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# ARIZONA TAX RESEARCH ASSOCIATION

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### **ATRA to Oppose Income Tax Initiative**

The ATRA Board of Directors recently voted to oppose the “Invest in Education Act” (IIE), a poorly-conceived proposal to double Arizona’s personal income tax rates on high income filers and direct those dollars to K-12 employee salaries. Instead of asking all Arizonans to participate in funding public education, the authors are cynically employing a populist strategy of passing the tab to “someone else” in order to improve their chances at the ballot. This time the target is high income filers: the IIE

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### **Save the Date!**

**ATRA Golf Tournament:**

Nov 2, 12:00 pm

Stonecreek GC

**ATRA Outlook Conference:**

Nov 15, 8:00 am

Embassy Suites Scottsdale

**Inside: Pima County Challenges Deseg Change  
SCOTUS Overturns *Quill* in *Wayfair* Decision  
County & Comm College Tax Update**

### **Lawsuits Mount as State Fumbles Taxation of Digital Goods and Services**

State lawmakers balked at the opportunity to provide clarity to taxpayers on which digital goods and services will be taxable in the State of Arizona. Despite a yeoman’s effort from Representative Michelle Ugenti-Rita and Senator David Farnsworth to improve the tax code for Arizona businesses, the bills (as explained in the ATRA April 2018 newsletter) did not pass.

The business community exercised great patience in waiting for the State to provide legislative clarity. They were warned of pending lawsuits. Without hope for administrative remedy, several claims have been filed while other

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**Income Tax Hike**, *Continued from Page 1*

proposes to increase the income tax rate for dollars earned over \$250,000 by 76% and double the tax rate for dollars earned over \$500,000.

Arizona aggressively cut income tax rates in the 1990s and made small cuts in the mid-2000s in order to make itself more regionally competitive. Despite 35% rate reductions and a series of deduction expansions, Arizona’s income tax produced 145% *more revenue* in 2017 than it did in 1991, adjusted for inflation. These gains outpaced population growth by 60%! A primary reason for this growth was a flood of small businesses and wealthy filers. Arizona became a destination location for wealthy retirees and part-year residents. Central to the positive environment for this small business explosion, which fueled the economic boom in Arizona, was regionally competitive income tax rates.

Between 1991 and today, income tax filers with more than \$1 million in adjusted gross income (AGI) grew from just 493 to 6,500. Let that sink in. With the top tax rate lowered from 7% to a regionally competitive 4.5%, more wealthy filers chose Arizona and small businesses flourished. The total revenues paid by \$1 million filers grew from just \$100.7 million in 1991 to more than \$700 million today (in constant 2017 dollars).

Amazingly, the proponents think that by doubling the rates, they will double revenues, completely ignoring any dynamic analysis. A massive and instantaneous tax increase is far more likely to create negative dynamic revenue impacts than small tweaks, which may not induce behavior changes. They ignore peer-reviewed studies which find that a 100% rate change will force 10% of current filers to shelter income elsewhere (or move) and 10% of filers who might choose to move to Arizona will divert. A 100% rate change will cause many filers to rethink their decision to file in Arizona.

**Funding public schools is a mandatory requirement of the State and the financial burden should be an obligation of all Arizonans. Isolating teacher pay raises on less than 2% of the population is awful public policy and should be rejected.**  
–Kevin McCarthy, ATRA President

Sadly, this rushed idea cannot accomplish its goal as drafted. School administrators will not be able to place these monies in base pay because of the volatility of the fund source. Any money derived will likely be paid twice a year in the form of a bonus much like Prop 301 dollars. Worse, the next economic downturn will create pressure to raise taxes elsewhere to solve this obvious problem.

Doubling Arizona’s highest marginal rate would rank Arizona in the top five nationally for income tax rates, ahead of New York, New Jersey, and Washington DC. This radical change will reverberate through the economy, impacting thousands of small businesses and leaders in Arizona’s economy.

Arizona’s economic success story and sustained in-migration has always been aided by good weather and low

individual tax burdens. Radically altering that formula will impact the economy. Is that worth a \$500 million tax increase which does not raise base teacher salaries? That is less new money for education than what lawmakers increased K-12 by this year alone (including money for population growth, inflation, and the 20x2020 teacher pay increase).

It seems an odd strategy for supporters to admit they lack the support of the populace; they clearly lack the confidence to ask all Arizonans to pay for additional funding to public education. Proponents do not enjoy the support of a broad coalition, have no economist backing the idea, or even have an analytical study demonstrating its economic impact. Arizonans should reject this initiative as a populist effort arising from fringe political groups.

