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2017 LEGISLATIVE SESSION UPDATE

Introduction

As the Legislature approaches the end of March, committees to hear bills are in their last week and all eyes are on the budget process. The FY2018 state budget will be subject to controversy and prognosticators are projecting a budget battle lasting several weeks.

GOOD BILLS

HB2011 bonds; levy; net of cash (Ugenti-Rita)

Since statehood, Arizona state statute has provided taxing entities the authority to levy property taxes for the annual debt service payment of voter-approved General Obligation (G.O.) bonds. Of all debt instruments governments may issue, G.O. bonds are the most secure since they are backed by the full faith and credit of the jurisdiction's taxing power. As such, these bonds typically receive the highest credit ratings and carry the lowest interest rates of all the debt instruments available to government.

As market values rose dramatically during the last decade, several taxing jurisdictions left tax rates the same which ultimately led to tax increases that mirrored the value growth. Case in point was the City of Phoenix. Until

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INSIDE: Agua Fria Builds \$75M High School; Adjacent Ways to Pay for \$6M

AZ #2 in Nation for Cigarette Smuggling 2006 Tobacco Taxes Cannibalized Existing Revenues

According to a joint study conducted by the Mackinac Center for Public Policy and the Tax Foundation, Arizona ranks #2 in the nation for cigarette smuggling with an estimated 49.3% of consumed cigarettes being smuggled. Available research concludes Arizona's tax rate of \$2.00 per pack— among the highest in the nation, contributes to its high smuggling rate. While it's impossible to validate the 49% figure, the evidence seems clear that Arizona has a cigarette smuggling problem.

In 2006, ATRA warned voters that a 68% increase in the tobacco tax rate would lead to a substantial decline in the

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recently, the City of Phoenix continually held its combined tax rate to \$1.82 for both primary and secondary property tax purposes regardless of changes in property values. As a result, while property values grew 80% in the City of Phoenix between FY 2005 and FY 2010, secondary taxes grew a whopping 95%. Due to the city's failure to adjust tax rates downward to offset the growth in property values, cash reserves in the city's G.O. debt reserve fund grew nearly three times more than the amount needed to pay its annual debt service by FY 2010.

In an effort to stop such unprecedented tax increases, ATRA advocated for legislation in 2013 to clarify that the amount levied in secondary taxes could not exceed the "net" amount necessary to meet the annual debt service payments for principle and interest, including any projected payments for new debt planned for the ensuing year, a reasonable delinquency factor, and any amounts necessary to make up for shortages or errors. Despite passage of that legislation, the City of Phoenix and a few other cities continue to hold reserves well in excess of the amount needed to pay their annual debt service. As a result, Rep. Ugenti-Rita sponsored this year's legislation under HB2011 that, as amended, again attempts to clarify existing law but allows the secondary levy to be net of all cash in excess of 10% of the amount remaining in the debt service fund from the previous year. Additionally, session law allows cities that have accumulated large reserves a two-year window to return the excess money back to taxpayers.

HB2011 currently awaits Senate COW while negotiations continue with the City of Phoenix regarding an extension to the current two-year window to return reserves.

HB2286 truth-in-taxation; increase; notice (Barton)

HB2286 simplifies the Truth-in-Taxation (TNT) notice that is required of taxing entities proposing an increase in property taxes. ATRA proposed this legislation in response to comments made by some counties that the current TNT notice is confusing for taxpayers in situations when the proposed tax increase occurs when property values increase and tax rates are kept the same. HB2286 makes the TNT message clearer for taxpayers by requiring the tax example in the notice to show how much the taxes would be on a home valued at \$100,000 with the tax increase and how much would be owed on the home without the tax increase.

HB2286 also extends the same oversight of the TNT requirements by the Property Tax Oversight Commission (PTOC) that currently applies to counties, community colleges, cities and towns to the operating levies of countywide special taxing districts. HB2286 passed unanimously out of the Senate Finance Committee and currently awaits a Senate floor vote.

SB1174 schools; desegregation funding; voter approval (Lesko)

SB1174 requires voter approval for Desegregation/Office of Civil Rights (OCR) levies beginning in Fiscal Year 2020. For the past 37 years, Deseg/OCR levies have been nonvoter approved and benefitting school districts show no desire to curtail their dependence on this additional tax. The bill states that school districts may keep their maximum current legal amount if it is voter approved, similar to an M&O override. Any amount not approved would begin a five year phase out.

