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ARIZONA TAX RESEARCH ASSOCIATION

NEWSLETTER VOLUME 73 NUMBER 3 APRIL/MAY 2013

Governor Signs Legislation to Protect Arizona's Machinery & Equipment Exemption

After months of negotiations between the Arizona Department of Revenue (DOR) and members of ATRA's Tax Policy Committee, the stakeholder's agreed on language necessary to protect the original intent of Arizona's machinery and equipment (M&E) exemption under the TPT prime contracting classification. Sponsored by Rep. Justin Olson, HB2535 passed out of the Legislature with unanimous support.

In 1996, the Legislature enacted legislation to reverse the Arizona Court of Appeals decision in *Brink Electric Construction Co. v. Arizona Department of Revenue*. That decision dramatically complicated the economic benefits associated with Arizona's tax treatment of exempt M&E under the prime contracting classification. At the time, a DOR regulation required that the installation, repair, or modification of M&E that is exempt at retail was not considered taxable under the prime contracting class if the M&E was not permanently attached

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Arizona Residents Rank Near Bottom in Income Tax Burden

Recent publications by a national tax research group and a state taxpayer organization rank Arizona low in income tax obligation compared to other states that levy an income tax. The Tax Foundation, based in Washington, D.C., compiled a ranking of states based on income tax collections per capita for tax year 2011. The analysis placed Arizona the lowest of the 41 states with a tax on wage income at $444 per capita. Research by the Minnesota Center for Fiscal Excellence (MCFE) also determined Arizonans' income tax liabilities to be some of the lowest in the nation. Although both studies ranked Arizona's tax burden low, the methodologies used by the two outfits differed greatly. While the Tax Foundation study provides a simple analysis of income tax collected with respect to population, the MCFE study provides a more accurate picture of states' income tax burdens than a per capita analysis by using an income tax liability simulator, which accounts for state-

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Statewide Debt Dropped in FY 2012

For the first time in more than a decade, total statewide debt decreased in fiscal year (FY) 2012. According to the Arizona Department of Revenue's Report of Bonded Indebtedness, total debt from the state's political subdivisions dropped $868 million (2%), from $42.8 billion in FY 2011 to $41.9 billion in FY 2012.

With 91 entities, Arizona's cities had the most debt outstanding of all jurisdictions in FY 2012 with $16.5 billion. State agencies held $9.3 billion in debt, followed by "other" agencies, which includes the Central Arizona Water Conservation District (CAP) and the Sports and Tourism Authority, with $5.3 billion in total outstanding debt. School districts had debt totaling $4.5 billion at the end of FY 2012.

Even though debt decreased in most jurisdictions, county and "other" debt grew by 13% and 6.6%, respectively. The collective increase was

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to the realty. The *Brink* decision put taxpayers in a worse position by dismissing the "permanent attachment" test and instead concluding that the activity would be considered taxable as long as the M&E remains "until the purpose to which the realty is devoted is accomplished." In response, the Legislature passed SB1280 in 1996 with the intent to overturn the adverse court decision under *Brink* by implementing the three-prong permanent attachment test. Although that legislation was intended to overturn *Brink*, DOR proposed a TPT ruling last year that reflected the holding of *Brink,* specifying that by merely bolting down M&E into a concrete base would be considered permanently attached to the realty, and as a result, subject to TPT under the prime contracting classification.

The final version of HB2535 makes it clear that the cost of the installation, assembly, repair or maintenance of exempt M&E is not subject to TPT under the prime contracting class if it has "independent functional utility." The term "independent functional utility" is defined to mean that the M&E can function without attachment to real property, and without regard to size or useful life of the equipment, other than attachment for other reasons such as to stabilize or protect the M&E during operation by bolting, burying or performing other similar non-permanent connections to either real property or its improvements.

Jennifer Stielow

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specific tax treatments and assumptions. Nine states—Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming—do not levy a tax on wage income. Corporate income tax was not included in either study.

