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ARIZONA TAX RESEARCH ASSOCIATION

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## Attorney General Sues ABOR over Abatement Deals

Arizona Attorney General Mark Brnovich has filed a lawsuit in Superior Court against the Arizona Board of Regents regarding the use of their tax-exempt status to shield private development from taxation. Following ATRA's legislative effort to end such activity last year, the AG studied the issue and concluded the legal structure of these development deals is extralegal.

ATRA first penned a Special Report on the issue in the fall of 2017, highlighting the growing practice made famous at Arizona State University with the Marina Heights development that houses a State Farm headquarters among other tenants.

At issue is not whether the universities may allow private development on public land—a common phenomenon in Arizona, but whether ABOR and its universities may shield that development from property taxes by holding the deed to the building. While it is true that state owned land is not subject to tax, any building (improvement) that otherwise would be subject to tax is subject to tax even if it resides on tax exempt land.

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## Study Confirms Contracting Noncompliance High

A study commissioned by the Arizona Department of Revenue has found the noncompliance rate for the prime contracting tax could be as high as 19%, resulting in a loss in tax revenues of nearly \$1 billion between 2010 and 2016.

Key characteristics of an ideal tax system include simplicity, transparency, and administrative ease. Arizona's prime contracting tax system is generally regarded as the most complex and inefficient area of Arizona's transaction privilege tax (TPT) system and is a far cry from being ideal. Unlike most other states that tax materials at retail, Arizona's prime contracting tax system allows contractors to purchase materials tax-free at retail with the use of exemption certificates and instead pay taxes on 65% of the gross proceeds of the contract. The ability to purchase materials tax-free on an honor system can certainly lead to

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## Income Tax Conformity Issue Languishes

In early February, Governor Ducey vetoed SB1143, which would have conformed Arizona's income tax to the current federal tax code for tax year (TY) 2018 while avoiding a tax increase. In addition to conforming to the federal code, it shaved 0.11 percentage points from the tax rates in each bracket.

The second effort to address TY 18 is legislation to decouple Arizona from six major changes in the federal code that increased the tax base, which would effectively hold state taxpayers harmless

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The AG’s lawsuit begins by reminding that in *Sullivan*, the Supreme Court limited ABORs ability to find other sources of revenue beyond charging for tuition and the state land trust by requiring legislative input: “the Legislature, or the institutions with the Legislature’s consent, [may] resort to other sources of revenue than that of state taxation for that purpose.” *Sullivan*, 45 Ariz. At 261.

As such, the State Legislature has allowed ABOR to use its land beyond traditional uses in three explicit ways: nonprofit hospitals, ABOR designated research parks, and athletic facilities districts established by a county board of supervisors. The Legislature has not authorized the use of land as witnessed in the Marina Heights project, the Mirabella Luxury Senior Living Condo, and the Omni Hotel developments, where a private developer builds an improvement at their own financial risk while ABOR retains deed to the building under an agreement that the property will be leased to them for a certain period of time.

Under these agreements, the value of the unpaid property tax is harvested, meaning the holder of the lease pays the university a fractional amount of “tax” via fees agreed to in the lease so both parties are financially rewarded on an ongoing basis. In the case of the Marina Heights development, ATRA calculated the total annual property tax that would be owed would be roughly \$12 million (and rising) if properly assessed as Class 1 Commercial. Instead, the property received eight years of no payments and then will begin paying an amount roughly 1/3 of that to Arizona State University.

The lawsuit points out the Legislature has contemplated similar deals, allowing cities, counties and certain special districts the authority to craft lease-back deals under strict guidelines through the Government Property Lease Excise Tax (GPLET). State law did not include ABOR land in the GPLET statutes, because “ABOR had not traditionally operated as a commercial real estate developer.”

Specifically, the lawsuit asks for injunctive relief on the latest development, forcing the Omni Hotel property be subject to property tax as any other Improvement on a Possessory Right, which is how private developments pay tax when settled on public land. Such is the tax paid by many hotels around the state, for example, which reside on public land.