*Please see the ATRA Special Report on this issue posted on our website's front page.*

-Sean McCarthy

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## Pima County/ TUSD Challenge New Deseg Law

In the state budget passed last month, the Legislature adopted a law which requires all taxes for Desegregation/ Office of Civil Rights (OCR) be collected as secondary property taxes, which in effect saves state taxpayers money by removing the state general fund subsidy. Homeowners in these districts who are presently over the constitutional 1% limit for primary property taxes will see a tax increase this year. This is because Deseg/OCR taxes are presently treated as primary property taxes but will be unprotected by the "1% cap" going forward as secondary property taxes, meaning they will be paid entirely by local property taxes. Most Deseg/OCR districts are unaffected because they are not 1% capped. The change impacts homeowners in Tucson Unified (\$126 per \$100K of value), Isaac Elementary (\$232 per 100K of value), and Maricopa Unified (\$47 per \$100K of value). Pima County is challenging this law change.

For decades lawmakers have struggled to manage one of Arizona's most peculiar institutions: the non-voter approved Deseg/OCR override taxes for school districts. Nineteen school districts annually levy additional taxes at the approval of their governing boards for supposed compliance with past court orders (in two cases) or monitoring from the federal OCR as it relates to allegations of discrimination of students based on race or ethnicity. That's right: school districts who violated children's civil rights 40-50 years ago may tax their residents more today and outspend their neighboring districts, sometimes by massive quantities. In almost every instance, the state's auditors have found the money is unrelated to whatever landed the district in the hot seat with the OCR and is simply more money for the district.

Instead of phasing these programs out, lawmakers capped the amounts the 19 districts could tax in 2008. While no group advocates for this as a coherent funding program, the benefitting districts argue they are used to having the money and want to keep it. State lawmakers are understandably tired of subsidizing it.

One district, Tucson Unified, remains under heavy yoke of the 9<sup>th</sup> Circuit Court of Appeals, who along with the District Court monitors TUSD for compliance with its court order to ensure its educational offerings are fair for

all students. Among other demands, the court requires certain racial quotas at each school and in specific programs, a comical demand in an open-enrollment state where the district has virtually no say in who shows up to which school.

Pima County declared the new state law unconstitutional, saying they will not enforce it and will invent a new tax construct by calling the Deseg tax a secondary property tax while applying 1% Cap protections. The new law clearly states Deseg/OCR taxes may only be levied on the secondary. One would think their disagreement would mean they could not levy the tax at all, since there is no law saying it may be taxed any other way. This has invited TUSD to litigate the issue, because the state will no longer backfill the subsidized amount, which is roughly \$16 million of their capped Deseg amount of \$64 million (not all of it is subsidized by state taxpayers).

The Pima County memo argues the state failed to address the enabling 1% Cap law, curiously referencing A.R.S. §11-972, a wholly unrelated statute. Pima County certainly must have meant A.R.S. §15-972, which dictates what happens once homeowner's primary property taxes reach the 1% Cap: a subsidy paid by the state via the homeowner rebate for education. A.R.S. §15-972 does not explain what a primary or secondary property tax is and certainly is not "enabling" the constitutional 1% Cap provision. It simply manages the problem created by the cap. The Constitution only states that homeowners stop paying at 1% of value, not how the cap is remedied. The Constitution is silent on the matter. That the Legislature did not alter how the 1% Cap is remedied in A.R.S. §15-972 is immaterial in this case.

What is debatable is whether the Deseg/OCR taxes may be considered a secondary property tax in light of the constitutional protections established in 1980. In their legal analysis, Pima County insists the secondary property tax is reserved for voter approved bonds and overrides. There are many nonvoter-approved levies on the secondary property tax, some created by the state. The question is whether Deseg/OCR may be one of them.

Article 9, Section 18 of the Constitution:

*Section 18. (1) The maximum amount of ad valorem taxes that may be collected from residential property in any tax year shall not exceed one per cent of the property's full cash value as limited by this section.*

*(2) The limitation provided in subsection (1) does not apply to:*

*(a) Ad valorem taxes or special assessments levied to pay the principal of and interest and redemption charges on bonded indebtedness or other lawful long-term obligations issued or incurred for a specific purpose.*

*(b) Ad valorem taxes or assessments levied by or for property improvement assessment districts, improvement districts and other special purpose districts other than counties, cities, towns, school districts and community college districts.*

*(c) Ad valorem taxes levied pursuant to an election to exceed a budget, expenditure or tax limitation.*

The question for the Court will be whether the Deseg/OCR tax is among the "other lawful long-term obligation (s) issued or incurred for a specific purpose" in Section 18. 2 (a).