Not surprisingly, the state with the highest per capita income tax liability as calculated by the Tax Foundation was New York at $1,864, which is more than four times higher than an Arizona resident would pay. Neighboring states, Connecticut and Massachusetts, ranked second and third at $1,808 and $1,765, respectively. Residents of these states have relatively high income compared to their counterparts across the country, along with relatively high tax rates, and will produce higher tax burdens.

The MCFE, formerly the Minnesota Taxpayers Association, ranked Arizona's income tax liability low in its publication, *Comparison of Income Tax Burdens by State*. Tax burdens were calculated by income level and tax filing status, placing Arizona near the bottom of most categories. All simulations were run using state tax systems in place for tax year 2010.

Assuming annual income of $50,000, the simulation for an Arizona single filer produced a tax liability of $1,148, ranking 39th lowest of 41 states, and an effective tax rate of 2.3%. Single filers in Oregon were calculated to have the highest tax liability of $3,012, equating to an effective tax rate of 6.0%. Arizona's burden came in well below the national average, which was calculated at $2,012. The only states ranking lower than Arizona in tax liability were New Jersey ($1,119) and North Dakota ($774). New Jersey and North Dakota ranked 7th and 34th, respectively, in the per capita analysis, illustrating the differences in the two studies. New Jersey, which has a high reliance on personal income taxes, also has a very progressive rate structure. As a result, those with annual incomes of $50,000 pay relatively modest taxes compared to upper income New Jerseyans.

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Published 10 times annually by the Arizona Tax Research Association, a nonprofit organization whose purpose is to promote efficient and effective use of tax dollars through sound fiscal policies. Permission to reprint is granted to all publications giving appropriate credit to the Arizona Tax Research Association.

Serving Arizona's taxpayers since 1940.

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overwhelmingly offset by decreases in all other jurisdictions, most notably state agencies, which dropped $702 million (7%). School districts also saw a significant decrease in debt of $269 million (5.7%), as well as cities.

Jurisdiction	FY 2007	FY 2011	FY 2012	1-Yr Change	5-Yr Change
Universities	$1,774,827,000	$2,532,231,000	$2,411,050,000	-4.8%	35.8%
K-12	$4,411,744,958	$4,754,651,317	$4,485,523,853	-5.7%	1.7%
Comm. Colleges	$807,100,000	$872,420,000	$850,630,000	-2.5%	5.4%
Cities	$13,305,513,076	$16,652,611,316	$16,456,674,642	-1.2%	23.7%
Special Districts	$1,202,309,313	$1,673,062,374	$1,607,858,257	-3.9%	33.7%
State Agencies	$6,252,505,500	$9,962,775,103	$9,260,634,433	-7.0%	48.1%
Counties	$1,028,985,713	$1,346,369,256	$1,522,864,145	13.1%	48.0%
Other	$3,312,457,982	$4,999,490,000	$5,329,947,000	6.6%	60.9%
TOTAL	**$32,095,443,542**	**$42,793,610,366**	**$41,925,182,330**	**-2.0%**	**30.6%**

Types of State and Local Debt

Governmental agencies access a wide variety of debt instruments, some of which require voter approval and adherence to debt limits. Making up $10.6 billion of total debt, **General Obligation (G.O.) bonds** are backed by property tax revenue, and therefore, subject to voter approval. The constitutional and statutory limits on the principal amount that may be issued vary for each jurisdiction but is typically a percentage of net assessed value of the jurisdiction.

Special Assessment/District bonds may or may not require voter approval. These bonds are issued when a special taxing district desires to finance a project and are secured by assessments or taxes levied against the property in the district. There was $453 million in outstanding special district bonds at FY-end 2012. In total, voter-approved debt, mainly G.O. and special district bonds, made up 26% of all bonded indebtedness in FY 2012, compared to 31% five years ago.

