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ARIZONA TAX RESEARCH ASSOCIATION

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Legislative Leaders Prep ATRA Outlook for 2017 Session

Capping off the 76th annual ATRA Outlook Conference was the newly elected Senate President Steve Yarbrough and Speaker of the House-elect J.D. Mesnard. Both gave their thoughts on the recent election and the upcoming legislative session.

Senator Yarbrough began by addressing perhaps the most important piece of the upcoming legislative session: passing a balanced budget amidst tightening revenue projections. He reinforced that the present economic expansion, slow though it may be, has lasted a historically-long 89 months and the state must be

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Gov Ducey Delivers Keynote at ATRA Annual Meeting

Governor Doug Ducey highlighted ATRA's 76th Annual Meeting at the Scottsdale Hilton. Governor Ducey shared his positive outlook on the state of affairs in Arizona, providing an update on ongoing projects.

Governor Ducey explained that he will continue to focus on improving the delivery of government services, highlighting measurable improvements in wait times at the Department of Motor Vehicles and the Department of Revenue. By applying business principles to government services, the Governor hopes to find efficiencies all across state government.

Governor Ducey said he looks forward to working with taxpayers and the new Legislature to solve key tax and public finance challenges in Arizona while maintaining a structurally balanced state budget.

Stavneak: State Budget Remains Tight

Richard Stavneak jump started the ATRA Outlook conference with a review of the state's fiscal picture. The Director of the Joint Legislative Budget Committee (JLBC) - now in his 30th year, brought the state budget to life before a packed ballroom at the Scottsdale Hilton. The main theme of Stavneak's update was the projected balance sheet for the next fiscal year is tight and any change in actual revenue collections could swing a balanced budget to a deficit in a hurry.

The budget baseline as projected 11 months ago in January predicted a budget surplus of $148 million for FY 2018 after accounting for formulaic spending increases and assuming no other discretionary changes. However, that number now has dropped considerably to just a $24 million surplus in ongoing revenues over expenditures. The bottom line is the Legislature has almost no increased discretionary spending capacity after it covers automatic formulaic changes in programs like K-12 and AHCCCS.

The projected cash balance for FY 2018, which could be described as one-time money is $101 million. The state's rainy day fund remains at $460 million, 3%-5% below recommended levels for a $10 billion state general fund.

The state continued its modest growth in FY 2016 with 3.5% overall growth in tax revenue collections and FY 2017 is off to a similar start. The FY 2017 budget presumed revenue growth of 4% and thus far is on track for 3.8% growth. Revenue growth is driven primarily by increases in individual income tax withholdings, sales tax, and insurance premium taxes. Increases are offset by a decrease in corporate income tax collections, which JLBC sources as the result of decreased rates, which are in the midst of a multi-year phase down.

Stavneak explained the Department of Revenue is now providing timely data on the use of tax credits which allows them to better forecast their impacts. Total tax credits from individual and corporate income taxes plus insurance premium taxes amounts to $397 million in FY 2016.

The largest formulaic budget increases forecasted for FY 2018 are in K-12 at $110 million for growth and inflation, $60 million for AHCCCS and $20 million for programs at the Department of Economic Security.

One of the biggest questions for the upcoming legislative session is how lawmakers will respond to the planned phase out of two critical K-12 spending changes: the funding of ghost students in prior year funding as well as the multi-site charter small school phase out, which in total save the state $43 million next year. These phase-outs are

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1814 W. Washington Street
Phoenix, Arizona 85007
(602) 253-9121

www.arizonatax.org

already accounted for in the budget baseline.

In addition to changes in the economy, which could result in significant swings in tax revenues, the state has several lawsuits it must keep an eye on. Stavneak provided a summary of two ongoing cases and one potential threat. If the plaintiffs are successful in the hospital assessment litigation related to Medicaid Expansion, the potential cost to the state would be in the $100 million to $250 million range. The Superior Court ruling that the rental car surcharge for the Arizona Sports and Tourism authority was unconstitutional because the money was not used for public highways or streets has a potential cost of $150 million. Furthermore, there are rumors of another K-12 lawsuit related to the state funding of K-12 capital costs.

ATRA Staff Tells of Good & Bad News

ATRA staff took the podium during the annual Outlook Conference bearing both good and bad news for taxpayers. Vice President Jennifer Stielow gave an update on property taxes in Arizona and explained the impact of Proposition 117 two years into its implementation. The good news: Arizona property tax levies have increased at half the rate of the historic norm under similar conditions witnessed pre-Prop 117.

