Tax Reform Package

In conjunction with the Fiscal Year 2020 budget, the Arizona Legislature passed HB2757, a tax omnibus bill supported by ATRA and most of the business community. It has two major provisions: it conforms Arizona’s income tax code to the federal code post Tax Cuts and Jobs Act (TCJA) and implements an economic nexus law to require remote sellers collect and remit Arizona transaction privilege tax (TPT).

Conformity

When the federal government expanded the personal income tax base and lowered rates in TCJA, it became necessary for states who conform their income tax code to the federal code to decide what to do about this expanded base of tax. If the state

See TAX REFORM PACKAGE, Page 2

2019 Legislative Session Wrap

After a 135 day legislative session, the State Legislature adjourned Sine Die on Memorial Day after passing 331 bills. More than a dozen ATRA designated Good Bills passed this session. Of particular importance, no ATRA designated Bad Bill passed. In the last three sessions, just one Bad Bill has passed out of 25. It’s worth pointing out that ATRA’s Good/Bad Bill list only includes serious legislative efforts which received a committee hearing.

Since the ATRA April Newsletter there were several updates to legislation ATRA has been tracking. Many Good Bills described in the last newsletter passed, to include:

See 2019 SESSION WRAP, Page 4

Paloma El Skipped Public Vote

Ignored Auditor For Years

On a drive through southwest Arizona on Interstate 8, just past Gila Bend, you’ll pass a small farming community sporting a brand new school. Paloma Elementary is in the final stages of a $10.5 million construction project to rebuild all their facilities for their 110 students. The issue is they were supposed to ask their voters if they could do it and they did not; even after they were told several times it was illegal.

If anyone should have heard about the controversy, it would be local rancher Les Heiden, who owns land adjacent to the school and has been familiar with the district for decades. He was shocked to hear Paloma not only

See PALOMA SKIPPED PUBLIC VOTE, Page 6
simply conformed to those changes, taxes on individuals and small businesses would increase if no other reforms were achieved. As passed, the bill retroactively conforms tax year 2018 to the federal tax code, which essentially adds $155 million to state coffers as scored by the Joint Legislative Budget Committee (JLBC). This amount was used in the budget to pay down state debt incurred during the recession. The debt reduction saves the state an ongoing $24 million.

For tax year 2019, the state similarly conforms to the latest federal code and the $217 million revenue increase associated with 2019 conformity is leveraged to make changes to the income tax code (see Ongoing Impact chart).

Consistent with the philosophy in the TCJA, HB2757 doubles the standard deduction and many filers will no longer itemize their deductions as a result. Higher standard deductions of $12,200 (single) and $18,400 (married) at the state level saves taxpayers from creating a Federal Schedule A for itemized deductions that they didn’t need for their federal taxes. The reform eliminates the personal and dependent exemptions.

The bill also dissolves one income tax bracket, going from five to four total brackets and shaves rates (see diagram of new tax brackets). These income tax changes offset the additional revenues produced from both conformity as well as the TPT changes (described below).

ATRA applauded these income tax reforms as they keep the faith with taxpayers that the income tax conformity process will not be used as a backdoor tax increase. Each year the state conforms to the federal code with little fanfare, despite its significance. If taxpayers could not rely on state lawmakers to fairly acknowledge when there is a tax increase as a result of conformity, there would be a renewed effort to permanently decouple from the system.

### Wayfair

Early in the 2019 legislative session, ATRA opposed an effort to implement an economic nexus law in HB2702, which did not include enough reform to reduce undue burdens on remote sellers, among other challenges (See the ATRA April 2019 newsletter for more). ATRA continued to work with Representative Ben Toma on necessary reforms to implement such a law in light of the SCOTUS *Wayfair* ruling, which dropped the physical presence nexus requirement. The result was a reform effort which goes a long way towards reducing these undue burdens and making Arizona’s law less susceptible to a legal challenge.
ARIZONA TAX RESEARCH ASSOCIATION

ATRA has long supported the policy of applying TPT (sales) taxes on sales conducted remotely but warned of the legal hazards. Remote sellers have the burdensome task of paying sales tax based on the destination of each product sold. In HB2757, Arizona is undergoing several necessary simplifications, such as creating a statutory retail base, so taxpayers nationwide can trust there is one code housed at the state level. The taxability and definitions of retail goods will be uniform between the state and localities for the first time in Arizona history. Between this major change and the 2013 TPT simplification reforms, which consolidated collection, remittance, and audit at the state level, Arizona can present a sales tax system that is easier to comply with and is less liable in a legal challenge.

