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ARIZONA TAX RESEARCH ASSOCIATION

NEWSLETTER

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2019 ATRA Legislative Program

Introduction/State Budget

ATRA's legislative program is developed each year with recognition that the Legislature and Governor's highest priority for the session should be passing a state budget that is not only balanced but is sustainable. The preeminent challenge facing state policymakers is ensuring that the Fiscal Year (FY) 2020 budget is structurally balanced – meaning ongoing spending does not exceed ongoing revenue and that one-time revenue (rainy day fund and cash balance) is not appropriated for ongoing spending.

For the first time in many years, strong economic growth has driven state tax collections above budgeted estimates for two fiscal years, dramatically improving the state's fiscal condition. The Joint Legislative Budget Committee (JLBC) is estimating that lawmakers will have access to more than \$900 million in one-time revenues for the FY 2020 budget. It is imperative that Governor Ducey and lawmakers carefully distinguish between appropriations that create on-going expectations from obvious one-time expenditures like capital outlays and debt retirement.

ATRA will provide updated state budget recommendations to the Legislature after the JLBC and the Office of Strategic Planning and Budgeting (OSPB) have submitted their recommendations for the FY 2020 budget.

Taxation

Property Tax

Property tax reform. ATRA has led the effort to reform Arizona's property tax system and reduce the disparity in tax treatment between business and residential property. As a result of previous ATRA-backed legislation passed in 2005, 2007, and 2011, steady progress has been made in reforming the underlying policies that drive Arizona's high business property taxes. That progress is the direct result of policymakers addressing the root cause of that problem: the shift of taxes from residential property to business through higher assessment ratios on business property.

Most legislative sessions include debates surrounding reforms to Arizona's tax code. ATRA believes any effort to reform Arizona's tax system should include further reductions to the class one assessment ratio with the ultimate goal of 15%.

Prevent greater access to the property tax. For the 2019 session, ATRA will oppose efforts on the part of Arizona State and local governments and special districts to increase access to the property tax base. Despite widespread recognition that Arizona’s business property taxes are a major impediment to economic development, there is considerable pressure each year at the Capitol to increase access to the property tax.

In addition, ATRA will advocate for continued compliance with the state’s Truth-in-Taxation (TNT) law. Since its passage in 1998, the state has consistently complied with the TNT law. For the last four years, the Qualifying Tax Rate and the State Equalization Tax Rate have fallen as a result of the TNT law. While that rate has both risen and fallen with the fluctuations in the real estate market, ATRA believes adherence to the TNT law is an important principle that will benefit taxpayers over time.

Targeted Property Tax Breaks. For decades, ATRA has led the effort at the Capitol to oppose rifle-shot property tax breaks to specific industries. ATRA will continue to support policies that provide for equitable treatment among property taxpayers and oppose efforts that undermine that important policy principle.

For the 2019 session, ATRA will pursue the following legislation:

Prospectively apply GPLET to Board of Regents; Community Colleges; and School Districts (Senator Vince Leach)

There presently is not a mechanism in law to tax possessory interests on government-owned property other than for cities, counties and some special districts who are subject to GPLET. Arizona’s universities, through the Arizona Board of Regents, have begun aggressively using their tax-exempt status to enter the real estate development business. For years this occurred primarily on university research parks, which were supposed to be areas where private business would work with the universities to bring research to market. Instead they have mostly become a tax-free zone.

The most curious case has occurred at Arizona State University (ASU), where university property was converted into the State Farm facility on Tempe Town Lake using a 99-year “lease back” arrangement. Instead of paying millions in property taxes to local governments, including K-12 schools, the development pays a small tariff to ASU. Harvesting local government revenue to benefit university budgets is a policy that is counterproductive for state and local governments and bad for taxpayers.

The legislation will seek to prospectively apply the existing GPLET law to the Arizona Board of Regents, community college districts, and school districts.

