Arizona Tax Research Association

Revenue and Budget Update

November 18, 2016

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’18 Forecast – Little Discretionary Flexibility

- The projected ’18 cash balance is $101 M, but the structural balance is only $24 M

- Numbers will shift by January, but expect general theme to be the same

- With $460 M Rainy Day Fund, projected cash reserve is $560 M
  - 5.8% of revenues; rating agencies recommend 8-10%

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Revenue Forecast

’17 YTD Continues Slow ’16 Revenue Growth

	’16 Actual	’17 YTD
Sales	2.9%	3.2%
Individual Income	5.5%	6.9%
Corporate Income	(13.9)%	(31.1)%
Insurance Premium	9.9%	7.5%
Other	11.1%	37.3%
Overall	3.5%	3.8%

- Includes preliminary October estimates
- Revenues exclude fund transfers and urban revenue sharing
- Through October, year-to-date revenues $53 M above forecast

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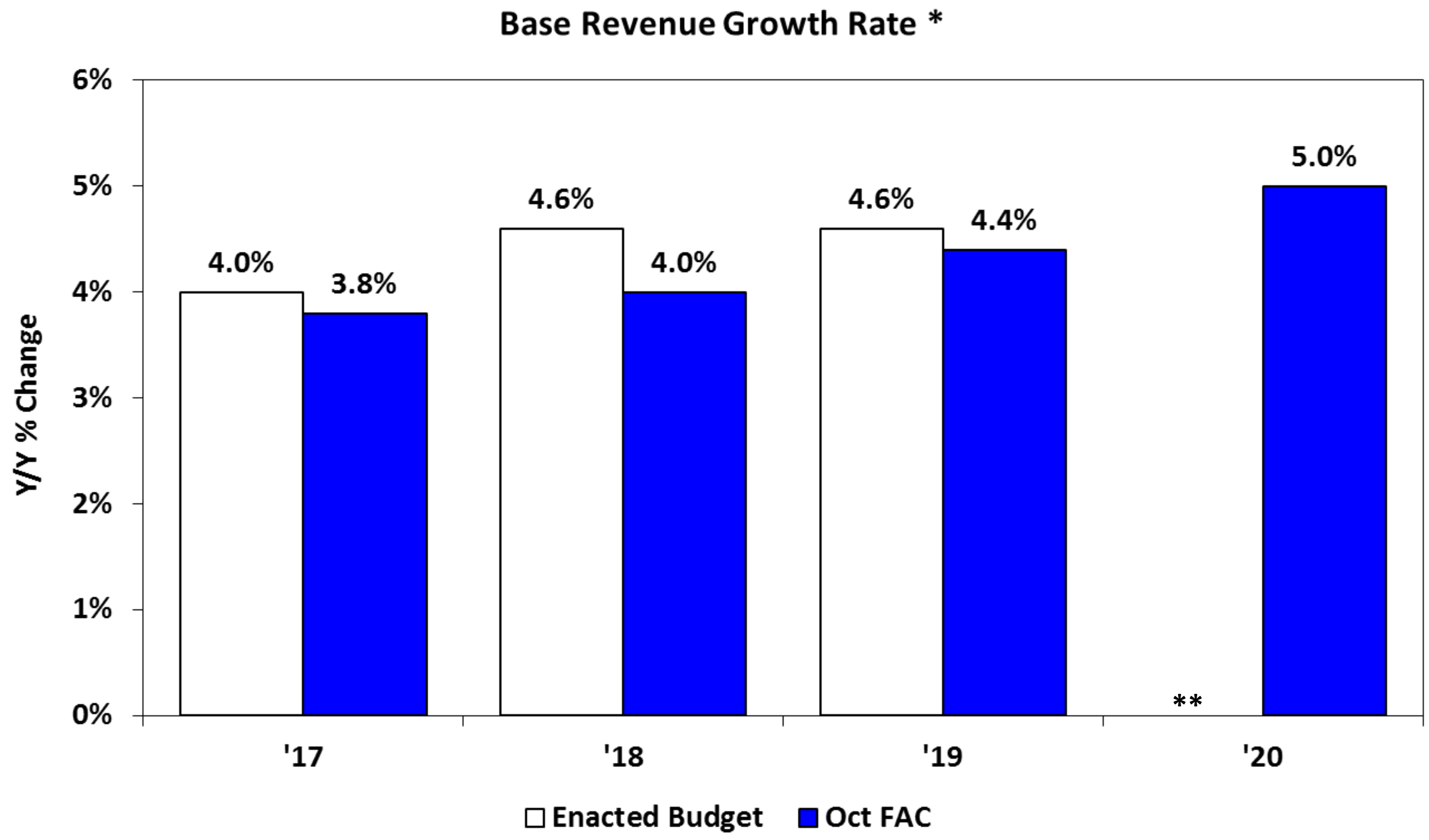
October Forecast vs. Enacted Budget
- Both Based on 65% Probability



