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ARIZONA TAX RESEARCH ASSOCIATION

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OSPB: Another Strong Revenue Year

ATRA's 79th Annual Outlook Conference began with a budget presentation from Matt Gress, the Director of the Governor's Office of Strategic Planning and Budgeting Office (OSPB). Gress presented the Governor's vision for the state, an overview of state revenues and spending, and the health of the economy.



Gress pointed out the state not only has a \$1 billion rainy day fund after appropriations in the last session, the General Fund is projected to have significant structural cash balances for the next several years. He pointed out the post-recession recovery was slow, with below-average growth in most years relative to prior

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Larry Lucero Given Lifetime Achievement Award

On rare occasion, ATRA presents a lifetime achievement award to a member who has served ATRA with distinction over their career. This year, ATRA presented a lifetime achievement award to Larry Lucero, who recently retired from Tucson Electric Power.

Larry served 23 years on the ATRA Board of Directors including two as the Chairman of the Board in 2010 and 2011. Larry also served for several years as Chair of the Legislative Policy Committee where his sound policy advice helped shape ATRA



legislative program at the state capitol. In presenting the award to Larry, ATRA President Kevin McCarthy said "Larry will always be remembered for his pleasant demeanor and constant reminder that even in the rough and tumble world of politics that nice guys can still win."

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Tax Litigation Could Impact Major Policy Issues

ATRA Board Members and tax lawyers Pat Derdenger and Otto Schill briefed attendees on important tax litigation in Arizona. In the tax policy world, many key issues are not settled in the Legislature but are adjudicated in courtrooms. In particular, the precise application of the Transaction Privilege Tax (TPT), from scope issues to the applications of exemptions, are routinely the subject of litigation.

Shill started the discussion by briefing the ongoing litigation in the area of digital goods and services, where the state faces at least four lawsuits, two of which are relatively new. All four cases challenge the state’s position that all software is tangible personal property and the remote access of software constitutes a rental of personal property (see ATRA June 2018 newsletter for more on this topic).



Filed in the summer of 2018, both Netflix and ADP are challenging the Department of Revenue’s position that their service constitutes a rental of personal property, because the legal requirement that the customer receive tangible property for their exclusive use and control has not been met. In both cases, ADOR asked the court to dismiss the case but the Tax Court will likely rule on them in 2020.

NuOrder Technologies, which creates software that automates takeout orders for restaurants with website buttons, has filed a class action lawsuit on behalf of all Software as a Service (SaaS) providers against the state, making similar claims as Netflix and ADP. GoDaddy has filed a lawsuit over the taxation of their website hosting and website securing services. While the vendor

and product in each case is slightly different, the legal questions are fairly similar. Given the outcomes the State has faced in similar lawsuits in the rental of personal property, the plaintiffs make a strong case that their product does not meet the legal threshold of “exclusive use and control,” though neither lawyer made predictions on any case. Either way, they are likely to extend for many years through higher courts on appeal.

Lower courts are unlikely to rule on the issue of whether software counts as tangible personal property, since the precedential case (*State v. Jones*) was established by the Arizona Supreme Court. For taxpayers, it would be ideal if the Arizona Supreme Court had the opportunity to relook at this case, since the court in the 1950’s took the curious and absurd view that soundwaves emanating from a jukebox were tangible personal property. It’s rather clear that was a rental of a machine, or a rental of tangible personal property, and not a retail sale. Taxpayers would greatly benefit from a fresh view of what constitutes tangible personal property, and that it be tangible and actual property that a customer can own personally.

Derdenger briefed the *Phoenix v. Orbitz* case, where the City of Phoenix successfully won at the Arizona Supreme Court a TPT case over whether online travel companies (OTCs) owed sales tax on the service portion of their charge to hotels for the booking of hotel rooms. Details of the case were briefed, but the emphasis was on a smaller portion of the Supreme Court ruling, which said that the Phoenix position appeared to be a new application of the law and the law required “formal and clear notification” to taxpayers, adding teeth to prior rulings calling for similar fair warning to taxpayers. The court remanded the issue to lower courts to determine how far back OTCs would owe back taxes. Importantly, the court acknowledged the cities Model City Tax Code had the exact language as state law in this area, meaning the interpretation applies to both state and city TPT (see ATRA September 2019 newsletter).



