Henchman of Tax Foundation Briefs Fed Tax Reform

The 77th annual ATRA Annual Meeting and Luncheon featured keynote speaker Joseph Henchman of the Tax Foundation. Henchman discussed the ongoing efforts in Washington to reform the nation’s income taxes, to include a breakdown of the current House and Senate proposals.

Beginning with a history of the income tax in America, Henchman described previous reforms and the shortcomings of the current system where extensive exemptions, credits, and deductions leave just 39% of all

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Legislative Leadership Preview 2018 Session

House Speaker J.D. Mesnard, Senate President Steve Yarbrough and Representative Mark Cardenas addressed ATRA Outlook, providing their perspective on the upcoming 2018 legislative session.

Rep. Cardenas outlined the minority caucus’ platform, to include fixing unfunded mandates to local governments and a desire for tax reform that would broaden the base and lower rates.

Speaker Mesnard outlined several challenges ahead, including the taxation of digital goods and services, fixing prime contracting and income tax reform.

President Yarbrough also outlined several legislative battles he expects early next year, to include water policy, opioid crisis, independent redistricting, teacher pay, the A-F school grading scale and public safety pension impacts on local government budgets.

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Richard Bark Named 2017 ATRA Outstanding Member
Stavneak: State Budget Remains Tight

Kickstarting ATRA’s 77th Annual Outlook Conference was Richard Stavneak, Director of the Joint Legislative Budget Committee (JLBC), who presented the state’s fiscal picture. In direct contrast to the last several years, the state budget appears to face a cash shortfall despite being structurally balanced. In the recent past, a structural imbalance held ongoing spending steady but cash balances stimulated some one-time spending.

The FY18 budget looks to come in $24 million short and the FY19 baseline budget projects an $80 million cash shortfall.

The FY18 budget was crafted with a narrow 0.4% margin, meaning revenue changes in either direction matter a great deal: the situation could easily improve or degrade. The shortfall was caused by slow revenue growth in 2017 (3.3%, the slowest since 2010) which was the combination of 4% growth in both transaction privilege tax (TPT, sales) and individual income tax with 35.5% decrease in corporate income taxes, well below projected. JLBC cited flat profits and a decline in audit collections as contributing factors to below-forecast corporate income tax collections.

For FY19, JLBC now predicts 4.1% base revenue growth which provides base revenues of roughly $10 billion.

One interesting note was in tax credits, where for the first time ever corporate school tuition organizations (STOs) did not max out their credits which grow by 20% annually. The largest year-over-year growth was in the charitable organization category. In 2016 the individual income tax credit limits were doubled for this category, which grew them from $37 to $71 million in one year. JLBC estimated the General Fund cost to be just $11 million.

One concern heading into the FY19 budget planning is the roughly $90 million of one-time spending in FY18 that they expect to see advocacy for their continued appropriation. That number includes $17 million in K-12 capital for the School Facilities Board, $12 million to DES for Prop 206 minimum wage adjustments and $15 million to the universities.

Formula increase in the FY19
baseline include the usual suspects: caseload growth in K-12 ($148 million), AHCCCS- Medicaid ($112 million) and DES- Developmentally Disabled Medicaid ($47 million). These cost increases are borne into the JLBC baseline and must be accounted before any other budgetary item is prioritized.

While the state’s fiscal picture looks to improve over the next few years, it must presently deal with a cash shortfall in next year’s budget. While some have advocated to use the state’s “rainy day” fund, most have soured on the idea to tap that fund during a growing economy. Another possibility is using the Drug Manufacturer’s Rebate Fund which has a one-time balance of $70 million presently; $30 million of the fund was used last year. Also, the Volkswagen settlement provides the state $57 million which is to be targeted towards emission reduction and could provide the opportunity to supplant other funds.

**Stielow & McCarthy Provide Update on Property Tax Issues**

ATRA President Kevin McCarthy and Vice President Jennifer Stielow provided an update to Outlook attendees on current property tax issues.