*Excludes one-time revenues, tax law changes, and urban revenue sharing
** Enacted ’17 budget did not include a ’20 estimate

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Will DOR Staffing Decision Reduce Revenues?
- Forecast Has Not Been Adjusted

- DOR reduced its collection/audit staff from 332 FTEs in ’16 to 224 FTEs in ’17
- Revenue impact is unknown
- 78 FTEs and contracted collectors added in ’11 were budgeted to increase revenue by $53 M
- DOR says it is focusing on improving voluntary compliance

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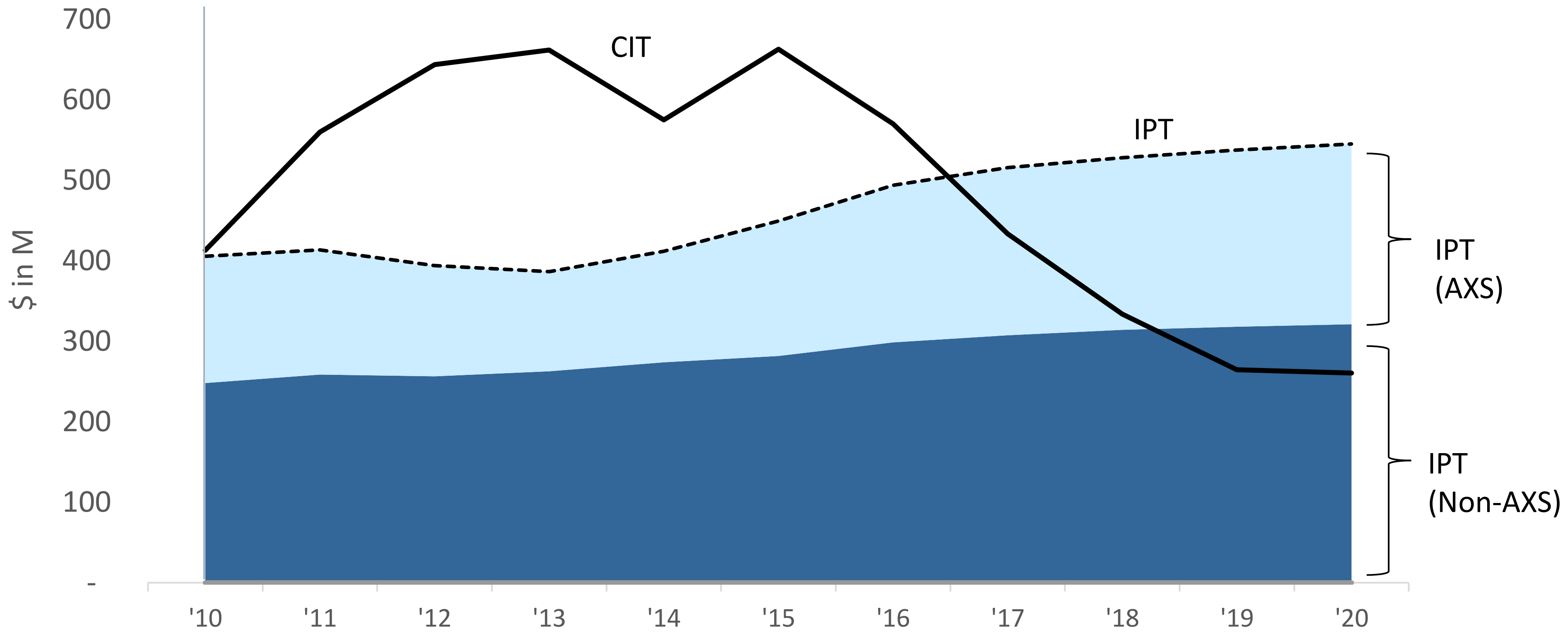
Insurance Taxes Surpassing Corporate Taxes
- AHCCCS-Related Premiums Built into Federal Reimbursement