Advocates for the few benefitting school districts suggest that making them voter approved all but officially ends the tax, signaling to lawmakers that their community may not support these programs. The measure passed the

Senate Appropriations committee but remains stalled on the Senate floor. Several lawmakers have privately told ATRA staff that instead of arguing for a legislative remedy to Desegregation/OCR taxes, ATRA ought to file a lawsuit testing their constitutionality as it relates to the “general and uniform” clause. *SB1174 was held in the Senate Committee of the Whole.*

HB2213 GPLET Reforms; K-12 Taxes (Leach)

As amended, HB2213 limits the total length of any prospective economic development deal to eight years from twenty-five years if there is any tax abatement period. The current limitation of an eight year abatement is maintained inside central business districts. The underlying bill eliminated the full abatement, requiring GPLET deals immediately begin paying K-12 GPLET excise taxes. A compromise between developers, cities and ATRA resulted in restoring the full abatement in exchange for eliminating “the tail”— years nine through 25. In year nine the property is conveyed to the lessee from the government lessor and is added to the property tax roll.

The bill also makes technical adjustments to all GPLET deals, improving collection and remittance procedures. The lessee no longer will calculate their own tax and the government lessor is now responsible. Finally, any use of the 2010 grandfathering provision to apply 1996 GPLET rates must be confirmed by the Department of Revenue as being in compliance with the 2010 grandfathering provision.

The underlying bill also attempted reforms at the definitions of slum and blight. It did not appear there was enough time during session to arrive at a consensus definition. ATRA agreed to work with stakeholders in the off session to discuss the issue. *HB2213 passed the House 50-9, Senate Finance 7-0 and awaits a hearing in the Senate Committee of the Whole.*

BAD BILLS

SB1149 NOW: community engagement district (Worsley)

As amended in the Senate, SB1149 allows the creation of a new special district called a Community Engagement District, whereby the governing body of a municipality establishes a district around a multipurpose facility for sporting, entertainment, cultural, civic or convention activities. The district must be formed before 2019, approved by all real property owners, and not exceed 30 acres in size. The district has the authority to add up to a 2% excise tax to existing taxes as well as recapture half of all state transaction privilege taxes to pay for the multipurpose facility. There are several other routine laws relating to formation, board makeup, board duties, reporting found in like Tax Increment Financing (TIF) laws. The bill is advertised as the vehicle for a new publicly funded arena for the Arizona Coyotes NHL franchise.

The bill also has boilerplate language establishing property TIF for the creation of multiple districts to finance road construction. The necessary law changes to implement property TIF are not found in the bill in order to make it work and it was not discussed at length in committee.

ATRA has a long track record of opposing TIF as well as publicly funded sports facilities. SB1149 suffers from many of the same policy features as other attempts at sales TIF, where the normal appropriations process is skipped and general fund revenues are siphoned off before lawmakers have the chance to prioritize revenues. Worse, the argument that the revenues generated in the district are “foregone” or “brand new money” goes from unsupported to impossible in the instance of moving a team across town to a new arena. The business failure the Coyotes may be experiencing in their publicly funded Glendale arena is certainly not a statewide concern. Moreover, the bill is a not a tailored vehicle and could be used by any city for any number of projects, creating an unforeseen drain on the state general fund. *SB1149 is currently being held in the Senate Committee of the Whole.*

HB2526 property tax; reducing limited valuation (Grantham)

HB2526 would have required that if the Full Cash Value (FCV) of property is reduced as the result of an appeal that the Limited Property Value (LPV) be reduced by the same percentage. Proponents testified in the House Appropriations Committee that the LPV should be an appealable value like the FCV since it is the only taxable value.

This year's proposal is a similar attempt to last year's effort that would have allowed the LPV to be appealed based on the "equity" approach. Just like last year, ATRA questioned the constitutionality of amending state statute that would allow a different calculation of the LPV in contrast to the constitutional provision that clearly mandates a 5% annual increase. Furthermore, ATRA argued that there is no rationale in tying the same percentage reduction between the FCV and LPV when there is no direct correlation in the calculation of the two. The bill failed the House Appropriations Committee by a vote of 5-8.

HB2516 one-year property tax assessments (Mitchell)

For several years the county assessors have been advocating for legislation that would dramatically collapse the existing property valuation/appeals and budget/tax calendar from 18 months down to just six months. The assessors' main argument for valuing and taxing property in the same year is that it will make a complicated system easier for taxpayers to understand. ATRA argued that the calendar change would do significant damage to the state and local budgeting process.

