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ARIZONA TAX RESEARCH ASSOCIATION

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2011 LEGISLATIVE WRAP-UP

Major ATRA Initiatives Pass

The Legislature adjourned the First Regular Session of the Fiftieth Legislature Sine Die on April 20. The session was highlighted by the first balanced state budget since fiscal year 2007 and a business tax reform package that included one of ATRA's key priorities for the session. ATRA's 2011 Legislative Program included a proposal to phase down the assessment ratio on class one (business) property from 20% to 18% and class two from 16% to 15%. Some other reforms included in the tax package consisted of an increase to accelerated depreciation on business personal property, a reduction in the corporate income tax rate, and an incremental increase to an elective single sales factor under the corporate income tax (for more information on the tax reform package, please refer to the February 2011 *ATRA Newsletter*).

Several other important bills from the 2011 ATRA Legislative Program were passed and signed by Governor Brewer. This newsletter edition includes a summary of those ATRA initiatives, as well as commentary on a few bills that ATRA opposed (*a complete list of bills that ATRA tracked during the 2011 legislative session can be found on the ATRA website at http://arizonatax.org).*

THIRD-PARTY CITY TAX COLLECTIONS/AUDITS STOPPED

SB1165 puts to rest a very serious tax problem that developed in Arizona in recent years. In 2008 and over ATRA's strongest opposition, the League of Arizona Cities and Towns entered into a partnership with Revenue Discovery Systems (RDS) to assist in establishing contracts with cities to assume their tax collection and audit responsibilities (See the January 2010 *ATRA Newsletter)*. ATRA believed the cities lacked the legal authority to contract with a third-party to collect and audit its sales taxes. In addition, ATRA argued that it was a dramatic move in the wrong direction from a tax policy perspective.

After a failed attempt to preempt the cities during the 2010 legislative session, the ATRA Board of Directors made the decision to seek legislation one more time prior to turning to the courts to resolve this issue. Senator Steve Yarbrough, Chairman of the Senate Finance Committee, agreed to sponsor SB1165 during the 2011 session to prohibit cities from contracting with third-party entities for the collection of sales taxes. Additionally, cities would be prohibited from employing or contracting with sales tax auditors on a contingent-fee basis.

Followed by last year's failed attempts, SB1165 received overwhelming support during the 2011 legislation session, with a vote of 45-14 out of the House and 24-5 in the Senate. SB1165 was signed into law by the Governor on April 12, 2011.

If there was any silver lining in the two-year effort to stop Arizona's sales tax system from further deteriorating, it was that state policymakers were re-educated on the dramatic need to reform our state and local sales tax code.

Arizona is one of only a few states that allows for an independent municipal sales tax structure that is not only different from the state base but also varies between each of Arizona's 92 cities. Whereas most other states have a single sales tax base that businesses must comply with, Arizona businesses are required to comply with multiple tax bases. In addition to the requirement to remit multiple sales tax payments, Arizona businesses are faced with the potential administrative burden of audits from the state as well as municipal auditors.

As a result of the growing interest in uniformity among policymakers, the ATRA Tax Practitioner's Committee has started its work toward developing a uniform base between the state and city tax bases.

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HB2201 unclaimed property; holder information rulings (Harper)

Recommended by the ATRA Tax Practitioner's Committee, Rep. Jack Harper sponsored HB2201, which provides unclaimed property holders the option to anonymously seek guidance from the Department of Revenue (DOR) regarding DOR's interpretation of the laws or rules governing unclaimed property holdings through a Holder Information Ruling (HIR). Currently, a holder of unclaimed property must disclose its identity to DOR when requesting a ruling. Only taxpayers have the ability to seek anonymous guidance from DOR and HB2201 simply provides unclaimed property holders with that same option.

In existing statute, the holders of unclaimed property have the ability to seek direction from DOR regarding the laws of unclaimed property through a Private Holder Ruling (PHR) if the holder's identity is disclosed (identical to a Private Taxpayer Ruling for sales and income taxpayers). Under a PHR, a holder of property may make a request to DOR outlining the specific issue in question. The Department may issue a ruling within 45 days if no unclaimed property liability has accrued with respect to the facts contained in the request, and if issued, the ruling is only applicable to the holder that made the specific request.