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Adjustments Reduce Growth Rate to 2.0% in ’17

$ in M

	’18	’19	’20
Base Revenue Growth (4.0%/4.4%/5.0%)	401	455	534
One-Time Fund Transfers	(79)	0	0
Previously Enacted Tax Legislation	(119)	(78)	(31)
Urban Revenue Sharing	(12)	(7)	(13)
Total	**191**	**370**	**490**
% Change	**2.0%**	**3.8%**	**4.9%**

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Current State of Tax Credit Policy
- '16 Actual Credits Taken

$ in M

Credit	IIT	CIT	IPT
School Tuition Organizations	99	30	26
Public School Extracurricular	46	0	0
Research & Development	12	97	0
Charitable Organizations	37	0	0
Renewable Energy / Solar	5	10	0
New Employment	0	5	4
Other	16	6	4
Total	**215***	**148**	**34**

*Excludes $148 M for IIT paid to other states and $32 M for Prop 301 credit

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Spending Forecast

’17 – ’20 Baseline Spending Projections

- Baseline reflects changes to active statutory and other funding formulas - no discretionary additions
- Continues annual suspension of $493 M of inactive formulas (including $372 M for K-12)
- Continues $931 M in K-12 “rollover” payments
- Assumes spending classified as one-time or expiring in ’17 budget does not continue

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Projected Spending Changes

- $200 M In ’18 Statutory Spending Offset By Elimination Of 1-Times

	$ in M Above Prior Year		
	’18	’19	’20
K-12 – Formula	110	134	167
K-12 – Expiring Statutory Provisions	(43)	0	0
AHCCCS	60	118	144
DES	22	27	30
Corrections	7	1	2
Universities	(15)	0	(3)
DCS	0	0	0
SFB	(1)	(35)	32
DPS – Border Task Force Equipment	(15)	0	0
Counties – Cost Sharing Offset	(8)	0	0
Capital – $8 M ADOA/$10 M Vets Home	(18)	0	0
Capital – ADOT Highway Projects	(87)	0	0
Other	(11)	3	1
Total Spending Changes	**1**	**248**	**373**
Total Spending	**$9,639**	**$9,887**	**$10,260**
% Change	**0.0%**	**2.6%**	**3.8%**

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Cash and Structural Balance Forecast

’18 Cash Balance Exceeds Structural Balance
- Excludes $460 M Rainy Day Fund Balance

FY 2018 Baseline Projection

	($ in M)	
Balance Forward	$ 77	
Ongoing Revenues	9,663	$24 M Structural Balance
Ongoing Spending	(9,639)	
Cash Balance	$ 101	