Finally, it was appropriate to acknowledge the revenue windfall associated with this TPT law change, as both individuals and businesses will certainly pay more TPT going forward. In particular, businesses who pay use tax on items purchased out of state will now pay higher retail TPT rates. By using this revenue increase as part of a tax reform package, a good faith effort was made to give the money back to taxpayers.

Revenue Neutral to the State But not Taxpayers

The bill was described as a small revenue reduction to the state General Fund (GF) by JLBC at ($24 million), which is fair because though that amount was “paid for” with debt reduction, it is not a permanent obligation. However, it’s important to note the entire discussion about revenue neutrality was limited to the impact to the state GF only. Revenues to the Prop 301 education fund, counties, and cities were not offset in the bill and will be a significant revenue gain for these jurisdictions.

The Government Accountability Office (GAO) conducted a comprehensive study to determine which retailers were not already collecting and remitting sales taxes in various states to find the revenue impact of remote sellers. Arizona’s expected total revenue increase was an estimated $190 million to $293 million. JLBC argued the GAO numbers were high due to lack of clarity related to which marketplace facilitators (MF) are already remitting, among other considerations. They used a total collections amount of $176 million, which translates to an $85 million increase to the state GF.

JLBC did not fully explain why they used an estimate below the GAO’s low estimate but the consideration of MFs who are already remitting was considered by the GAO, and in Arizona, MFs have not been collecting TPT for their marketplace sellers. The bill ensures they will going forward. Further, the GAO estimations are based on size of the economy alone, not local rate pressure considerations. The reality is Arizonans have a greater incentive
to shop online retailers who are not collecting sales tax than consumers in other states with far lower rates, which suggests Arizona’s revenue gain may be higher at the margins. Also, their estimate uses a low average tax rate of 8.25%, when the population-weighted average in Arizona is 8.49%. Finally, the JLBC estimate does not appear to adjust for the switch from use tax to retail rates. Arizona counties and more than half of cities do not have a use tax, which means businesses across Arizona will immediately begin paying more in tax at retail than what they used to pay in use tax.

If the revenue estimate used the midpoint of the GAO estimate at a total of $248 million revenue increase, the state GF impact would be $114 million, $77 million to the cities, $40 million to the counties, and $17 million to Prop 301. Under this assumption, taxpayers will pay about $74 million more than the JLBC estimate. Considering the ($24) estimated cost to the overall tax package, this means a median estimation of the tax impact is a $50 million cost to taxpayers. That notwithstanding, ATRA credits lawmakers for this sensible reform effort which does a considerable amount of good for taxpayers in Arizona.

-Sean McCarthy

2019 Session Wrap, Continued from Page 1

SB1033 property tax statements; mortgaged property (Leach)

This bill requires county treasurers mail a property tax bill to all property owners, including those with mortgages. Chapter 163.

SB1248 property taxes; valuation; property modifications (Leach)

SB1248 sets a statewide threshold for the modification of a property at 15% of total value before a “Rule B” Limited Property Value change is allowed instead of at the discretion of each county. SB1248 awaits the Governor’s action.

SB1161 S/E: school facilities; revisions (Leach)

As amended in the House, SB1161 makes several changes to laws surrounding school district facilities. The section of law related to publishing vacant or partially used district space is rewritten and has several new reporting requirements, largely aimed at encouraging districts to make efficient use of partially used or unused space. One significant change is districts may dispose of district space without a public vote if the space has been vacant for three years. Chapter 247.

HB2097 personal property; reporting; exemption (Cook)

HB2097 clarifies that a taxpayer with personal property within the constitutional exemption threshold is not required to file a report with the county assessor. Chapter 225.

Readers should see the ATRA April Newsletter for more information on the above bills.