Vice President Jennifer Stielow explained the volatility in property values and taxes over the last 15 years. However, over the last three years since Prop 117 has been in effect, the 5% cap on taxable values coupled with the reluctance of taxing authorities to increase tax rates has limited the annual growth in property taxes to just 3.4%. Without Prop 117, taxpayers would continue to be exposed to dramatic tax increases that result from fluctuations in market values, which have grown at an annual rate of 9.8% since 2014. As intended, Prop 117 has had a stabilizing effect on Arizona’s property tax system and taxpayers are benefitting from a more transparent process.

Stielow discussed Arizona’s property tax burden, where business (class 1) taxpayers shoulder twice the tax burden than residential (class 3) taxpayers as a result of a classification system that intentionally shifts taxes between property classes with varying assessment ratios. Arizona’s business tax rankings have improved over the last decade as a result of the reductions to the class 1 assessment ratio but that hasn’t diffused the interest in targeted tax breaks that undermine the progress made over the years. Targeted tax breaks like the Government Property Lease Excise Tax (GPLET) and universities using their tax exempt status for private development, for instance, only worsen inequities in the property tax system and increase taxes on other taxpayers.

ATRA President Kevin McCarthy discussed the continued calls for tax increases for K-12 schools despite the additional $3.5 billion that will be distributed over ten years as a result of Prop 123 and without recognition of the current inequities in the system. A system once designed for equity has developed significant inequities over time and as a result, the state and its taxpayers face perpetual lawsuits, including the latest capital lawsuit that includes a taxpayer uniformity challenge.
McCarthy provided several examples of K-12 finance inequities, including the $211 million that just 18 of the 213 school districts levy for Desegregation/Office of Civil Rights expenditures, $25 million levied for the small school adjustment in about 50 districts in rural Arizona, and the approximately $80 million hold-harmless levied for the “transportation delta” which is concentrated in districts which have contracted in enrollment.

Non-formula K-12 finance inequities have led to extraordinarily high tax rates in Phoenix and Tucson, which increases the pressure and demand for tax abatement under GPLET particularly in the City of Phoenix. Furthermore, the high tax rates in both Phoenix and Tucson continue to aggravate 1% Cap costs, which taxpayers statewide continue to subsidize to the tune of about $24 million per year through the state general fund. McCarthy urged lawmakers to consider equity reforms before or alongside any new funding for K-12 schools. Finally, he stressed taxpayers need safe harbor from the perpetual general and uniform lawsuits with a reformed K-12 finance system which is equitable enough to pass constitutional muster.

Panel Discusses Tax Treatment of Digital Goods & Services

The ATRA Outlook Conference included a lengthy policy discussion on the taxation of digital goods and services. House Ways and Means Chairman Michelle Ugenti-Rita, Deputy Director of the Arizona Department of Revenue (ADOR) Grant Nülle, and ATRA Senior Research Analyst Sean McCarthy hosted a panel to discuss the state’s position.

An ongoing Ad Hoc Joint Committee at the Legislature has been studying the issue and the panel highlighted the committee’s findings and their vision going forward. Nülle acknowledged that ADOR understands the criticisms surrounding the current tax treatment of digital goods and services. While they defend their decisions thus far, they agree statutory clarity would be beneficial for all parties. Nülle reiterated that ADOR stands ready to help the Legislature codify the tax treatment of digital goods and services as the Legislature dictates.

McCarthy explained the tax policy history surrounding software and other digital goods and the evolution ADOR followed to begin taxing cloud services. He explained there are two generic categories: ‘Digital Goods’, which captures downloaded software and content and ‘Cloud Services’, which captures remotely accessed software where a host is providing a series of services. He stressed that Arizona lacks legal clarity in all areas related to the taxation of digital goods and services. Further, the taxpayer confusion causes uncertainty in the market and is bad for the state’s competitiveness.