Also under current law, if DOR later modifies or revokes the ruling as the result of a change or clarification of the law, DOR is prohibited from applying the change or clarification retroactively as long as the holder's identity was disclosed (PHR). Additionally, DOR is prohibited from demanding any penalty or interest attributable to erroneous advice it furnished to the holder if the holder reasonably relied on the ruling and the penalty or interest did not result from a failure by the holder to provide adequate or accurate information.

HB2201 passed through the Legislature unanimously and was signed by the Governor.

HB2202 DOR closing agreements (Harper)

Another bill that was proposed by the ATRA Tax Practitioner's Committee and sponsored by Rep. Jack Harper amends a provision in the Taxpayer Bill of Rights that protects taxpayers in situations when there is an extensive misunderstanding or misapplication of the tax laws. If the Department of Revenue (DOR) determines that at least 60% of the taxpayers included in the same "affected class" have not complied with their tax obligations, then DOR may enter into closing agreements with the group of affected taxpayers. Unfortunately, the current definition of "affected class" is so broad that few taxpayers have been granted relief under this provision.

Under current statute, DOR is required to hold a public hearing to determine the extent of the possible misunderstanding and the affected class of taxpayers. If it is determined that there has been an extensive misunderstanding, DOR may enter into a closing agreement with the affected class of taxpayers to abate some or all penalties, interest and tax that taxpayers failed to remit or to apply the tax prospectively. In an attempt to increase the effectiveness of this statute, HB2202 narrows the definition of "affected class" by adding taxpayers who are also "similarly situated," and for transaction privilege tax or use taxpayers, taxpayers in the same industry code under the North American Industrial Classification System (NAICS) may also be considered.

Additionally, HB2202 requires DOR to make an initial determination as to the existence of an affected class of taxpayers, in which case DOR may determine that there has not been an extensive misunderstanding and notify the taxpayer(s) that the request is denied. If a public hearing is held, DOR has 60 days to notify the attendees at the public hearing and publish a public notice on its website stating whether relief will be granted. More importantly, HB2202 provides persons that are denied relief under this provision the right to appeal DOR's determination.

ATRA worked closely with DOR on this bill, which passed unanimously out of the House and the Senate, and was signed into law by the Governor on April 28.

SB1218 fire districts; accounts; finances (Allen)

The fire district assistance tax (FDAT) is a countywide secondary property tax that is levied by the county on behalf of all fire districts. The tax rate is limited to 10-cents per $100 of assessed value and the FDAT distribution is based on 20% of each fire district's local levy, which is currently capped at $300,000 for all districts, excluding merged districts. Over time however, the hold-harmless provision for merged district distributions has created inequities within the system that were never anticipated and a main

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provision included in SB1218 is a remedy to that problem.

The inequities in the FDAT came to light in 2008 when three fire districts entered into an agreement to merge, which included the fire districts of La Canada, Heritage Hills, and North Ranch Linda Vista. One of the requirements included in the written agreement of the merger was that each district had to increase their local levies enough in order to maximize their FDAT distribution in the year prior to the merger. That required each district to triple its local levy in order to equally increase the total FDAT distribution to the district. Once merged, the FDAT would increase from $350,000 to $900,000. Because of the hold harmless provision for merged districts, the newly merged fire district of Mountain Vista was able to drop its local property tax rate down to previous levels in the year following the merger and still receive the $900,000 in FDAT. As a result, Mountain Vista by far receives the largest FDAT distribution of the more than 160 fire districts in Arizona.

ATRA worked closely with fire district representatives in crafting this amendment to prevent future abuse to the FDAT statute. SB1218 updates the cap on FDAT distributions that has been in place for almost 20 years to $400,000 for all districts, including merged districts, and without regard if the fire district boundaries cross county lines.

As a result of the Governor's signature on SB1218, this important amendment to the FDAT statute will become effective beginning in tax year 2012.

HB2336 model city tax code; official copy (Olson)

In the past, the non-profit organization, the League of Arizona Cities and Towns (League), has been responsible for the maintenance of the official copy of the Model City Tax Code (Code). The Code allows each individual city to determine which services or industries will be subject to transaction privilege tax (TPT) and the rate at which the service is taxed. Because cities have a separate TPT base than the state, Arizona's sales tax structure is one of the most difficult to comply with in the nation.