Policymakers may not be aware that over 30 years ago Arizona's property valuation and tax calendar was greatly condensed and similar to the timelines proposed under HB2516. One major flaw associated with the old calendar was that taxing jurisdictions did not have their final equalized values when determining the amount to be levied to fund their budgets. As a result, major reforms were implemented in 1994 to expand the calendar to allow appropriate timelines for valuing property, the appeals process and the finalization of values necessary for the publication and distribution of constitutional levy limits of local governments, as well as the transparency associated with the tax rate setting process under TNT for state and local governments.

ATRAs strong opposition to HB2516 is rooted in the belief that a transparent budgeting and tax rate setting process requires public information that both elected officials and taxpayers can rely on and provides taxpayers the opportunity to engage their elected officials when making important decisions. The bill failed in the House Appropriations Committee by a vote of 3-10.

\$75 Million High School; Adjacent Ways to Pay for \$6M

As one of the few growing school districts statewide, Agua Fria Union High School District is breaking ground on a \$75 million high school. The funding sources are just as eye opening. The State of Arizona is kicking in \$33.4 million, an amount derived from a statutory formula based on student growth and a per square footage amount. District voters approved a bond in 2015 which supplements the project by roughly \$30 million. Finally, the district will add an additional Adjacent Ways tax to its primary property rate of roughly \$6 million over two years and apply those proceeds to pay for all roads, sidewalks and utilities associated with the project. Sadly, this has become the blueprint for all major K-12 construction projects.

Adjacent Ways is an unlimited tax a school board may add to its primary property tax without voter approval to pay for costs such as sewers, gutters, sidewalks and emergency lane access. It was added to school finance laws because there were circumstances where unforeseen costs would arise, such as the city expanding roadways or changes to utility connections. Policymakers decided it was too complex to determine when and how much a district would need this money so no cap was placed— it's completely up to the school board. It has morphed into a fund which is covering any cost which can be legally construed to fit an Adjacent Ways project, including planned projects. This levy is collected in the schools primary property tax rate, an amount levied on top of the normal rate. It is not displayed as such on the tax bill. A school board does have to publish a truth-in-taxation notice and approve it in a board meeting.

It stands to reason that if a local school board is going to ask its voters to pay debt service for construction projects, it ought to include all project costs— not soft peddle the request by loading up a substantial amount of the project into a nonvoter approved levy. Districts claim exact Adjacent Ways costs are unpredictable even for planned projects. The extent to which that is true applies similarly to all construction projects.

It is curious that the State has participated in this ruse through the School Facilities Board (SFB), encouraging districts to spend Adjacent Ways monies where convenient to relieve costs for the State. If Arizona is responsible for building a school, it ought to be responsible for all the roadwork on school property, sidewalks and hooking up the utilities. A school without these features is incomplete. It's possible the state will have to relook at its New School Construction formula to ensure horizontal construction costs are covered. For the state to insist locals charge these aspects of the project to the local tax base conflicts with *Students First*, where qualified new construction costs are covered by the state.

For school districts with higher property values, the standard has become to ask local voters to approve a certain amount of bonds while burying a not insignificant amount of the project cost in Adjacent Ways. Districts with smaller tax bases cannot possibly do this as the tax rate to achieve the same result would be prohibitively high. This is precisely the outcome courts have told the State they must avoid.

The courts have been clear on this issue: the State owes districts adequate school space which must include all normal features of a school. If locals want to tax themselves to build \$75 million schools, they ought to be upfront about all additional costs and not supplant millions from Adjacent Ways.

At ATRA's request, lawmakers passed reform bill SB1117 in 2016 which required SFB validation of all Adjacent Ways expenditures. This has provided significant clarity on how this money is used. The results aren't pretty. As the Legislature mulls changes to K-12 capital finance laws, it should consider requiring planned bond projects include all expected costs so voters know the true impact up front.

For the state to insist locals charge these aspects of the project to the local tax base conflicts with *Students First*, where qualified new construction costs are covered by the state.

-Sean McCarthy

TOBACCO TAX PROBLEMS, *Continued from Page 1*

revenues received by the existing recipients of the tobacco tax including the State General Fund, Corrections Fund, and the Tobacco Tax & Health Care Fund.

The Joint Legislative Budget Committee projected the loss in revenues for existing programs which receive tobacco tax monies as a result of the 2006 Prop 203 to be \$23 million. ATRA estimated the loss would be double. It turns out ATRA also estimated low: the losses in revenue to existing programs in its first full year (2008) was \$59.3 million. Some 10 years later the loss has grown to \$64 million per year, or 25.4%— not counting inflation.

The State General Fund alone receives \$15 million less in tobacco tax revenues annually since Prop 203. While a reduction in tobacco consumption has likely contributed, Arizona moved from #7 in cigarette smuggling in 2006 to #2 today, showing a direct impact of the tax increase from Prop 203.