Property tax levies grew just 6.9% over the last two years despite significant increases in property values. ATRA studied the impact of strong growth years on tax levies and found that over two year periods between 1996 and 2008, when full cash value growth averaged 20%, tax levies grew on average 14%. In the first two years under Prop 117, property values have grown 22% statewide, yet taxes grew at half the historical rate. Taxpayers have surely noticed the strong uptick in the residential real estate market. Under Prop 117, properties are now subject to just one taxable value that is limited to no more than 5% annual growth- the key factor to slower levy growth.

In 2016, most tax increases can be explained by voter-approved activity, discussed in greater detail in the ATRA November Newsletter. Anecdotally, ATRA noticed several jurisdictions chose not to raise their tax rates. Previously they could have held steady their tax rate, which against fast rising values led to significant tax increases. The bottom line is taxing

jurisdictions now cannot simply leave their rate constant and access large tax increases. To wit, Prop 117 has performed as expected.

President Kevin McCarthy updated Outlook attendees on Government Property Lease Excise Tax (GPLET). The good news here is the state Auditor General has released a thorough report exposing the many problems with the economic incentive tool which should spur further reform. The bad news is the 2010 legislative reforms to GPLET do not appear to have had the intended impact and progress has been retarded.

In 2010 lawmakers sought to curtail the length and scope of GPLET deals by limiting them to 25 years and making the in-lieu excise tax rates closer to actual property tax payments. The state Auditor General found that just 6% of new deals use the new rates because cities have made ample use of a grandfather clause which allowed cities to use pre-2010 laws if they could point to anything which indicated a deal was in the works before the law change.

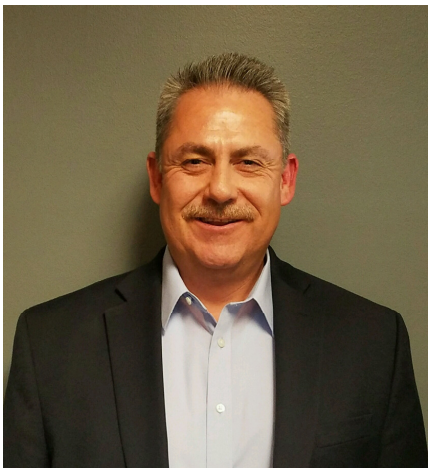
A major problem for GPLET is both the Auditor General and the Joint Legislative Budget Committee have found myriad problems in the reporting, payment and distribution of GPLET revenues. The entire program is mired in confusion. Further, cities like Phoenix have regressed to using GPLET as a tool to subsidize multi-family residential units and retail. See the ATRA March 2016 newsletter for more discussion on GPLET.

McCarthy called for lawmakers to reassess GPLET laws and further reform both the policy itself and its administration. ATRA suggests local governments should not be able to use their tax-exempt status to abate taxes, particularly for K-12- which they currently may do for up to eight years in central business districts. This unfairly passes the costs of education to uninvolved taxpayers. Further, the grandfathering clause from 2010 has clearly run its course and ought to be repealed to prevent further abuse. Lastly, all state and local governments should comply with GPLET laws to ensure all jurisdictions are on equal footing.

Finally, Senior Research Analyst Sean McCarthy provided a brief update on Desegregation/Office of Civil Rights (Deseg/OCR) spending for K-12 school districts. McCarthy relayed some good news inasmuch as school districts are no longer arguing the money is court mandated (outside of Tucson Unified) and have largely agreed the program has outlived its useful existence and should eventually be phased out. The bad news is there has not been a serious proposal to phase out the program because many are unwilling to take the money from school districts because the general understanding is the money is not used to remediate civil rights violations but on common things schools spend money on. Districts are asking for new money to replace Deseg/OCR, something which will prove difficult under state budget constraints especially when each of the 18 who access the special tax levy do so at varied levels.

ATRA will pursue reform of Deseg/OCR again in 2017 but will advocate to make this special budget override be voter approved by FY2020 at the district level in order to alleviate 1% cap issues, bring transparency to the issue and drive community awareness of this 30 year old program.

Steve Barela Elected ATRA Chairman



Steve Barela, the Director of Tax at Arizona Public Service, was elected as the Chairman of the Arizona Tax Research Association's Board of Directors at the 76th Annual Meeting. He takes the helm from Michael DiMaria, who served an unprecedented three-year term as Chairman. Steve Barela is a former ATRA staffer, serving as a research analyst from 1998 to 2000. Barela has served on the ATRA Board of Directors since 2008. He also previously served as the Chair of the ATRA Tax Policy Committee.

The other officers elected were **Richard Bark**, Freeport-McMoRan, first vice-chair; **Michelle Bolton**, Cox Communications, second vice-chair; **Bill Molina**, Apollo Education Group, third vice-chair; and **Dave Minard**, Individual, Secretary/Treasurer.