Representative Michelle Ugenti-Rita confirmed that she is disappointed ADOR
moved into the space of taxing digital services without a legal mandate and intends to clarify their legal authority in the next legislative session. She reiterated she does not believe services rendered electronically are taxable and are impractical to tax given the administrative difficulty such as sourcing the tax when both the purchaser and seller can be anywhere in the world.

McCarthy asked for lawmakers to provide precise language in law that does not leave taxability decisions to administrators but makes the difficult choices in statute. Inaction leaves the state legally liable and taxpayers in precarious legal positions as they wonder whether they must collect taxes from their customers or not.

Richard Bark Named 2017 ATRA Outstanding Member

The 2017 Outstanding Member is Richard Bark of Freeport McMoRan. He was awarded during the Annual Luncheon following the ATRA Outlook Conference. Bringing a wealth of experience in public policy development at the State Capitol, Richard Bark has consistently used that expertise to advance the ATRA mission. As the Director of Government Relations for Freeport McMoRan, Richard has built a solid reputation as an expert in numerous areas of public policy. His leadership on a multitude of issues has proven to be a great asset to the ATRA Board of Directors for many years.

ATRA Officers Re-Elected for 2017

At the 77th Annual Meeting following the Outlook Conference, Steve Barela, the Director of Tax at Arizona Public Service, was re-elected Chairman of the Arizona Tax Research Association’s Board of Directors. Barela is now in his second year as Chairman. The other officers re-elected were Richard Bark, Freeport-McMoRan, first vice-chair; Michelle Bolton, Cox Communications, second vice-chair; Bill Molina, University of Phoenix, 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 2022: Richard Bark of Freeport McMoRan, David Minard, Individual, Mark Gaspers of The Boeing Company, Dave Howell of Wells Fargo, Jeff Sandquist of Veridus, Pat Derdenger of Steptoe & Johnson, Steve Trussell of Arizona Rock Products Association, Terry Ryan of Apple, Inc, and Matt Beckler of ON Semiconductor.
income as taxable at the federal level.

Reformers generally advocate for a widening of the tax base by removing some or all of the exemptions and credits while lowering rates. Layers of credits and exemptions added over the years have left a redundant and complex mess for taxpayers. The policy outcome is “Most rich pay a lot but some pay nothing (taking lots of deductions or hiding income) and most poor pay nothing but some pay a lot (EITC structure, low standard deduction).” Tax reform would aim to bring equity across tax brackets to avoid the situation where some pay zero while others are overburdened.

On the issue of corporate income tax reform, Henchman pointed out that the U.S. top marginal corporate income tax rate is increasingly uncompetitive as the worldwide average has dropped over the last several decades. Effective tax rates for corporate income are generally high although they vary widely by industry. The present “international” system encourages foreign inversions and also encourages debt financing as debt-equity taxed differently than cash.

One critical complexity to handling business income taxation is that pass-through business income (paid via the personal income tax) now exceeds the net income in corporations. The number and significance of pass-through businesses has grown in the last several decades. Lawmakers are wrestling with how to bring equity between the corporate income tax rate and the tax on business income paid.

The House and Senate tax reform proposals are very similar with a few major differences. Both propose dropping the top marginal corporate tax rate from 35% to 20% and move the system to a territorial based system instead of an international one to encourage repatriation, though with different rules. Both reduce credits and eliminate most exemptions while increasing the standard personal deduction to roughly 12,000. The House’s effort is more aggressive and dissolves the individual income tax
brackets to four with a “bubble” rate at the top for high-earners.

One major controversy is over the elimination of the State and Local Tax (SALT) deduction, popular in states with high state and local income taxes. The Senate version eliminates SALT while the House version eliminates all but the first $10,000 of homeowner property taxes. Elected officials from states like New York, New Jersey and California are sure to fight these provisions.

The biggest impact to the state from a conformity perspective is a small increase to state tax revenues due to the broadening of the tax base. Repatriation could result in a large one-time windfall for states. At writing, the House passed their version and the Senate version awaits a floor vote.