The AG’s civil filing explains that in the landmark *Scottsdale Princess* case, the courts ruled the state’s Possessory Interest Tax law was unconstitutional because it exempted (through grandfathering) certain properties from property taxes, noting the Constitution does not give the Legislature such authority. It is therefore hard to believe ABOR has some unique authority to do so on its own.

The smoking gun in the lawsuit is the legal life raft written into the development agreements: an admission on the part of the developers and ABOR that there is no statutory authority for these deals.

*“The “novelty” of this tax scheme can be seen in a key provision of the lease that shows even the parties to the agreement doubted*

*ABOR's ability to take part in a conveyance to evade taxation— if the arrangement with ABOR in the Marina Heights deal is declared unlawful for any reason, then the lessee can force the City of Tempe to take title of the improvements and impose a GPLET on the property to attempt to ensure a backup, preferential tax treatment without use of ABOR's status.”*

For more on this angle, see “State Farm Has a GPLET Safety Valve” in the ATRA April 2018 Newsletter.

Finally, the lawsuit argues the Arizona Constitution demands all property be subject to tax unless it has been exempted in the Constitution. Relevant case law has affirmed that government property must be used for an exempt purpose to retain its tax exemption.

The 2019 Legislative Program included a bill to prospectively put similarly situated properties on all public land in the GPLET statutes; however, the lawsuit has put legislative efforts on hold. ATRA will continue to track the case and provide updates as they are available.

-Sean McCarthy

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## **TAX CONFORMITY**, *Continued from Page 1*

from a tax increase. HB2526 and SB1166 passed out of committee but are held in Rules in both chambers, signaling this effort is also dead.

The effect is Arizona presently remains decoupled from the changes made by the federal government, creating uncertainty for Arizona taxpayers as it relates to their 2018 filing. The tax forms printed by ADOR presume full conformity, though state law does not. Tax administrators and CPAs are reportedly telling clients to wait to file their state taxes until a new law clarifies the situation.

In December 2017, Congress and President Trump passed the most significant change in personal and corporate income taxes in a generation. The Tax Cut and Jobs Act (TCJA) significantly reduced corporate income tax rates among other changes. The changes for individuals were designed to reduce compliance costs by simplifying the complicated federal tax code and reduce taxes for most taxpayers. The law limited deductions and exemptions in return for an almost doubling of the standard deduction, while also cutting rates.

In the 2018 legislative session, the Legislature passed and the Governor signed a law which not only conformed Arizona to the federal code for tax year 2017, but for the first time ever also conformed Arizona in prospective years to the same federal code. This means the present law decouples Arizona for tax year 2018 from the federal code as it stands after the massive TJCA.

Despite strong growth in state tax revenues and a one billion dollar surplus, the Governor's veto means Arizona taxpayers are in jeopardy of being hit with a \$233 million income tax increase that will grow to a Arizona Department of Revenue (ADOR) estimated \$300 million next year if the government passes a simple conformity bill. By any measure, it would be one of the largest tax increases in state history.

With an expanded definition of federal adjusted gross income (FAGI), most state income tax systems faced the prospect of higher taxes. As a result, most states sprang to action last year to reduce rates, increase deductions or make other changes to ensure taxpayers were not negatively impacted by the TCJA. In fact, out of the 13 "static" conformity states, Arizona is joined by only California as two states that have yet to address this important issue.

Arizona's failure to act on conformity last year created a self-imposed crisis as the clock ticks toward the April 15th filing deadline with no clarity on how taxes should be paid.

Initially some policymakers feigned confusion or ignorance regarding the tax impact on Arizonans— this despite the analysis from ADOR clearly acknowledging the looming tax increase. ATRA joined some state lawmakers calling for a special session in December to act rapidly on a plan to both negate the looming tax increase but also provide timely guidance to Arizonans regarding their 2018 state income tax liability. The Governor has signaled his interest in waiting on the budget to act on conformity, which means there will be considerable confusion with the filing of 2018 tax returns, including the possibility of amended returns.

Two principles should guide lawmaker's action in resolving this problem. First, Arizona should maintain the theme of the TCJA and try to pass a conformity bill that does not overly complicate Arizona's tax code. Using FAGI as the starting point for Arizona taxable income is common across the country and provides a degree of simplicity for both the state and taxpayers. However, it does demand that lawmakers honestly and transparently acknowledge annual federal tax code changes that either increase or decrease Arizona taxpayer's liability.