	FY 2007	FY 2011	FY 2012	1-Yr. Difference	1-Yr. Change	5-Yr. Difference	5-Yr. Change
G.O.	$9,548,387,471	$10,844,268,717	$10,557,891,093	-$286,377,624	-2.6%	$1,009,503,622	10.6%
Revenue	$16,405,130,220	$20,343,437,535	$19,842,549,190	-$500,888,345	-2.5%	$3,437,418,970	21.0%
MPC	$3,227,909,728	$7,147,855,360	$6,846,813,229	-$301,042,131	-4.2%	$3,618,903,501	112.1%
COP	$2,527,311,951	$3,911,045,567	$4,174,732,712	$263,687,145	6.7%	$1,647,420,761	65.2%
Impact Aid	$64,840,000	$38,245,000	$49,850,000	$11,605,000	30.3%	-$14,990,000	-23.1%
Spec. Assmt.	$411,524,919	$508,758,187	$453,346,106	-$55,412,081	-10.9%	$41,821,187	10.2%
TOTAL	**$32,185,104,289**	**$42,793,610,366**	**$41,925,182,330**	**-$868,428,036**	**-2.0%**	**$9,740,078,041**	**30.3%**

The most utilized debt instrument is **Revenue Bonds**, making up nearly half of all outstanding debt in FY 2012 at $19.8 billion. Debt service on revenue bonds is paid by revenues generated by the project for which the bonds were issued. These bonds may or may not be subject to voter approval and are not subject to any debt limits.

Municipal Property Corporation (MPC) bonds are not issued by a political subdivision directly. Instead, they are issued by a nonprofit corporation to finance a project, which is then leased back to the political subdivision. These bonds are primarily issued on behalf of cities, though they are also issued on behalf of counties and special districts. MPC bonds are not subject to voter approval and are not subject to any limits. Outstanding MPC bonds totaled $6.8 billion in FY 2012.

At more than $4.2 billion outstanding in FY 2012, **Certificates of Participation (COP)** are proportional shares of annually appropriated long-term leases and are not subject to voter approval. COPs were issued by each jurisdictional category in FY 2012 except for community colleges. There is also no debt limit on COPs.

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School districts sometimes issue **Impact Aid Revenue Bonds**, which are paid from revenues received through a federal program that reimburses school districts for lost revenue as a result of federal activity. These bonds totaled $49.8 million in FY 2012 and do not necessitate voter approval.

The debt report also notes outstanding **Lease Purchase** Contracts, which are agreements between two parties in which the purchaser agrees to purchase property after leasing the property for a specified amount of time. Lease purchase contracts totaled $979.5 million in FY 2012, up from $938.6 million in FY 2011. These contracts are not considered debt for purposes of determining debt limits.

The Department's report is a compilation of data provided by the counties, community colleges, cities and towns, school districts, and other political subdivisions throughout Arizona. The debt reported includes principal amounts only, excluding all interest payment obligations.

Debt by Jurisdiction

Cities

Top 10 Outstanding Debt	
City	**Outstanding Debt**
Phoenix	$7,077,098,068
Mesa	$1,494,554,974
Scottsdale	$1,147,746,020
Tucson	$1,096,821,221
Glendale	$1,037,220,000
Tempe	$706,840,646
Chandler	$530,335,000
Gilbert	$470,115,000
Peoria	$333,697,652
Lake Havasu City	$303,108,024

Top 10 Per Capita Debt	
City	**Per Capita Debt**
Cave Creek	$11,869
Tolleson	$9,156
Williams	$8,142
Queen Creek	$5,995
Lake Havasu City	$5,784
Sedona	$5,507
Scottsdale	$5,266
Phoenix	$4,874
Glendale	$4,560
Cottonwood	$4,426

Cities and towns hold the largest portion of statewide debt, totaling $16.5 billion in FY 2012, down $196 million (1.2%) from last year. Of the 91 incorporated cities and towns, 74 held debt. MPC bonds, which make up 41% of total city debt, decreased $295 million (4.2%), from $7.1 billion to $6.8 billion. The decrease in MPC bond debt was partially offset by a $123 million (2.6%) increase in revenue bonds. G.O. debt rose negligibly in FY 2012 after dropping 4.5% in FY 2011.