Mailing Property Tax Bills to Mortgagees (Senator Vince Leach)

ATRA will pursue legislation requiring all county treasurers to mail a statement reflecting the current property bill to every mortgagee. There is currently no statutory requirement for County Treasurers to mail property tax bills to

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mortgagees. Fortunately, nine of the fifteen counties currently mail property tax bills to all taxpayers. ATRA believes this critical information should be made available to taxpayers in every Arizona County.

Sales Tax

Clarify Taxation of Digital Goods/Services (Senator Michelle Ugenti-Rita)

Following a 2017 Ad Hoc Joint Legislative Study Committee which recommended statutory updates to make clear what is taxable in the digital space, ATRA will again pursue legislation in 2019 to update Arizona's tax code related to the taxation of Digital Goods and Services (DGS). Existing sales tax laws deal with tangible personal property. The application of sales taxes to intangible products purchased over the Internet has gripped states across the country who struggle to make clear distinctions between taxable and nontaxable purchases. Arizona has yet to define these taxes in law and can draw from nationwide best practices.

In the absence of clearly defined laws, the Arizona Department of Revenue has taken the aggressive stance through audits that any transaction occurring on the Internet that involves software is subject to Transaction Privilege Tax (TPT), typically through the rental of personal property classification. Given that all digital transactions leverage software in one form or another, this can only mean that every exchange via the Internet is taxable, regardless of whether or not it clearly is a service. Interestingly, Arizona is the only state to attempt to tax digital services such as remotely accessed or cloud software without a state law on the taxation of software generally.

A fair resolution to this process would be to tax products which mirror analog goods or amusements, which are typically subject to tax in Arizona, and exclude those which most closely reflect services. The proposed legislation will make licensed software, digital goods, and streaming products subject to tax while excluding digital services, defined as remotely accessed software. The taxable products will not be dependent on a particular delivery or purchase model.

Arizonans deserve to know their tax obligations. With lawsuits mounting, the state's liability for taxing without authority is growing. This legislation will bring Arizona into compliance with the federal Internet Tax Freedom Act, which among other things prohibits states from taxing products provided electronically that are not similarly treated in their analog form. Importantly, it will provide clarity to the business community who presently is in the untenable situation where they cannot possibly know which products are subject to tax.

Taxing Remote Sellers

On June 21, 2018, the United States Supreme Court in the *Wayfair v. South Dakota* case, reversed its 1992 *Quill* decision that required a physical presence for a state to impose a sales tax obligation on a remote seller. In the ruling, the Supreme Court said key features of South Dakota's system removed or addressed undue burdens upon interstate commerce. South Dakota's state and local sales tax code, over a period of several years, was simplified to address the Supreme Court's concerns regarding undue burdens placed on remote sellers. Unfortunately, Arizona's state and local sales tax code remains one of the most administratively complex in the country — well short of the Supreme Court's requirements set forth in the *Wayfair* decision.

ATRA will support the creation of a legislative study committee to analyze and recommend changes to Arizona's state and local sales tax system necessary for Arizona to begin taxing remote online sellers.

Independent Functional Utility

Like most states in the country, Arizona provides a sales tax exemption for machinery and equipment (M&E) used in manufacturing, mining, utility, and telecommunications. Arizona businesses have struggled for years with state auditor's efforts to complicate and undermine this important exemption by attempting to tax the labor associated with the installation of the exempt equipment through the prime contracting tax. State policymakers have attempted to address this problem in prior legislation. The most recent attempt to provide clarity regarding the tax treatment on the installation of exempt M&E was HB2535 in 2013. HB2535 established that the labor for the installation of exempt machinery and equipment was deductible if the equipment had "independent functional utility." The independent functional utility test clearly established that the exemption was not lost if the labor was associated with assembling the M&E or stabilizing it through bolting or burying it. The Legislature's support for protecting the M&E exemption was reflected in the unanimous support for HB2535.

Regrettably, private letter rulings from the Arizona Department of Revenue are again attempting to narrow the exemption. Those rulings are in direct conflict with the 2013 law — denying the labor exemption for equipment being attached to real property for purposes of stabilization.

ATRA will pursue legislation to clarify the tax treatment for the installation of exempt M&E and the legislative intent of the 2013 law.