SB1451 statewide ballot measures; circulators; procedures (Leach)

As amended in conference committee, SB1451 makes several changes to the initiative and referendum process which should improve the legitimacy of this brunt lawmaking option. Of late, initiatives have been mired by a
shoddy and fraudulent signature gatherings process funded by out-of-state interests. The bill requires all paid
circulators and all out-of-state circulators for statewide initiative and referendum measures register with the
Secretary of State (SOS) and provide their contact information and a signed, notarized affidavit. The SOS will
assign them a circulator registration number which they must include on each signature sheet. Registered
circulators must not have a civil or criminal penalty imposed for election fraud within five years, not have been
convicted of treason or a felony without their civil rights restored, or not have ever been convicted of fraud,
forgery or identity theft. There were several other smaller changes. SB1451 awaits the Governor's action.

FY2020 Budget Highlights

The Fiscal Year 2020 budget spends $10.79 billion in ongoing spending from the State General Fund (GF), a
6.7% increase over last year with planned spending increases of 5.2% in FY21 and 4.6% in FY22. Inclusive of one-
time spending, total expenditures are tracking at roughly $1 billion more than ongoing spending. The estimated
FY20 ending balance is $65 million. With positive revenue trends produced by a strong economy, lawmakers both
substantially increased spending and avoided the desire by some to increase taxes through conformity and sales tax
reform (see Tax Reform article in this newsletter). With remaining cash, $542 million was deposited into the rainy
day fund.

In addition to the tax conformity/Wayfair legislation, there were several revenue impacting changes. A charitable
deduction was created which may be used by those who elect to use the standard deduction, at a discounted 25%
of the value of the donation, which was an effort to replace the lost tax advantage for many filers who will no
longer itemize on their state and federal tax returns. The projected cost was an ongoing $24 million.

The new $32 Highway Safety Fee added last year was put on a two-year repeal. This reduces the fee from $32 per
vehicle to $0 in FY22 in one step at a savings of $185 million to taxpayers and a GF cost of roughly $107 million.
This is positive for taxpayers as the fee was designed to evade the Prop 108 requirement for a two-thirds
approving vote for tax increases. The fee demonstrated the danger of allowing unelected officials to set tax rates,
as the Highway Safety Budget jumped in its first year from an estimated $149 million to $168 million.

The corporate income tax credit for student tuition organizations will no longer grow by 20% per year after FY20
and instead will grow by 15% for FY21, 10% in FY22, 5% in FY23, and then 2% or inflation every year thereafter.
JLBC scores this as an increase to GF revenues of $5.3 million in FY21 and $18.7 million in FY22.

Finally, the estimated June Transaction Privilege Tax payment threshold was increased from $1 million to $4.1
million in annual tax exposure on a phased-in basis. This estimated June payment was a budget gimmick used
during the recession to pull forward revenues in order to balance the budget and is particularly burdensome on
retailers who must make an early tax payment during one of the slowest months of the year. The “cost” to the GF
was a reported $10 million in each year of the phase in but is more of an accounting issue since these revenues will
simply be paid in July, the next fiscal year.

The vast majority of new spending was directed at K-12 and higher education. In addition to increases for
population and inflation, which are paid for by a combination of state aid and property taxes, the State paid the
second installment of the 20% teacher pay increase at a cost of $164.7 million, funding a 5% average pay increase.
It’s worth noting this money simply increases formula spending and schools are encouraged to raise pay by 5%. They
must report their year over year pay changes on their website. District and Charter Additional Assistance was
increased $137 million as part of a multi-year plan to restore that fund. Designed for soft capital items, these funds are entirely unrestricted and are allocated on a per pupil basis. The results based funding program was increased $30 million and the school counselor/resource officer program received an additional $20 million for a total of $32 million. Funding for facilities through the School Facilities Board was boosted and received a $25 million supplemental for the current year. There were several smaller appropriations made to targeted programs.

Additionally, $130 million was committed to the I-17 expansion over three years from the State Highway Fund and $95.3 million for other road projects such as an I-10 widening study south of Chandler. Roughly $90 million was added to college and university programs ranging from baseline increases to targeted spending such as $15 million for the teachers academy and $15 million for an aviation center at Pima College. There were considerable pay increases for state public safety and corrections officers at a cost of roughly $73 million. There are dozens of smaller appropriations made across the spectrum, reminiscent of a “good times” budget where nearly every program benefits from a spending increase.