City of Phoenix accounts for a substantial portion of total city debt, with $7.1 billion outstanding. This is down $130 million (1.8%) from last year's total. Mesa has the second largest debt load with $1.5 billion outstanding, $130 million more than last year. Scottsdale had the third highest debt total after a slight decrease in FY 2012, bringing its total to $1.1 billion. Five cities have debt in excess of $1 billion and eight of the ten highest debt cities are in Maricopa County.

Sixty of the 74 debt-holding cities decreased their debt a collective $412 million. Following behind Phoenix was Gilbert, which cut $52 million (10%) from its total debt. The $216 million collective increase by 14 cities behind Mesa was San Luis ($18 million, 23%) and Kingman ($13 million, 25%).

Since FY 2008, Cave Creek, has led all cities in per capita debt, which decreased 7% in FY 2012 to $11,869. The 12% increase in Tolleson's debt made it the second highest in per capita debt of all cities at $9,156. The debt per capita decreased in Williams, dropping it to third highest with $8,142. Phoenix remained eighth highest with $4,874 in per capita debt.

During FY 2012, 24 cities executed 68 new debt issuances at a sum of $1.7 billion. Phoenix issued $351.6 million in MPC bonds and $296.5 million in G.O. bonds. The substantial increase in Mesa's debt total was the result of the issuance of $59 million in G.O. bonds and $293.1 million in revenue bonds. Of the 68 new issues in FY 2012, 32 were revenue bonds, 21 were G.O. bonds, 12 were MPC bonds, two were lease purchase agreements, and there was one COP issue. Phoenix and Tucson each had eight new issues and Mesa and Flagstaff had seven.

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Twenty-two cities have outstanding G.O. bonds, which are subject to constitutional debt limits. No cities exceeded their debt limits in FY 2012 but capacity is shrinking in some cities. Tempe held the most debt as a percentage of its limit at 85%, followed by Tolleson at 70%. Goodyear is at 68% of its limit while Chandler is at 65%. Phoenix has the seventh most debt as a percentage of its limit at 50%.

State Agencies & Universities

In FY 2012, there were 114 reporting state agencies, not including universities, of which eight reported debt. The debt for the eight agencies totaled $9.26 billion, down $702 million (7%) from last year. The Health Facilities Authority had more than one-third of the outstanding debt, with $3.5 billion in revenue bonds. Three-quarters of total state agency debt was in revenue bonds with the remainder in COPs. State agencies use COPs and revenue bonds because of constitutional limitations. Since FY 2006, debt for state agencies has grown $4.3 billion (77%).

Debt for Arizona's three state universities decreased $121 million (4.8%) in the last year, from $2.5 billion to $2.4 billion. Overall, COPs fell 25%, with the University of Arizona's COP debt falling 40%. Arizona State University's $122 million (18%) increase in revenue bonds led to a rise in total outstanding university revenue bonds of $93 million (5.6%). Arizona State's aggregate debt increased $111 million (11%) to $1.13 billion. Northern Arizona University's debt increased slightly to $423 million, up $6.8 million (1.5%) from last year. Debt for the University of Arizona decreased $239 million (21.8%) to $858 million as a result of the retirement of COPs.

All universities issued debt in FY 2012 totaling $534 million. Arizona State issued $244 million in revenue bonds, Northern Arizona issued a lease purchase of $12 million and revenue bonds of $24 million, and University of Arizona issued revenue bonds of $96 million and COPs totaling $158 million.

School Districts

In FY 2012, total debt for K-12 school districts decreased $274 million (5.8%), from $4.8 billion to $4.5 billion. G.O. bonds, which account for 99% of all school district debt, dropped $285 million. Roosevelt Elementary is the first district in two years to issue COPs, amounting to $4.8 million. Impact aid debt grew from $38.2 million to $49.9 million.

A majority of school district debt is in G.O. bonds, more specifically, Class B bonds. Class B bonds are bonds approved by voters after December 31, 1998 and are subject to statutory debt limits of 10% of a unified district's net assessed value (NAV) and 5% of an elementary or high school district's NAV. Bonds approved before January 1, 1999 are known as Class A bonds, which are subject to the constitutional debt limits of 30% of NAV for unified districts and 15% of NAV for elementary and high school districts.