Derdenger and Shill also provided updates on *Carter Oil v. ADOR*, which is testing whether dyed diesel fuel used in mining qualifies as exempt machinery and equipment. They covered *Vangilder v. Pinal County*, which relates to the legality of the election concerning the new half-cent TPT in Pinal County for transportation (see ATRA April 2018 newsletter). In *Englehorn v. City of Phoenix*, they updated the Goldwater litigation on the use of GPLET, which should soon be ready for a Superior Court ruling. Finally, they covered how *State v. ABOR* is not just a case on ABORs use of its tax-exempt status for economic development but is also a vehicle for testing the *McFate* decision which limits the Attorney General to suing state agencies unless it has specific legislative authority (See ATRA February 2019 newsletter).



Senate President Karen Fann, Speaker of the House Rusty Bowers, and Senate Minority Leader David Bradley addressed ATRA Outlook with their perspective on the upcoming 2020 legislative session.

Legislative Leaders Address Outlook



ATRA Briefs Major Tax Issues for 2020

Kevin McCarthy kicked off the ATRA staff presentations on the major tax issues facing policymakers and taxpayers by acknowledging the good work done by Governor Ducey and lawmakers in the 2019 session. McCarthy noted that passing good tax policy is not easy and policymakers should be credited for pursuing tax changes that improved Arizona's overall tax climate.

McCarthy began the property tax discussion by noting that key lawmakers are already pointing towards a property tax reform effort that will include a reduction in the class one assessment ratio. He reminded that it has been a longstanding goal of ATRA to reduce the assessment ratio of business property, currently at 18%, to 15%. ATRA has led the previous efforts to decrease the inequity between business and residential property and warned new elected officials that this policy debate is often driven by politics and not data.

ATRA Vice President Jennifer Stielow provided an overview of Arizona's classification system and the history of previous assessment ratio changes. She explained that currently over \$830 million is shifted from residential properties to business and Arizona is one of only sixteen states that assesses business property at a higher rate than residential.

Stielow also presented the current effective tax rates paid by all Arizona property taxpayers from ATRA's property tax model. Class one property (business) currently accounts for 21% of all property and pays 35.6% of all taxes leading to the highest effective tax rate at 1.91%. Conversely, class three property (residential) accounts for 49.6% and pays 38% of all taxes with an effective tax rate 0.87%.

Jennifer also presented the recent study from Minnesota Taxpayers Association that annually ranks business and residential property nationally. That study ranked Arizona industrial property in Phoenix as the sixth highest in the country and residential property at twenty-fifth.

McCarthy wrapped up the property tax program by saying the correct policy path for fixing Arizona's high business property tax problem is addressing the high assessment ratio. Conversely, the poor policy choice would be to side step the problem and engage in targeted tax breaks to new businesses through government economic development schemes like Government Property Lease Excise Tax (GPLET) and ABORs lease-back contracts. Finally, McCarthy warned about the damage that could be done to the property tax system generally if the rumors surrounding a ballot measure to increase the state property tax materialize. Not only would a new statewide property tax increase homeowner 1% cap costs to the state general fund, it would also reverse the previous reforms that reduced the effective tax rates on business property.

Sean McCarthy continued with an update on sales and income tax issues, beginning with a recap of the Wayfair legislation under HB2757 that was championed by Rep. Ben Toma. Although ATRA initially lobbied the



Legislature to create a study committee to address this complicated issue, policymakers were persistent in moving forward with a law that would allow the state to tax remote sellers and marketplace facilitators that meet certain sales thresholds. In order to ensure remote sellers have a uniform base to comply with at the state and local level, the cities were preempted on the retail base with the exception of a few Model City Tax Code “options” that were codified in statute. In addition, lawmakers agreed with ATRA’s recommendation that increased taxes should go back to taxpayers.



Sean reminded that the state’s response to the conformity challenge was created by the Tax Cuts and Jobs Act (TCJA). In an effort to simplify Arizona’s personal income taxes and be consistent with the TCJA, Arizona also doubled the standard deduction. ATRA strongly supported the tax package that wrapped the Wayfair reform with income tax conformity to improve both sales and income taxes in Arizona.

On the taxation of digital goods and services, Sean noted ATRA’s effort to create clarity in this area failed over the past two legislative sessions as policymakers could not agree upon the appropriate tax policy. Consequently, the Legislature’s failure to act has left the tax policy decision up to the courts.