In recent years, in an effort to avoid reducing state revenues, lawmakers have "decoupled" certain provisions from the federal code, rejecting changes that narrowed Arizona's tax base. Consistency would argue that we should protect the taxpayer when federal changes broaden the base and increase state revenue. This inconsistency will rapidly undermine public confidence in the state's administration of our income tax laws and potentially lead to calls for a permanent decoupling from the federal income tax code.

-Kevin McCarthy

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## **NONCOMPLIANCE**, *Continued from Page 1*

noncompliance— the question is just how much?

In 2012, Governor Brewer's TPT Simplification Task Force recommended that the state and local governments "should act aggressively" to transition from the current prime contracting tax to a tax on materials at the point of sale. In its final report, the Task Force emphasized that the lack of a uniform tax base between the state and its 91 cities creates complexities for contractors operating in multiple jurisdictions across Arizona. Furthermore, even if there were some degree of uniformity, the various jurisdictions have differed in their interpretation of the code. With such excessive complexities, contracting businesses are forced to dedicate increased resources in order to comply with their tax obligations rather than focus their energy on business operations.

Although legislation was introduced to advance the Task Force's recommendation during the 2013 session, the final version of the bill eliminated the contracting tax only for small contracting activity. Under the new MRRA law, construction projects involving maintenance, repair, replacement, or alteration (within specific thresholds) are subject to tax on materials at retail rather than the contracting tax. Although the new law benefitted smaller contractors working only on MRRA jobs, compliance became more difficult for other contractors who engage in MRRA projects and who also act as the prime under the contracting class. Although the intent was simplification, the one unintended consequence is that it shifted the complexities of the system from one group of contractors to another.

Understanding the ongoing complications surrounding the prime contracting tax, Rep. Regina Cobb spent the last few years sponsoring legislation to again eliminate prime contracting and replace it with a tax on materials at retail. Those efforts failed due to strong resistance from the League of Arizona Cities and Towns (League). One of the major hurdles was the ongoing disagreement between the cities and the taxpaying community regarding the level of noncompliance. For instance, a 1999 Arthur Andersen study conducted on ATRA's behalf determined the noncompliance rate as high as 41% whereas the cities claim there is minimal noncompliance, if any. In fact a recent study contracted for by the League argues that noncompliance isn't an issue for large companies that have ample resources to ensure compliance, never mind the burden on smaller companies that may have a higher incidence of noncompliance because they generate less revenue.

In an effort to inform the noncompliance debate, Rep. Cobb successfully sponsored legislation in 2018 to appropriate funds to the Arizona Department of Revenue (ADOR) to contract with an independent third party to study the noncompliance rate under the prime contracting class.

Released in late January of this year, the study utilized similar methods as used by the Internal Revenue Service (IRS), modified with state-provided data on TPT returns and audit results. For example, the IRS has found an obvious link between income tax compliance and third-party information reporting. Through this research, the IRS concluded income amounts subject to substantial information reporting and withholding had minimal "net misreporting" of 1%, compared to 7% with substantial information reporting but not withholding, and 63% when income amounts are subject to little or no information reporting. These findings are highly relevant particularly in determining noncompliance under the prime contracting tax since there is little if any third party information available to substantiate income, deduction, and exemption amounts. Furthermore, IRS has determined that the estimated voluntary compliance rate under the contracting tax is 81.7%. Using the IRS variables, the study reported that the noncompliance under the prime contracting tax could be as high as 19%, resulting in a loss in tax revenues of nearly \$1 billion between 2010 and 2016.

With taxpayer noncompliance shorting Arizona and local taxing jurisdictions millions of dollars each year, a materials-based tax system is the obvious solution since it would eliminate all ability to evade taxes, whether intentional or unintentional. The results of this study will hopefully allow such an effort to finally advance. With this in mind, Rep. Cobb sponsored HB2734 this year to create a study committee that will examine best practices from other states and policy experts on the taxation of prime contracting in an effort to decrease noncompliance. The bill passed the House with a unanimous vote and currently awaits a committee assignment in the Senate.

-Jennifer Stielow