the 2014 tax year. Also, the new credits and enhancements to existing credits should improve Arizona’s business climate. Of course, many states are enacting tax incentives in an effort to attract businesses. It will be interesting to see which states are the most successful in meeting this objective.

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22 ARIZ. REV. STAT. § 43-105(A).
23 P.L. 111-240.
24 P.L. 111-312.
25 ARIZ. REV. STAT. § 43-105(B).
26 ARIZ. REV. STAT. § 43-1121(1).
27 Id.
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