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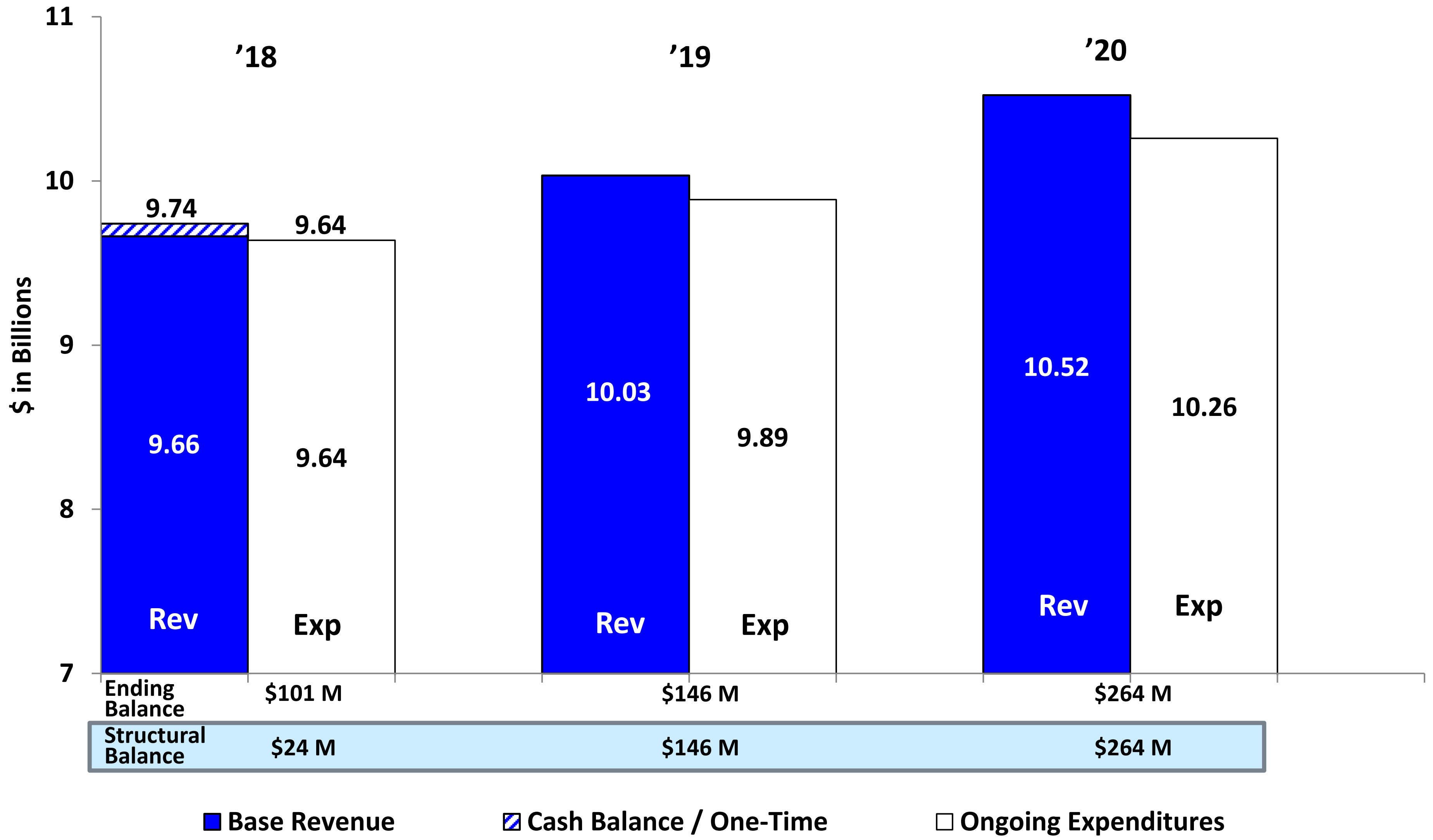
General Fund Balance Improves Over Time, But…



Projected ending balances assumed to be allocated
as part of the budget process

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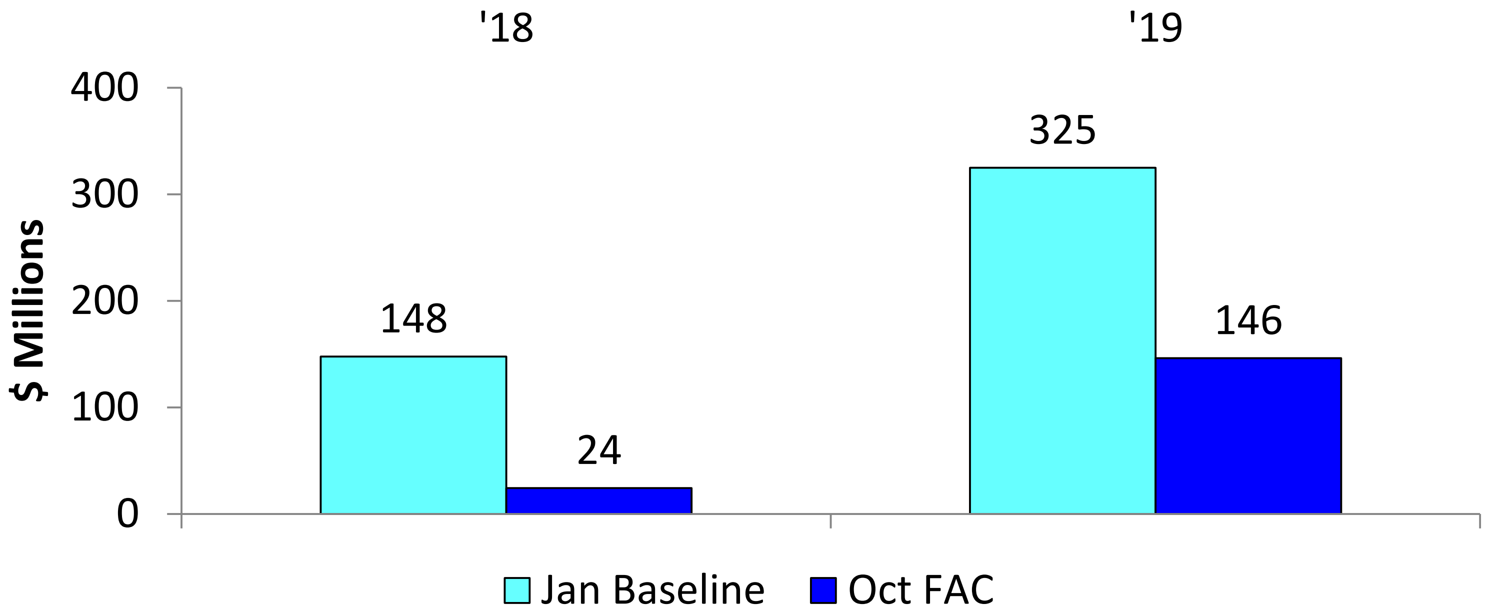
Structural Balance Estimates Are Volatile
- Risks of Developing Budget Around '19 or '20 Estimates