With 92 participating cities, the Code is constantly undergoing changes. Unfortunately for businesses trying to comply with the Code, the League only updated the Code quarterly, allowing months to pass before any changes were reflected. On several occasions, the Code lagged changes by several months. In the introduction section of the Code, a message by the League even states that "we cannot guarantee nor can we be responsible for its accuracy."

Sponsored by Rep. Justin Olson, HB2336 requires the Department of Revenue (Department) to maintain the official copy of the Code, effective July 1, 2012. In addition to the transfer of duties, the Department is required to reflect any changes to the Code, including tax rate changes, within ten days of approval by the Model Tax Code Commission.

The bill was signed by the Governor after passing unanimously out of the House and Senate.

HB2338 special districts; secondary levy limits (Olson)

Currently in Arizona's property tax system, primary levies, which cover the maintenance and operations budgets of most jurisdictions, are limited to 2% growth plus new construction. Additionally, the values against which primary taxes are levied are limited, which protects home and business owners against steep increases in taxes when property values skyrocket. On the other hand, secondary levies, which fund voter approved bonds, overrides, and special districts, are levied against the secondary net assessed value (SNAV) which is unlimited in growth. Despite required voter approval for most secondary levies, taxpayers remain susceptible to drastic increases in secondary property taxes. Fortunately for taxpayers, considerable progress has been made in the effort to lower property taxes. In 2009, ATRA successfully limited the annual growth of fire district levies, which are levied against the SNAV, to 8% plus annexations. But even though last year's legislation was a victory for taxpayers, the abuse endured by taxpayers is far from over.

With no limits on secondary levies, special districts, including library, adult and juvenile jail, and public health services, have vastly exceeded growth of all other levies, primary or secondary, in the past several years. From tax years 2004 to 2007, special district levies grew 86%, more than doubling the growth rate of all other secondary levies combined. The annualized increase for this span was 23% for special districts and 11% for all others. Over these three years, SNAV increased 62%. From 2007 to 2010, a time period marked by a slumping economy, special districts still managed to produce an increase of 16% compared to 5% for all other jurisdictions combined. During that same time, SNAV increased a mere 5%.

Seeking to stop the barrage on taxpayers, Rep. Justin Olson introduced HB2338, which would have subjected special district levies to the same limitations that currently only apply to primary levies. When special district levies experienced a massive increase from 2004 to 2007, primary levies increased only 16% (5% annually) despite an increase in primary net assessed value of 39%. HB2338

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would have limited special district levy growth to 2%, plus the additional amount attributable to new construction, beginning in tax year 2011. These districts, however, would not have lost capacity if they elected not to levy to the limit in any given year. Had these limits been in place over the last seven years, taxpayers would have been spared millions of dollars. Unfortunately the Governor vetoed the bill.

SB1313 Public health districts; voter approval (Murphy)

SB1313 requires a public vote prior to the creation of a Public Health Services District (PHSD). Current law allows a county board of supervisors (Board) to create a PHSD with either a unanimous vote of the Board or voter approval. Special taxing districts, with very few exceptions, require at least some level of taxpayer/voter input prior to their creation. SB1313 eliminates a county's ability to sidestep the voters by requiring their approval prior to creation of a PHSD.

Back in 2000, legislation was created to give a county board of supervisors the authority to create a PHSD, which is a special taxing district that is funded with either a 25-cent secondary property tax rate or a 0.10% sales tax. Six counties, to date, have created the district—Apache, Coconino, Greenlee, Navajo, Pinal, and Yuma—each created with just a unanimous vote of the board. And although the original intent of the law was to have the district provide funding for services such as animal disease control and health inspections, this special taxing district has been used to fund a great array of services that extend well beyond the original intent of the legislation, including healthcare-related costs, and even costs related to building construction.

ATRA believes that taxpayer approval is warranted in the decision to create a new taxing district. SB1313 grandfather's in the existing six districts that have already been created but would require future PHSD's to be voter approved.

As a result of the Governor's signature, SB1313 is effective beginning January 1, 2011.