ATRA has long argued the Deseg/OCR program is a sham and should be phased out. If the courts agree with the state and the law proceeds as passed, lawmakers will have less interest reforming this program going forward as they are no longer subsidizing the high tax rates in some of the jurisdictions. In 2017, ATRA asked lawmakers to

make Deseg/OCR voter approved secondary property taxes as an override, which did not pass. With an uphill battle, ATRA will continue to remind lawmakers this stain on Arizona's public finance system must eventually be removed.

-Sean McCarthy

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## **STATE FUMBLES DIGITAL**, *Continued from Page 1*

taxpayers mull their options. Meanwhile, the State continues to illegally levy taxes on many digital goods and services at random. This isn't ATRA's opinion alone, but the concurrence of the state's foremost tax lawyers and national experts.

After hearing from several taxpayers in 2016 of massive confusion in the taxation of digital products such as data storage and software-as-a-service (SaaS), ATRA asked lawmakers to convene a study session in early 2017. Senate President Steve Yarbrough and House Speaker J.D. Mesnard convened a joint ad hoc study committee to review the issue in the summer of 2017. The unanimous finding of the committee was that Arizona required clarity to tax digital products and must address the issue in law.

In the meantime, the Department of Revenue (DOR) continued to tell various businesses— quite literally one at a time, that their product was subject to Transaction Privilege Tax (IPT, or sales tax).

HB2479 and SB1392 failed for two important reasons. HB2479 sailed through the House with a bipartisan vote but before the Senate version was voted on, the Joint Legislative Budget Committee (JLBC) released a fiscal note which stated there were unknown fiscal impacts and amazingly enough, included estimates from an advocacy group, the League of Arizona Cities and Towns that estimated a dramatic decrease in state revenues. After ATRA demonstrated their data was grossly overestimated, JLBC released a memo acknowledging the state impact was overstated, yet never updated their fiscal memo. The League's fiscal impact estimate of \$78 million to the state was an anchor on the effort. When school teachers marched on the Capitol towards the end of session, one of their demands was no tax cuts. Shell shocked lawmakers ultimately decided it wasn't worth drawing their ire.

### **Policymakers Left Businesses in a Pickle**

Without clarity on which products are taxable, businesses face an impossible decision over whether to begin collecting taxes without the legal authority to do so. Tax attorney James Busby of The Cavanagh Law Firm recently published on the topic in the June 4 issue of *State Tax Notes*:

*“By not specifying whether digital goods and services are subject to tax in Arizona, the Legislature left providers in a damned-if-you-do, damned-if-you-don't position. That is, to the extent they choose to collect tax on their proceeds from providing digital goods and services to Arizona customers without specific statutory authority to do so, they expose themselves to potential class action lawsuits for allegedly collecting more tax than is lawfully due. Yet if they do not collect tax from their Arizona customers and the DOR determines that they should have paid tax, they may have to pay tax they did not collect from their customers, along with penalties and interest, if audited.”*

\*\*Note: James Busby is an ATRA Board Member

## Lawsuits Could Cost the State Big Money

ATRA was told that several companies held off on refund claims which result in lawsuits against the State of Arizona in hopes that the Legislature would resolve the issue. Without remedy in sight, some have filed refund claims while others are weighing legal options. Without statutory authority, the state is highly liable for refund claims which may threaten state coffers. DOR representatives admitted in a hearing in 2017 that there should be clarity in state law regarding the state's tax treatment of digital goods and services.

In the next article, ATRA will explore the legal issues in depth to build understanding for policymakers and taxpayers alike. This common picture provides a framework for determining which products should be taxable.

-Sean McCarthy

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# SCOTUS Overturns *Quill* in *Wayfair*

The SCOTUS June ruling overturning *Quill/Bellas Hess* in *South Dakota v. Wayfair* is good news for Arizona businesses and taxpayers. The court sided with South Dakota and invalidated the “physical presence” test for the collection of sales taxes on remote sellers. The Court made the case for why South Dakota’s simplified sales tax law does not burden out-of-state (remote) sellers, but also insisted that states with more complex or overreaching laws would be in violation of the commerce clause. Known for having one of the most complex and burdensome sales tax systems in the United States, Arizona will be forced to simplify its sales tax if it wishes to require out of state sellers collect sales taxes in Arizona.