**Paloma Skipped Public Vote, Continued from Page 1**

didn’t get voter approval but ignored their auditors for years. Heiden’s property taxes are “up considerably” since the project began. A survey of the other ranches and farms in the area show similar results: Hofweigen Dairy is up 22%, LandCoDairy is up 27%, PalomaAdobe is up 34% and the Hettinga Farm is up 48%. Property tax increases will vary based on the value changes of each property. Tax rates are up 58% for Paloma Elementary over the last few years. For ranchers and farmers, a $20,000 increase in property taxes can delay an offseason expansion or new equipment. For an industry like agriculture that relies on a high-profit year to carry them through tough years, property tax spikes are a serious burden.

Paloma Elementary falls into a special category of school districts that are so small they are allowed access to the “Small School Adjustment” (SSA), a benign sounding feature of the school finance system that essentially allows tiny districts to tax and spend as they choose locally. The result is districts spend wildly different amounts to educate their students based on property values in the district and their board’s tolerance for additional local taxes. They receive their equalized budget as normal per a formula that adds money for being small and isolated, but since lawmakers didn’t know how to craft a formula to address these tiny districts, they left it up to their local board to set a SSA tax rate to add whatever funds they choose. The 2018 Auditor General Spending Report reported Paloma spent $51,000+ per pupil last year, leveraging roughly $31,000 per pupil in SSA, the highest in the state.

SSA was created to allow tiny school districts the ability to levy another local property tax so the school could afford to operate. It certainly was not intended to become a source of funding for major school construction, avoiding the public vote process other districts must use to secure General Obligation (G.O.) bonds. Lawmakers made it clear in 1997 that schools leveraging SSA could not use local funds for construction above $250,000 without securing a public vote per A.R.S. § 15-342 (25). It’s not under dispute whether Paloma ignored this law: their auditors told them as much in 2015. They did so again in 2016, 2017, and 2018.

The intent of the voter approval requirement isn’t only to ensure voters are aware of and approve their taxes
rising to pay for expensive construction projects, it is to ensure the community is aware the district will be making changes to its capital footprint, which create significant long-term financial obligations. This is particularly important for a small, rural district.

Who Knew What and When?

Officials speaking on behalf of the district say they weren’t sure voter approval was necessary at the outset of the project and when they received feedback from their auditor that it was required, they presumed “it was not a big deal.”

Emails from the district suggest they have long been aware of the voter approval requirements in A.R.S. § 15-342 (25). Long-time district Superintendent Kristin Turner inquired about the law to the Arizona Auditor General (OAG) in 2013 as it related to the purchasing of housing for teachers, called teacherages (see the email below).

Paloma’s auditors inquired about the lack of voter approval in March 2016 (see email below), likely in relation to their FY2015 audit, which would document their violation of the law. When Heiden saw the emails and years of audit write ups he could only shake his head: “Well, this isn’t right.”

For the last several years, audit firm Dobridge has told Paloma Elementary they were in violation of state law. In Arizona, it is the school district Governing Board’s responsibility to respond to and correct audit hits. While the Department of Education (ADE) and OAG receive audits, the Uniform System of Financial Records (USFR) questionnaires are not made public and deficiency correction is considered a local
problem. The District reports the Governing Board was similarly told by district staff that this audit violation was considered minor and not told it was explicitly illegal. Paloma Elementary does not make its board meeting minutes available on their website.

Project manager Tim O’Malley, a consultant hired to oversee and manage the project, suggested the district understood they were supposed to get voter approval but that it was superfluous in a rural area: “Everyone knows everyone out here and they knew what we were doing… Why would we spend thousands on an election where there are only 27 voters?” ATRA did not verify the actual number of voters in Paloma Elementary. Like the district, O’Malley said he thought the issue would be “at most, a minor write up.” He suggested the law should be changed for small districts, and they should be able to replace the voter approval with a petition process instead.

Dobridge limited their comments to repeating what was in the USFR Questionnaire: the district was not in compliance with the law. They said it would be inappropriate for a CPA to comment on the district’s interpretation that the failure to follow the law was not serious; all their communication is done through official audit publications. Based on the annual write-ups, it seems unlikely the CPAs told the district the issue was not serious.

How Did this Happen?