SB1609 Retirement systems; plans; plan design (Yarbrough)

ATRA has been at the center of policy debates regarding Arizona's defined benefit retirement systems for decades. As reported in the February 2011 *ATRA Newsletter,* state and local employer contributions to public retirement programs in Arizona climbed 140% between 2004 and 2010. Employer contributions to the Public Safety Personnel Retirement System (PSPRS) skyrocketed 281% over that time period.

This session, ATRA expressed strong support for reforms to Arizona's four defined benefit plans. SB 1609, sponsored by Sen. Steve Yarbrough and supported by House Speaker Kirk Adams, survived strong opposition by public employee unions and still awaits action by Governor Brewer. The following are the major reforms to the four plans:

PSPRS

- Normal retirement date: Currently 20 years of service or 62nd birthday and completion of 15 years of service. For an employee who becomes a member of the system on or after January 1, 2012, 25 years of service if the member is 52 ½ years of age.
- Deferred Retirement Option Plan (DROP): Retains DROP for only existing members of PSPRS as of January 1, 2012. Members with less than 20 years of service on January 1, 2012 who elect to participate in DROP are required to pay an alternate contribution rate (ACR) equal to the employer contribution rate. Changes the method in which interest is earned on the new DROP accounts.
- Average benefit compensation: Currently, the benefit is calculated based on the highest average of the three most recent years of a 20-year period. For members on or after January 1, 2012, the calculation is changed to five of the last 20 years.
- Contribution rates: The current employee rate is 7.65%. Rates increase gradually based on the following: For FY 2012, 8.65%; FY 2013, 9.55%; FY 2014, 10.35%; FY 2015, 11.05%; FY 2016 and after, lower of 11.65% or 33.3% of the sum of the member's contribution rate from the preceding fiscal year and the aggregate computed employer contribution rate that is calculated, whichever is lower. Member's contribution rate shall not be less than 7% and Employer's rate not less than 8%. Beginning in FY 2012, the amount of the member's contribution that exceeds 7.65% shall not be used to reduce the employer's contributions.
- Normal pension: Member on or after January 1, 2012 with 25 or more years of service, monthly amount equal to 62.5% of member's average monthly benefit compensation, not to exceed 80% of average monthly benefit (currently 20 years of credited service, monthly amount equal to 50%). Varying percentages apply based on other than 25 years of credited service.

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- (ACR) for return-to-work: Beginning July 1, 2012.

EORP (Elected Officials Retirement Plan)

- Average yearly salary: from 3/10-year average (member before January 1, 2012) to 5/10-year average (member on or after January 1, 2012).

- Membership termination: An elected official who becomes a member of the plan on or after January 1, 2012 shall be paid the member's accumulated contributions plus interest (no employer contributions). An elected official who received a refund who is subsequently reemployed as an elected official who redeposits the amount withdrawn with interest or who redeems prior service is subject to the benefits and duties in effect at the time of the elected official's most recent reemployment.

- Contribution rates: currently 7%. For FY 2012, 10%; FY 2013; 11.5%; FY 2014 and after, lower of 13% or 33.3% of the sum of the member's contribution rate from preceding fiscal year and the normal cost plus the actuarially determined amount to amortize the unfunded liability for the employer, whichever is lower. Member's contribution rate shall not be less than 7% and Employer's contribution rate not less than 10%. Beginning in FY 2012, the amount of the member's contribution that exceeds 7% shall not be used to reduce the employer's contributions.

CORP (Corrections Officers Retirement Plan)

- Normal retirement date: Members before January 1, 2012: 20 years of service or in the case of a dispatcher, 25 years of service or the employee's 62nd birthday and completion of 10 years of service or 80 points. Members on or after January 1, 2012: 25 years of service if employee is at least 52.5 years of age or employee's 62nd birthday and completion of 10 years of service.

- Average monthly salary: Member before January 1, 2012, 36 of 120 months; member on or after January 1, 2012, 60 of 120 months.

- Contribution rates: through June 30, 2011, 8.41% and 7.96% for dispatchers. Beginning FY 2012, lesser of 8.41% or 50% of the sum of member's contribution rate from preceding fiscal year and aggregate employer contribution rate (dispatcher rate either 45 basis points less or same as other CORP members depending on funding value of system). Member contribution rate shall note be less than 7.65% and employer not less than 5%. Beginning in FY 2012, the amount of the member's contribution that exceeds 8.41% or 7.96% shall not be used to reduce the employer's contributions.