- 1% variance in revenue estimates yields $625 M over 3 years
- Assumes no discretionary changes in next 3 years
- Lower revenues and higher spending reduced projected '18 balance from $148 M to $24 M in 9 months.

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Forecast Challenges

- Pending Litigation
- One-Time Funding (Or Not)
- New Initiatives

Pending Litigation

- Hospital assessment litigation – Potential $100 M - $250 M cost if plaintiffs are successful

- Rental car surcharge litigation – Potential cost of $150 M

- Possible litigation – State funding of K-12 building costs

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Is One-Time Spending Really One-Time?
- Numerous Spending Items Expire in ’17

	$ in M
ADE Formula Spending	43
Local Assistance (HURF/DJC)	38
Universities	19
Department of Child Safety (’16)	23

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New Initiatives

	$ in M
Repeal / Replace Affordable Care Act	?
Prop 206 Minimum Wage Impacts	?
Full Day Kindergarten	240
▪ Excludes construction costs	
University Resident Student Formula	78
▪ $234 M by Year 3	
New Tax Reductions	?

National Look at State & Local Taxation Issues

ATRA's 2016 Outlook Conference
Scottsdale Hilton Resort
November 18, 2016

Nikki E. Dobay
Council On State Taxation
(202) 484-5221
ndobay@cost.org

Agenda

- November 2016 Election: State Results
- Federal Tax Policies: Implications for State Taxes
- Pending Federal Legislation
- State Tax Reform
- U.S. Supreme Court Docket
- Sales Tax Development: Services and Digital Goods

November 2016 Election: State Results

November 2016 Election Results:
Key State Ballot Initiatives

State	Initiative	Result	Margin
Arkansas	**Issue 3** – State bonding authority cap removal and expanded local economic development bonding authority	PASSED	65% Y; 35% N
California	**Prop. 55**: Extend state's special top individual income tax rate of 13.3% on income over $250,000 until 2030	PASSED	62% Y; 38% N
Colorado	**Amd. 69** – Impose a 10% payroll and personal income tax on top of existing 4.63 flat rate to fund ColoradoCare (a new public option health care system)	FAILED	80% N; 20% Y
Louisiana	**Amd. 3** – Eliminate corporate income tax deduction for federal taxes paid, triggering a 6.5% flat CIT rate	FAILED	56% N; 44% Y
Maine	**Question 2** – Impose a 3% personal income tax rate on income over $200,000	PASSED (Likely)	50.5% Y; 49.5% N 96.5% reporting
Missouri	**Amd. 4** – Amend constitution to ban new sales taxes on services	PASSED	57% Y; 43% N