Sean wrapped up the session discussing continued calls from some to hike the income tax on higher incomes to fund increased K12 spending. Over the last several decades, the number of millionaire filers has grown dramatically since the Legislature reduced the top marginal rate of 7% in the early 90’s to the current 4.54%. Over that same time, Arizona’s personal income tax revenue growth outpaced population and inflation growth by 60%. Sean cautioned that increasing taxes on the wealthy could cause high income tax earners to flee or never migrate to Arizona. Although Arizona’s income tax rates are some of the lowest in the country, total individual income taxes still account for one-third of total state revenues. Increasing rates on Arizona’s highest earners would further expand the gap between highest and lowest tax brackets and weaken the stability of the income tax system.

Nikki Dobay Provides National Perspective

Nikki Dobay, Senior Tax Counsel at the Council on State Taxation (COST), spoke during the ATRA Outlook luncheon, updating attendees on important tax issues around the country. She covered state reactions to the *Wayfair* decision and expanding nexus issues that will continue to arise. She also covered national efforts to provide some uniformity in economic nexus and marketplace facilitator laws. She briefed two COST initiatives they are asking states to adopt related to corporate income tax administration. Finally, she presented some bad policy developments in other Western states which should concern taxpayers and be avoided.



STATE FISCAL PICTURE, *Continued from Page 1*

recoveries until 2017. However growth has been strong ever since, fueled by personal income, manufacturing, employment, sales, and population growth in Arizona.

General Fund revenues continue to outpace projected revenues, with FY 2019 beating forecasts by 2.3% or \$248 million, even better than the year prior where revenues beat FY 2018 forecasts by \$218 million. Year to date FY 2020 revenues are showing 8% growth, well beyond forecasts. Instead of ending with a projected balance of \$65 million, the state looks to have more than \$300 million in ending structural balance this year.



FY 2018 general fund revenues beat forecasted revenues by \$218 million (2%) and data shows that FY 2019 will be the second year in which the state budget is structurally balanced. In fact, the October Finance Advisory Committee (FAC) ending balance for FY 2019 is projected to be \$824 million, and is estimated to grow to \$1.15 billion in FY 2020.

Revenue growth allowed for the \$540 million deposit in the Rainy Day Fund earlier this year as well as \$636 million in one-time spending plus \$162 million in new, ongoing spending for FY 2020.

Gress reviewed the various financial demands the state faces from corrections issues, ongoing education demands, to election funding. He described the particular problem the state faces with recruiting and retaining corrections officers in an economy where hiring is difficult and officers find higher wages in other jobs. Vacancies sit at 23% statewide, which has been rising quickly since early 2017.

For the second year, Gress emphasized the need to balance fiscal prudence and program needs, while at the same time avoiding past fiscal mistakes. Concerns over the next economic downturn are shaping budgetary decisions. The Governor's office wants to balance spending with prudent saving.

Richard Bark Elected ATRA Chairman

At the 79th Annual Meeting following the Outlook Conference, **Richard Bark**, Director of Governmental Relations for Freeport McMoRan was elected Chairman of the Arizona Tax Research Association's Board of Directors. The other officers elected were: **Michelle Bolton**, Cox Communications, first vice-chair; **Bill Molina**, University of Phoenix, second vice-chair; **Byron Williams**, Southwest Gas Company, third vice-chair; **Dave Minard**, Individual, Secretary/Treasurer.

The following members were elected to seats on the ATRA Board of Directors for terms expiring in 2024: **Will Barnow**, CORE Civic; **Kelley Wilson**, Deloitte Tax, LLP; **Byron Williams**, Southwest Gas Corporation; **Michelle Bolton**, Cox Communications; **Lori Daniels**, Individual; **Bas Aja**, Arizona Cattle Feeders Assoc; **Tim Lawless**, CREED; **Bill Molina**, University of Phoenix; **Heidi Thomas**, Early Warning Systems, LLC; **Tait Rudd**, Grand Canyon Education, Inc.

ATRA Recognizes Steve Barela, Outgoing Board Chairman

At the annual membership luncheon, ATRA acknowledged the service of ATRA Board Chair Steve Barela who wrapped up a three-year stint leading the ATRA board. Steve Barela is Director, Indirect Tax & Policy for Arizona Public Service. ATRA President Kevin McCarthy noted that Steve is the first ATRA staffer to return and serve on the ATRA Board. Kevin also thanked Steve for his tireless efforts to expand the ATRA membership base.



More than 300 attended ATRA Outlook 2019



Michael Preston Green, Senator Rick Gray,



Rep. Steve Pierce asks a question



Rep. Pamela Powers-Hannley & Larry Lucero



Walter Richter, Michelle Bolton, Megan Martin, & Senator Karen Fann



Glenn Farley & Rep. T.J. Shope