First Things First received \$164.8 million in 2008 via the Early Childhood Development and Health Fund and has witnessed a reduced amount in each year since, receiving \$126 million last year.

The Mackinac Center for Public Policy is a Michigan think tank which uses a statistical analysis of available data to estimate smuggling rates. The Journal of Health Economics and the National Tax Journal have also published peer reviewed studies on the phenomena of high taxes influencing cross-border tobacco smuggling.

The report claims: “Excessive tax rates on cigarettes approach de facto prohibition in some states, inducing black and gray market movement of tobacco products into high tax states from low tax states or foreign sources.”

The high water mark for tobacco taxes collected in Arizona was in 2008, the first full year of the implementation of the Prop 203 tax increase, when \$407 million was collected in total. The amount has decreased in nearly each year since. Now just \$317 million is collected, meaning the

Luxury Tax on Cigarettes and Tobacco

Table 1

COLLECTIONS AND DISTRIBUTION

Fiscal Year	General Fund	Corrections Fund	TTHCF ^{1/}	TPTF ^{2/}	ECDHF ^{3/}	SFAF ^{4/}	Total
2016	\$24,550,412	\$5,143,144	\$66,415,766	\$92,031,875	\$126,206,733	\$2,941,563	\$317,289,493
2015	\$23,645,756	\$5,230,839	\$67,071,278	\$93,055,529	\$122,239,828	\$2,848,986	\$314,092,216
2014	\$25,810,507	\$5,100,324	\$61,694,151	\$91,923,081	\$124,371,662	\$2,918,213	\$311,817,939
2013	\$24,530,414	\$5,041,634	\$65,750,954	\$91,044,441	\$125,771,470	\$2,956,134	\$315,095,047
2012	\$24,931,105	\$5,142,535	\$65,665,913	\$90,953,118	\$129,391,158	\$3,043,448	\$319,127,277
2011	\$25,066,894	\$5,230,772	\$68,781,910	\$95,586,289	\$130,083,235	\$3,058,479	\$327,807,579
2010	\$25,810,438	\$5,307,048	\$69,089,344	\$96,335,427	\$133,118,902	\$3,888,483	\$333,549,642
2009	\$29,080,647	\$5,129,852	\$76,972,057	\$108,934,079	\$151,363,815	\$2,868,990	\$374,349,440
2008	\$32,467,344	\$6,206,674	\$83,868,465	\$116,127,254	\$164,805,113	\$3,946,308	\$407,421,158
2007	\$37,558,776	\$6,206,673	\$100,500,062	\$137,624,178	\$74,445,246	\$1,778,847	\$358,121,881
2006	\$39,578,709	\$6,206,674	\$106,821,045	\$145,399,774			\$298,006,202
2005	\$38,360,552	\$6,206,608	\$102,310,127	\$138,521,611			\$285,398,898
2004	\$36,757,081	\$6,206,674	\$98,163,310	\$133,563,168			\$275,104,562
2003	\$41,174,667	\$6,206,674	\$105,027,137	\$59,938,321			\$212,346,799
2002	\$43,206,460	\$6,206,674	\$108,177,154				\$157,590,288
2001	\$43,124,883	\$6,206,674	\$108,709,176				\$158,040,733
2000	\$43,446,233	\$6,196,674	\$109,786,025				\$159,428,932
1999	\$43,895,551	\$6,206,674	\$112,735,957				\$162,838,182
1998	\$44,443,108	\$6,206,674	\$114,104,507				\$164,754,289
1997	\$43,676,616	\$6,206,675	\$115,961,006				\$165,844,297

^{1/} Tobacco Tax and Health Care Fund (Proposition 200 in 1994. The distribution was altered in Laws 2007, Chapter 150).
^{2/} Tobacco Products Tax Fund (Proposition 303 in 2002).
^{3/} Early Childhood Development and Health Fund (Proposition 302 in 2006).
^{4/} Smoke-Free Arizona Fund (Proposition 201 in 2006).