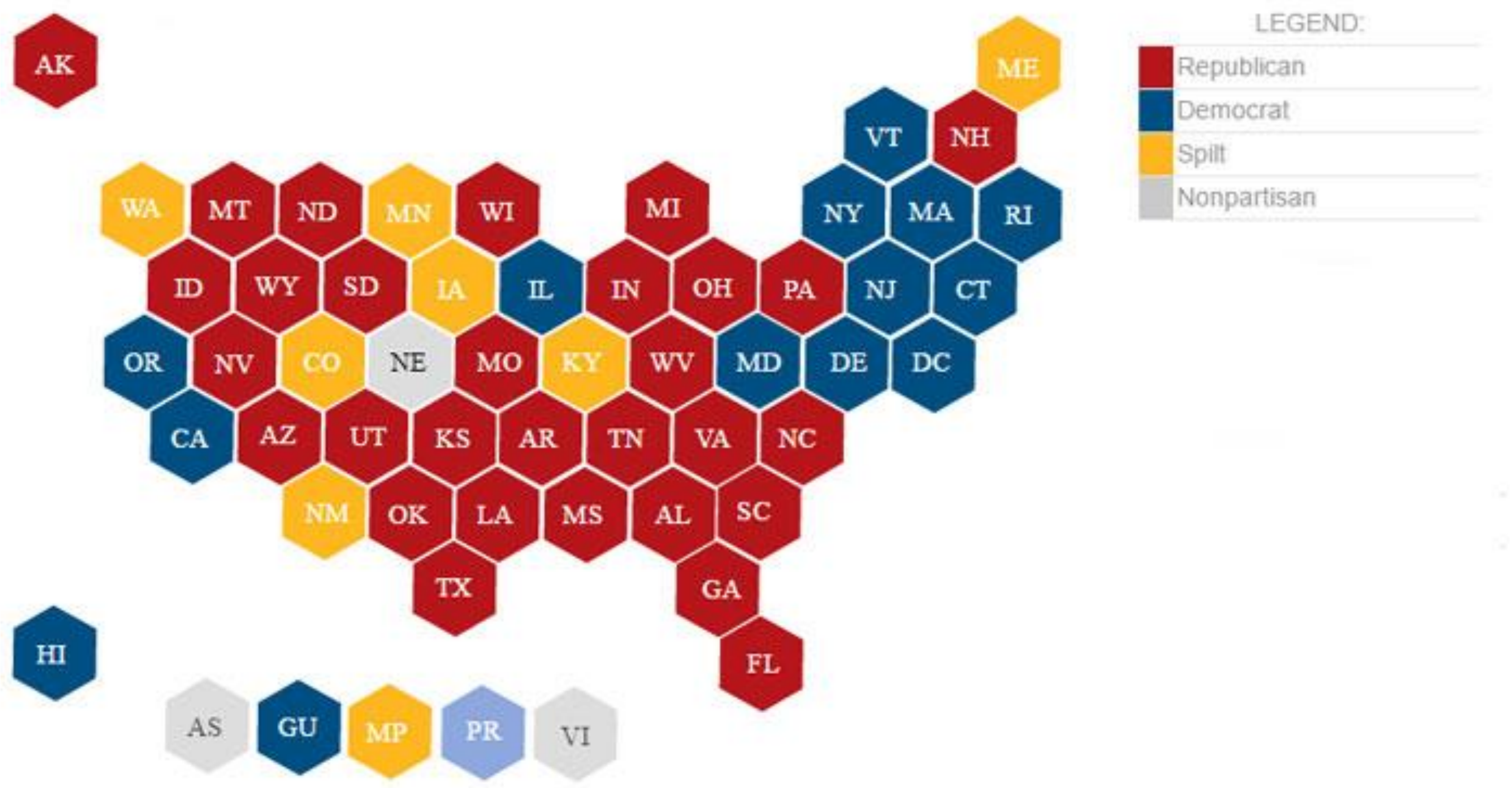
November 2016 Election Results:
Key State Ballot Initiatives

State	Initiative	Result	Margin
Nevada	**Question 4** – Amend constitution to exempt durable medical equipment from sales tax	PASSED	72% Y; 28% N
New Jersey	**Question 2** – Amend constitution to require gas tax revenue be deposited in Transportation Trust Fund	PASSED	54% Y; 46% N
Oklahoma	**State Question 779** – Additional 1% sales tax, earmarked for education funding	FAILED	59% N; 41% Y
Oregon	**Measure 97** – Gross Receipts tax on C-Corp. income over $25 million	FAILED	59% N; 41% Y
WA	**Initiative 732**– Impose carbon tax, offset by sales tax rate decrease	FAILED	58.5% N; 41.5% Y
Olympia, WA	**Initiative 1** – impose 1.5% personal income tax on income over $200,000 (would be first income tax in Washington State, informing state income tax debate)	FAILED	55% N; 45% Y