For years Paloma Elementary levied a modest SSA levy that amounted to an additional 70% of their formula budget, which is about average for SSA districts. The levy was $425,000 in FY14. That changed when a massive utility grade solar power plant was to be located inside the district. O’Malley admitted the district figured it could leverage the growth in value with big increases to the SSA levy to pay for the construction project without overly spiking the tax rate. That didn’t work as planned, as their primary rate went from $5.02 per hundred in FY14 to $7.97 this year, a 58% jump. They estimate their tax rate will drop back to $6.00 per hundred next year, although the solar plant has successfully sought a property tax refund based on a valuation correction, throwing the final stage of the project into disarray. One outcome of a public vote may have been the utility company informing the district of their plans to exercise tax credits, which lower the property value of the solar plant. O’Malley said the solar plant is difficult to get ahold of and so they did not discuss their plan with them in advance.
According to district officials and O’Malley, the district wanted to avoid a G.O. bond because they could save on interest costs via a “pay as you go” process. This is mostly irrelevant—a vote is required regardless of the funding mechanism for Paloma. However it’s worth noting they could have used a G.O. bond. With the additional property value from the utility, the district would have just enough debt capacity to approve a bond up to $15 million. Deciding to use cash likely saved taxpayer money, assuming locals would have approved a similar bond amount. When asked why they did not seek voter approval for construction as required by law, the district and O’Malley are quick to point out their repayment method arguably saved money, irrelevant though it may be. While interest costs add to a project, most bond programs extend far beyond five or six years, which keeps tax rates from spiking as they did in Paloma. These are just some of the concerns that get ironed out when a district must engage its voters.

Bizarrely, the district explains they were given new legal advice in early 2019 and now understand their failure to seek voter approval was against the law. Their board voted in April to refer a ballot measure this November to retroactively approve the construction projects.

**What is the Policy Response?**

Fundamental to the relationship between government and its citizens is a culture of transparent compliance with the law, where independent audits represent a “good faith” verification to the public. The OAG insists most districts faithfully attempt to improve on each audit. To the extent audits can be ignored as happened in Paloma, there is a problem.

The OAG did not highlight Paloma as being in ‘marginal compliance’ in any of the last several years, but rather scored them on their OAG Spending Report as being ‘Compliant’. ATRA was told this is because their audit was largely free of major accounting errors, though their 2015 audit did find 11 violations, including four attendance reporting issues. OAG also did not submit a finding to the State Board of Education (SBE) per A.R.S. §15-271 (E), which requires OAG report to SBE if a district fails to correct deficiencies within 90 days after receiving a notice of the deficiency. Paloma was not put on marginal status or sent an official notice on this issue. Paloma’s auditor reported the failure to get voter approval for four years in a row and yet were still deemed ‘compliant’ by OAG. To be fair, OAG reviews hundreds of audits each year and even if they had listed them as ‘Marginal Compliance’, it’s unclear if that would have changed anything.

What is particularly unsatisfying in this case is OAG conducted a special “performance audit” on Paloma which was published in June 2018. While the OAG audit noted several areas of concern, such as some relatively minor issues related to purchasing controls, the audit makes no mention of the illegal construction purchases. When asked, OAG explained that the focus was on spending performance, meaning they are looking at internal controls, efficiency of expenditures, and compliance with best practices… but would not document an issue related to seeking voter approval for a purchase as required by law.

Annual financial reports (AFR) for districts and charters are publicly available on ADE’s website, yet those do not speak to compliance; it really only shows money spent by broad category. School audits for those who receive
a certain amount of federal funding can be found on the Internet if one has knowledge of the federal audit clearinghouse website; otherwise they must be requested individually through a Freedom of Information Act (FOIA). However those official audits do not detail issues with compliance, only vaguely referring to “lack of internal controls” or related language. Very often they won’t address compliance issues at all. Only the USFR Questionnaire has actual information about compliance with state laws, accounting protocols, best practices, and more.

This raises several policy issues. Taxpayer funded audits, including the USFR Questionnaire should be publicly available and reasonably easy to find. Presently, they are difficult to locate. The decision to refer a district to SBE should be more transparent and based on objective criteria. While districts and charters should continue to enjoy fairly broad latitude on how to spend or save their money, there should be transparency in how those dollars are spent and how well they comply with existing laws.

Taxpayers like Les Heiden shouldn’t find out their school district broke the law because someone stumbled across it. That’s not good government. The public trust requires disclosure and honest dealing—especially when fessing up to mistakes. If government, including school districts, have nothing to hide then this shouldn’t be especially controversial.

-Sean McCarthy