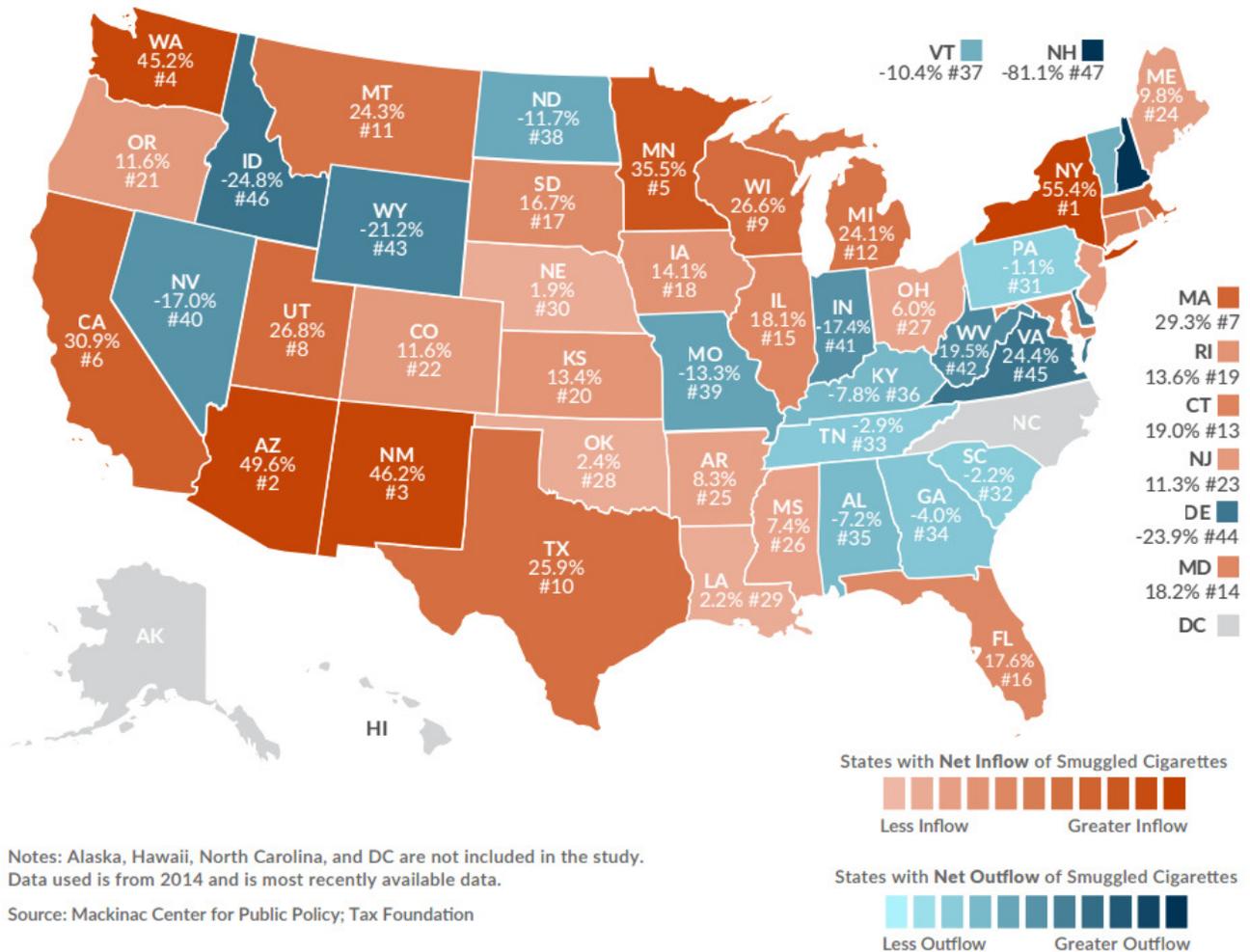
SOURCE: Department of Revenue, Luxury Tax Section.

From: 2016 JLBC Tax Handbook

Figure 2.

Cigarette Smuggling by State

Smuggled cigarettes consumed as a percentage of total cigarettes consumed, 2014



68% tax increase now nets only a 6.5% revenue increase against the 2006 baseline.

Smuggling doesn't just impact government coffers: "Growing cigarette tax differentials have made cigarette smuggling both a national problem and in some cases, a lucrative criminal enterprise." In Arizona, smuggling happens in a variety of fashions, with illegal cigarettes originating from both out of state and overseas. Illegal distributors purchase out of state, or on an Indian reservation, or smuggled across the international border.

The last two fiscal years show a small uptick in tobacco tax collections; they may have bottomed out in 2014. The 2010 National Prevent All Cigarette Trafficking Act may be the result. Previously, it was easy to avoid state tobacco taxes by purchasing online. Common carriers are no longer participating and penalties and back taxes to the purchaser are a real threat. The small uptick could also have resulted from an improving economy.

Several states are turning to luxury taxes on vapor products. The vapor product market has grown quickly in the last several years, drawing lawmakers' attention. As of last January, four states have elected to tax vapor products with 25 others considering legislation.

-Sean McCarthy