ASRS (Arizona State Retirement System)

- Normal retirement: Membership commenced before July 1, 2011: 80 points. Membership on or after July 1, 2011: 65th birthday, 62nd birthday plus 10 years, 60th birthday plus 25 years, 55th birthday plus 30 years.

- ACR for return-to-work: Beginning July 1, 2012.

SB1041 Arizona's quality jobs incentives (Reagan*)*

ATRA expressed strong opposition to SB1041, which would have provided sweeping property tax incentives to businesses expanding and locating their operations in Arizona. The bill provided a 75-percent property tax reduction for any business that would have met certain thresholds for new investments in property and new employees. Fortunately, Governor Brewer vetoed the bill.

The reduced property taxes would have been available to qualifying businesses between December 31, 2011 and June 30, 2017. A qualifying business would have been eligible for the property tax class six (5% assessment ratio) status for up to ten years. To qualify for the property tax incentive, a business would have been required to meet the following thresholds for capital investment and new employees:

- Within the exterior boundaries of a city or town that has a population of fifty thousand or more that is located in a county with a population of eight hundred thousand or more: Capital investment of at least five million and at least twenty-five new qualified employment positions.

- In any other location in Arizona: Capital investment of at least one million dollars and at least five new qualified employment positions.

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SB1041 defined a "qualified employment position" as a full-time position that pays at least equal to the county median wage and provides health insurance, sixty-five percent of which would be paid by the employer.

In addition, a company would have had to receive the consent of either the city council for property located inside a municipality, or the county of board of supervisors for all other property, before the property could be placed in class six. The Arizona Commerce Authority was given the responsibility of certifying businesses that would qualify for the property tax incentives.

For decades, ATRA has strongly opposed efforts to address Arizona's high business property tax problem by providing targeted incentives to selected industries. ATRA's opposition to previous efforts to "side-step" the high business property tax burden resulted in policymakers taking the appropriate action to address the problem head on. In 2005, state policymakers passed landmark legislation to reduce the business assessment ratio from 25% to 20%. That action has improved Arizona's relative position on business property from the fourth highest nationally to sixteenth in 2009. An ATRA supported measure in the recently passed Arizona Competitiveness Package calls for further reductions in the class one assessment ratio to 18% by 2016.

In addition to the tax policy concerns in SB1041, ATRA also expressed serious reservations that the inequitable tax treatment resulting from the measure would survive a court challenge. Article 9, section 1 of the Arizona Constitution states that "all taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax." While the courts have given the Legislature broad discretion in creating different classes of property, they have also cautioned that those distinctions in use, purpose or industry must be "real" and not be "arbitrary, specious, or fanciful." ATRA believes that creating such disparate tax treatment between potentially identical companies in the same taxing jurisdiction based solely on the timing and size of the investment is unconstitutional.

HB2407 community college correction; levy amount (Vogt)

For the second year in row, the Coconino Community College District pursued legislation opposed by ATRA that would have set a major precedent for property tax overrides for local governments. Currently, community college districts, along with school districts and county governments, have access to a voter approved property tax override. Those overrides are seven years in duration and are paid as secondary property taxes.

HB2407 would have provided the Coconino District the authority to seek a permanent override of their constitutional primary property tax levy limit. In addition, for the first time ever, that override would be levied as a primary property tax and not a secondary property tax. In Arizona's property tax system, the distinction between primary and secondary taxes is significant. Primary taxes are limited and owner-occupied homeowner taxes are capped at 1% of value and any taxes in excess of that cap are paid by the state in the form of state aid to schools.

Secondary property taxes, on the other hand, were established to fund voter approved bonds, overrides and special districts. As a result, these secondary taxes are without limit and homeowners' taxes are not limited. Correctly, the Constitution does not provide homeowners with 1% cap protection for the tax obligations associated with voter approved bonds and overrides.

ATRA argued that moving a voter approved tax override to the primary property tax would not only be bad precedent but also violate the constitutional requirement that taxes levied pursuant to an election to exceed a budget or tax limitation be excluded from the 1% cap. As a primary property tax, the taxes levied pursuant to Coconino Community College Districts' tax election would be subject to the 1% cap. HB2407 failed to receive a floor vote in the state senate.