Importantly, this ruling might have no immediate impact for Arizonans or remote sellers doing business in Arizona. The Court effectively blessed the South Dakota model and acknowledged Congress and lower courts will determine the bright line for what constitutes “sufficient nexus” (say, \$100,000 in gross sales) and what sales tax structure constitutes a fair compliance burden for remote sellers. The Court referenced compliance with the Streamlined Sales and Use Tax Agreement (SSUTA) as evidence of South Dakota’s low burden on remote sellers. Not only is Arizona not in compliance with SSUTA, the lack of uniformity between Arizona’s state and municipal sales tax bases puts Arizona well outside these standards. In fact, the national Tax Foundation ranks Arizona 47th in the nation for sales tax in its Business Tax Climate Index, which is not a reflection of high rates but difficult compliance.

ATRA has long advocated for tax equity between main street retailers and online vendors as it relates sales tax on tangible personal property. This ruling provides an opening for Arizona to modernize its tax code and create fairness among retailers. However, relief for main street retailers won’t come until the state acts to simplify its notoriously cumbersome sales tax systems.

# Comm College Tax Update

Eight of the twelve community college districts (CCD) have raised primary property taxes for Fiscal Year 2019. In positive news, Arizona Western (Yuma/LaPaz) appears to be joining the group of CCDs who will not automatically increase taxes annually as a matter of routine business. Yavapai, Central Arizona (Pinal), Maricopa, Eastern (Graham), and Santa Cruz are the others.

ATRA has long encouraged colleges to make strategic decisions about their tax rate and avoid treating property tax increases as foregone conclusions. Regrettably, a few colleges such as Mohave Community College have taken to describing their annual 2% tax increase as “increasing for inflation” which is a convenient descriptor which avoids debating the balance between college needs and taxpayer consideration, particularly in the face of declining enrollment. When new property is added to the tax rolls each year, which typically nets a 1% to 3% increase in overall district property value, districts benefit in the form of higher property tax revenues without raising taxes.

CCD	Primary Rate	Tax Increase	% Rate Change	Secondary Rate	% Change	% Levy Limit
Cochise	<b>\$2.40</b>	2%	1.2%	-	-	100%
Coconino	<b>\$0.47</b>	2%	(1.6%)	\$.12	(8.1)%	100%
Graham/Eastern	\$3.33	-	6.0%	-	-	94%
Maricopa	\$1.17	1.3%	(2.1%)	\$.20	(4.4%)	88.9%
Mohave	<b>\$1.34</b>	2%	(0.1%)	-	-	100%
Navajo/Northland	<b>\$1.85</b>	2%	2.5%	-	-	100%
Pima	<b>\$1.40</b>	2%	0.7%	-	-	100%
Pinal/Central	\$2.18	-	(2.5%)	\$.19	(40.1%)	78.6%
Yavapai	\$1.76	2%	(1.4%)	\$.19	(5.4%)	90.3%
Yuma/LaPaz	\$2.22	-	(1.6%)	\$.36	(1.9%)	98%
Gila Provisional	<b>\$.96</b>	2%	2.3%	-	-	100%
Santa Cruz Provis.	\$.49	-	(1.0%)	-	-	31%

**Bold= At Levy Limit**

# Proposed FY19 County Tax Rates

Arizona counties are in the midst of their FY 2019 budget season and all but four counties have adopted their tentative budgets. Primary taxes that fund the maintenance and operations of county government and the secondary property taxes that fund countywide special taxing districts for flood control, library, public health, services, and jail districts are subject to truth-in-taxation (TNT) laws. TNT requires counties, community colleges, and municipalities to notify taxpayers of their intent to increase property taxes over the previous year, exclusive of new construction, by publishing notice in a newspaper of general circulation and to hold a public hearing.

Based on the tentative budgets, the counties of Cochise, Maricopa, and Mohave plan to raise taxes by maintaining the same rates from last year (against increasing values) for both the primary and secondary property taxes and as a result will be subject to the TNT process. Other notable changes included the 39-cent rate decrease in Pima County's primary rate as a result of the Board of Supervisors' decision to repeal last year's adopted 25-cent primary tax rate to fund county roads. Additionally, the Coconino County flood control district (FCD) rate dropped nearly 24 cents since the tax base was broadened to include all of the cities and towns within the boundaries of the district (like all other countywide FCDs).