Because there are no new issuances of Class A bonds, the principal on these bonds decreased $270 million (29%) in FY 2012, compared to a 0.6% decrease in Class B bonds. The decrease in Class B debt, however, may have been the result of many school districts hitting their debt ceilings because of declining property values. The report shows that 30 districts have Class B debt in excess of their limits but none of the districts are out of compliance since the bonds were issued before the districts' values dropped. Coolidge Unified has the highest statutory debt as a percentage of its limit of 173%, but in terms of dollars, Dysart Unified has the most debt in excess of its

District	Outstanding Debt
Scottsdale Unified	$291,545,000
Tucson Unified	$270,675,000
Paradise Valley Unified	$265,120,000
Phoenix Union HS	$221,745,000
Mesa Unified	$210,315,000
Chandler Unified	$194,325,000
Deer Valley Unified	$186,625,000
Peoria Unified	$185,730,000
Dysart Unified	$174,425,000
Gilbert Unified	$153,565,000

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limit of $42.4 million. In FY 2012, 60 districts carried $647 million in Class A debt and 99 districts carried $3.9 billion in Class B debt.

Scottsdale Unified carried the largest debt load of $292 million after a new G.O. bond issue. The former perennial leader in school debt, Tucson Unified, had $271 million outstanding, followed by Paradise Valley Unified and Phoenix Union High School District, with $265 million and $222 million outstanding, respectively. Mesa Unified, whose voters approved $230 million in G.O. bonds in November, has $210 million outstanding. Of the 223 reporting districts, 98 did not report any debt.

Ranking districts in order of highest debt per student places Sedona-Oak Creek Unified at the top with $48,646 per student, down from $52,705 last year. Riverside Elementary in Phoenix ranks second at $27,405 debt per student, and Continental Elementary in Pima County has $23,062 debt per student. Scottsdale Unified ranked 11th highest at $11,810 per student debt. The average debt per student for all debt-holding districts was $5,368, which is down $293 (5.2%) from last year.

Special Districts

As previously noted, special district bonds finance projects that are typically paid by assessments on the property within the district. Some special districts also issue G.O. bonds, COPs, revenue bonds, and MPC bonds. Special districts include taxing districts for fire, public health services, flood, street lighting, irrigation, and many others. Of the 647 special districts, 163 reportedly held debt in FY 2012.

Special district debt decreased $65 million (3.9%) to $1.6 billion. Revenue bonds, which total $792 million, fell $15 million, and special district bonds, making up nearly a quarter of special district debt at $368 million, dropped $48.5 million. G.O. bonds, on the other hand, rose 1.2% to $422 million. COPs dropped $4.1 million to $25.8 million and all outstanding MPC debt was retired in FY 2012.

Ten districts issued debt in FY 2012 at a sum of $161 million, $120 million of which was for Electrical District (ED) #3 in Pinal County. Seven of the new issues were revenue bonds, including the issue for ED #3, two were special assessment bonds and one was a G.O. bond.

Counties

After debt decreased $20 million in FY 2011, counties increased debt another $176 million (13%) in FY 2012, from $1.4 billion to $1.5 billion. Most of the increase is attributable to Pima County issuing $76 million in G.O. bonds and $222 million in revenue bonds. County G.O. debt increased $3.4 million, from $453 million to $456 million, while revenue bonds grew by nearly one-quarter, from $770 million to $954 million. The increase in revenue bonds was the result of the issuance of $189 million in sewer bonds by Pima County. COPs decreased from $62 million to $54 million and MPC bonds dropped from $62 million to $59 million.