The following members were elected to seats on the ATRA Board of Directors for terms expiring in 2021: **Gary McDaniel** of Microchip Technology, **Romina Khananisho** of Honeywell International, **Heidi Schaefer** of Salt River Project, **Larry Lucero** of Tucson Electric Power, **Chris Herstam** of Lewis Roca Rothgerber Christie, **Ricardo Gonzales** of El Paso Electric, **Steve Twist** of Service Group of America, **Craig McPike** of Snell & Wilmer, **Connie Wilhelm** of Homebuilders of Central Arizona, **Nicole LaSlavic** of Arizona Association of Realtors, and **Susan**

Tom Manos Honored with the J. Elliot Hibbs Good Government Award

At ATRA's 76th Annual Meeting, Tom Manos was awarded the ATRA J. Elliot Hibbs Good Government Award at the close of his esteemed 30 year career in public service.

Well known for his focus on promoting lean government while providing excellent customer service, Manos was a force in state and county government for decades. As Maricopa County Manager, he restructured each county regulatory agency, streamlining application processes and becoming a better partner with the business community.

ATRA members characterize Tom's public service this way: He was an extraordinarily competent and effective public administrator who was always available and willing to engage taxpayers to explain and defend the county's decisions with decency and respect.

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prepared for an economic contraction.

President-elect Yarbrough reminded the audience the Legislature's hands are largely tied on the budget, with hundreds of millions of increased spending on programs like K-12 and AHCCCS on auto-pilot, leaving little room for budget flexibility. He called for caution on the use of one-time cash balances and called on a three to four year phase-out of the $932 million K-12 rollover provision which has continued since the recession years.

He noted that there are new spending requests from state agencies totaling $350 million, demands for all-day kindergarten, infrastructure spending, and increased appropriations to universities. He concluded his budget discussion by committing to a structurally balanced budget to avoid the mistakes of deficits which plagued the state during the recession.

Senator Yarbrough also listed the reasons why cutting or eliminating the individual income tax would be a steep climb, to include the challenges of raising other taxes and managing charitable tax credits. He called on reforms to improve school choice and financial equity between public district and charter schools.

House Speaker-elect J.D. Mesnard touched on many of the same themes as Senator Yarbrough. Speaker-elect Mesnard agreed that phasing out the personal income tax was politically challenging from determining how to expand the sales tax base to ensuring the government has enough revenue to function. He doesn't expect to see significant legislative movement in this area in the upcoming session. Instead he proposed to work towards adopting a single income tax rate for all taxpayers. Then the state could slowly reduce that rate gradually in the future if there was interest in reducing the income tax.

He committed to once again sponsoring a referral to voters to increase the business personal property exemption. Dubbed the "Small Business Job Creation Act," the 2016 version increased the exemption from the first $50,000 in full cash value to $2.4 million and allowed the Legislature the ability to increase it in the future.

Commenting on proposals related to economic development tools such as Tax Increment Financing (TIF), Speaker–elect Mesnard said he preferred broad-based tax reductions as opposed to targeted programs and a TIF deal would be a tough sell at the Legislature. Finally, he acknowledged two unsolved issues: Desegregation funding and Prime Contracting Transaction Privilege Tax reform and wished the stakeholders and champions well in their efforts.

Dobay of COST Breaks Down Taxation of Digital Services

Nikki Dobay, the West Coast Tax Counsel at the Council on State Taxation (COST), discussed the various tax policy challenges currently facing taxpayers across the states, the most prominent involving the taxation of digital services.

Continuous rapid growth in digital technology has increased the pressure on states to expand their sales tax base to include such digital goods and services, many of which resulted from new interpretations through rulemaking by state's revenue departments and some through updating their existing tax codes.

Among the states now taxing digital goods and services as a result of the rulemaking process are Connecticut, New York, Chicago, and in particular, Arizona. Consequently, there is no consistent legal definition of digital goods or services, which may include the taxation of membership and subscription fees, streamlining services, electronically delivered reports and photographs, data storage services, to name just a few examples. Dobay reinforced that since there is no consistent approach across the country to taxing digital goods and services, taxpayers will continue to face tremendous compliance challenges with the varied and evolving tax structures and rules.

Tim Lawless Named 2016 ATRA Outstanding Member

Long time ATRA member Tim Lawless of the National Association of Industrial and Office Properties (NAIOP) was awarded the 2016 ATRA Outstanding Member at the 2016 Annual Meeting.

As the President of NAIOP Arizona, Tim Lawless has built a strong background in numerous areas of public finance. For years, he has supported the ATRA mission by lending his personal expertise in state and local taxation and policy advocacy to make ATRA a better organization.

Lawless has become a fixture on the ATRA Board of Directors and the ATRA Legislative Policy Committee. His support of ATRA's advocacy efforts has had a major impact on the organizations success at the State Capitol. Through his leadership, NAIOP has been a consistent partner with ATRA in advocating for improved property tax policy for Arizona.