-Jennifer Stielow

COUNTY	Adopted 2018	Proposed 2019	TNT
<b>Apache (P)</b>	<b>0.5857</b>	<b>0.5922</b>	<b>0.5806</b>
<b>Apache (S)</b>			
Flood Control (FCD)	0.0845	0.0861	0.0861
Library (Ops)	0.3094	0.3067	0.3067
Library (Bonds)	0.1221	0.1089	-
Jail District	0.1996	0.1978	0.1978
Juv. Jail	0.0897	0.0889	0.0889
JR College	0.3750	0.3750	-
Post Sec. Ed.	0.1400	0.1400	-
Public Health Svc. (PHSD)	0.2500	0.2478	0.2478
<b>APACHE TOTAL</b>	<b>2.1560</b>	<b>2.1434</b>	
<b>Cochise (P)</b>	<b>2.6747</b>	<b>2.6747</b>	<b>2.6540</b>
<b>Cochise (S)</b>			
Library	0.1451	0.1451	0.1440
FCD	0.2597	0.2597	0.2594
<b>COCHISE TOTAL</b>	<b>3.0795</b>	<b>3.0795</b>	
<b>Coconino (P)</b>	<b>0.5678</b>	<b>0.5589</b>	<b>0.5479</b>
<b>Coconino (S)</b>			
Library	0.2556	0.2556	0.2467
FCD	0.4000	0.1622	0.3852
PHSD	0.2500	0.2500	0.2413
<b>COCONINO TOTAL</b>	<b>1.4734</b>	<b>1.2267</b>	
<b>Gila (P)</b>	<b>4.1900</b>	<b>4.1900</b>	<b>4.2014</b>
<b>Gila (S)</b>			
Library	0.2425	0.2425	0.2432
<b>GILA TOTAL</b>	<b>4.4325</b>	<b>4.4325</b>	
<b>LA PAZ (P) TOTAL</b>	<b>2.4900</b>	<b>2.3607</b>	<b>2.3607</b>
<b>Maricopa (P)</b>	<b>1.4009</b>	<b>1.4009</b>	<b>1.3543</b>
<b>Maricopa (S)</b>			
Library	0.0556	0.0556	0.0538
FCD	0.1792	0.1792	0.1706
<b>MARICOPA TOTAL</b>	<b>1.6357</b>	<b>1.6357</b>	

COUNTY	Adopted 2018	Proposed 2019	TNT
<b>Mohave (P)</b>	<b>1.9696</b>	<b>1.9696</b>	<b>1.9283</b>
<b>Mohave (S)</b>			
FCD	0.5000	0.5000	0.4830
Library	0.2716	0.2716	0.2659
T.V.	0.0200	0.0200	N/A
<b>MOHAVE TOTAL</b>	<b>2.7612</b>	<b>2.7612</b>	
<b>Navajo (P)</b>	<b>0.8903</b>	<b>0.8951</b>	<b>0.8951</b>
<b>Navajo (S)</b>			
FCD	0.2834	0.2788	0.2788
Library	0.0990	0.0995	0.0995
PHSD	0.2476	0.2489	0.2489
<b>NAVAJO TOTAL</b>	<b>1.5203</b>	<b>1.5223</b>	
<b>Pima (P)</b>	<b>4.4596</b>	<b>4.0696</b>	<b>4.4014</b>
<b>Pima (S)</b>			
Bonds	0.7000	0.6900	N/A
FCD	0.3135	0.3335	0.3088
Library	0.5053	0.5153	0.4987
Debt	0.7000	0.6900	N/A
<b>PIMA TOTAL</b>	<b>6.6784</b>	<b>5.6084</b>	
<b>Pinal (P)</b>	<b>3.8699</b>	<b>3.8300</b>	<b>3.7721</b>
<b>Pinal (S)</b>			
FCD	0.1693	0.1693	0.1642
Library	0.0965	0.0965	0.0941
<b>PINAL TOTAL</b>	<b>4.1357</b>	<b>4.0958</b>	
<b>Yuma (P)</b>	<b>2.5016</b>	<b>2.5288</b>	<b>2.4792</b>
<b>Yuma (S)</b>			
FCD	0.2794	0.2522	0.2742
Library (Ops)	0.6452	0.6608	0.6394
Library (Bonds)	0.2582	0.2426	N/A
<b>YUMA TOTAL</b>	<b>3.6844</b>	<b>3.6844</b>	

\*TNT rates in red font indicate TNT publication and hearings were required.