County	Outstanding Debt	Per Capita Debt
Pima	$1,172,359,145	$1,185
Pinal	$150,985,000	$394
Maricopa	$120,350,000	$31
Santa Cruz	$23,330,000	$489
La Paz	$18,115,000	$887
Mohave	$10,655,000	$53
Navajo	$9,135,000	$85
Gila	$7,205,000	$136
Cochise	$4,550,000	$34
Apache	$3,980,000	$55
Yuma	$2,190,000	$11
Coconino	$0	-
Graham	$0	-
Greenlee	$0	-
Yavapai	$0	-

With its new issues, Pima County holds $1.2 billion in debt, which is $1 billion more than Pinal, the second highest debt-holding county. Pima's debt grew $174.6 million (17%) in FY 2012, the highest increase of any county in terms of dollars. Santa Cruz County increased its debt 61% ($8.9 million) for the largest percentage

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increase of all counties with the issuance of $9.3 million in new revenue bonds.

Maricopa County's debt decreased $13.6 million in FY 2012, a reduction of 10.1%. Maricopa, with $120.4 million in outstanding revenue bonds, is responsible for less than 8% of total county debt. Coconino, Graham, Greenlee, and Yavapai did not report any debt.

In addition to holding more debt than any other county, Pima leads all counties with $1,185 in bonded indebtedness per capita. La Paz County, after issuing $18.1 million in bonds in order to pay a judgment determined by the courts, has the second highest debt per capita at $887. Of the eleven debt-holding counties, Yuma holds the least on a per capita basis at $11. Maricopa County holds $31 per capita, the second lowest of all counties.

County government debt is predominantly non-voter-approved. In fact, Pima is the only county that has voter-approved G.O. bonds and, despite more than $456 million outstanding, the county is only at 36% of its debt limit.

Community Colleges

Community College	Outstanding Debt	Per Student Debt
Maricopa	$616,235,000	$6,637
Central Arizona	$98,850,000	$17,043
Arizona Western	$64,760,000	$11,538
Yavapai	$40,470,000	$8,625
Coconino	$12,630,000	$5,374
Cochise	$10,195,000	$1,108
Mohave	$4,210,000	$970
Pima	$3,280,000	$123
Eastern Arizona	$0	-
Gila Provisional	$0	-
Northland Pioneer	$0	-
Santa Cruz Provisional	$0	-

Total debt for community college districts (CCDs) decreased $21.8 million (2.5%) in FY 2012, from $872.4 million to $851.6 million. There are twelve CCDs statewide, with Northland Pioneer, Eastern Arizona, and the Gila and Santa Cruz provisional CCDs reporting no debt. Because Maricopa CCD is responsible for 72% of total CCD debt, its $67.6 million (9.9%) drop drove the overall decrease. All other CCDs decreased debt except for Central Arizona College (CAC). Decreases in dollar amounts included Coconino ($3.9 million), Yavapai ($3.7 million), Arizona Western (AWC) ($2.1 million), Pima ($1.8 million), Cochise ($105,000), and Mohave ($85,000). CAC, Pinal County's community college, more than doubled its debt load, which rose from $43.8 million to $98.9 million. CAC jumped from fourth highest in total debt in FY 2011 to second highest in FY 2012.

All new debt issued in FY 2012 was in G.O. bonds. Maricopa CCD issued $69.1 million while CAC issued $59 million, and Yavapai added $28.5 million. G.O. bonds account for 98% of all CCD debt and are held by each district except in Cochise and Mohave. The remaining debt is in revenue bonds. After CAC's new issues, the district is at 28.2% of its debt limit, up from 9.5% in FY 2011. AWC, serving Yuma and La Paz Counties, is at 27.8% of its debt limit, and Maricopa is at 10.6%.

CAC's new incurrence of debt also gave the district the highest debt per student of $17,043. At $11,538, AWC carries the second highest debt per student and Yavapai is third highest at $8,625. Maricopa is fourth highest at $6,637.

Other Jurisdictions

Other jurisdictions are political subdivisions that do not belong to a particular jurisdiction but have boundaries that cross county lines, like CAP. Debt for other jurisdictions grew by $330 million (6.6%), from $5 billion to $5.33 billion. These jurisdictions issued $854 million in revenue bonds in FY 2012.

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