November 2016 Election Results:
Soda Taxes Ballot Initiatives

State	Result	Margin
San Francisco, CA	PASSED	62% Y; 38% N
Oakland, CA	PASSED	61% Y; 39% N
Albany, CA	PASSED	71% Y; 29% N
Boulder, CO	PASSED	26,890 Y; 22,617 N
Cook County, IL	TBD (Board of Commissioners set to vote on 1 cent per ounce tax on Nov. 10; would join Philadelphia, PA and Berkeley, CA)	

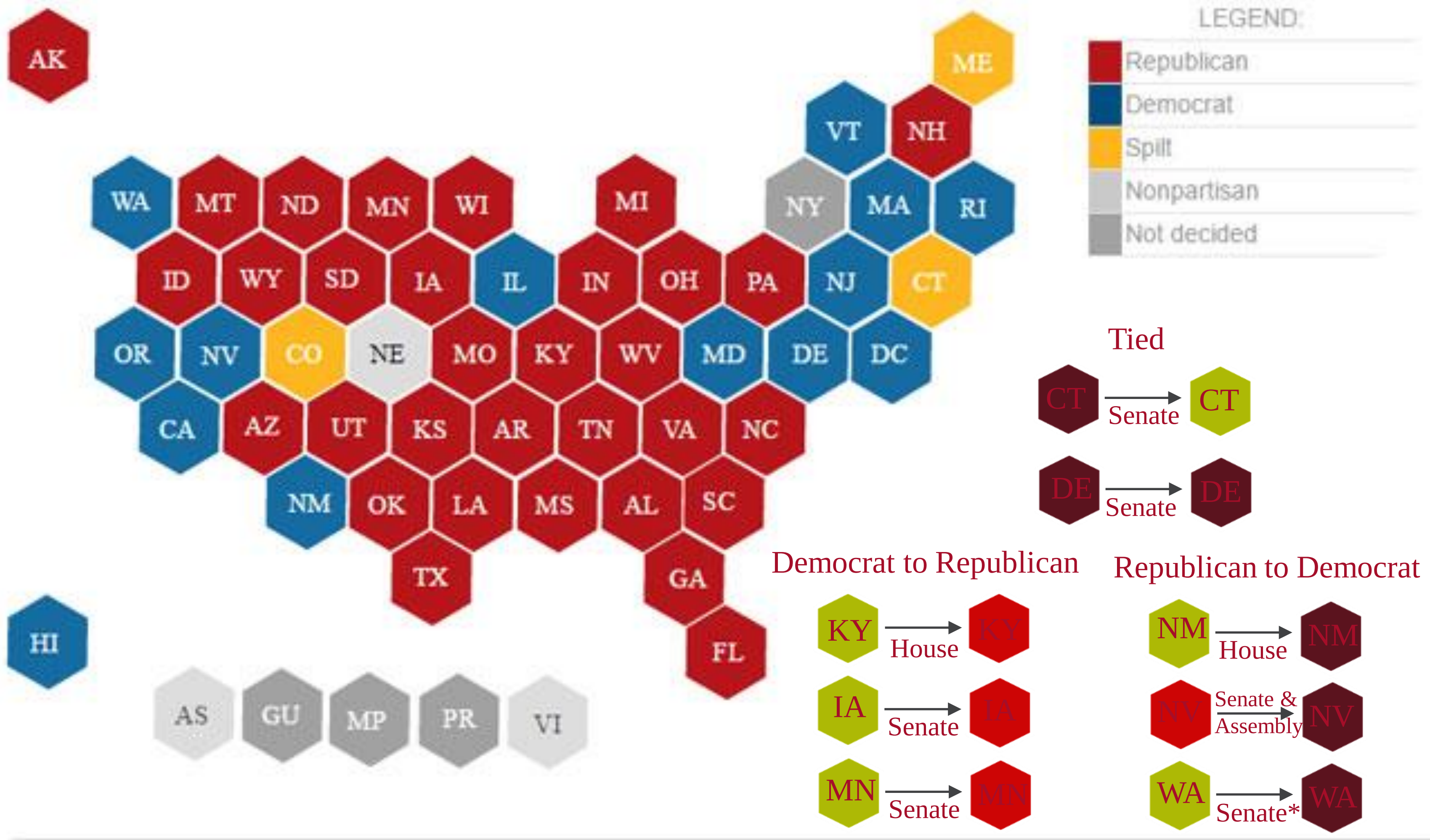
2016 Pre- Election Legislative Control



Source: National Conference of State Legislatures

2016 Post- Election Legislative Control

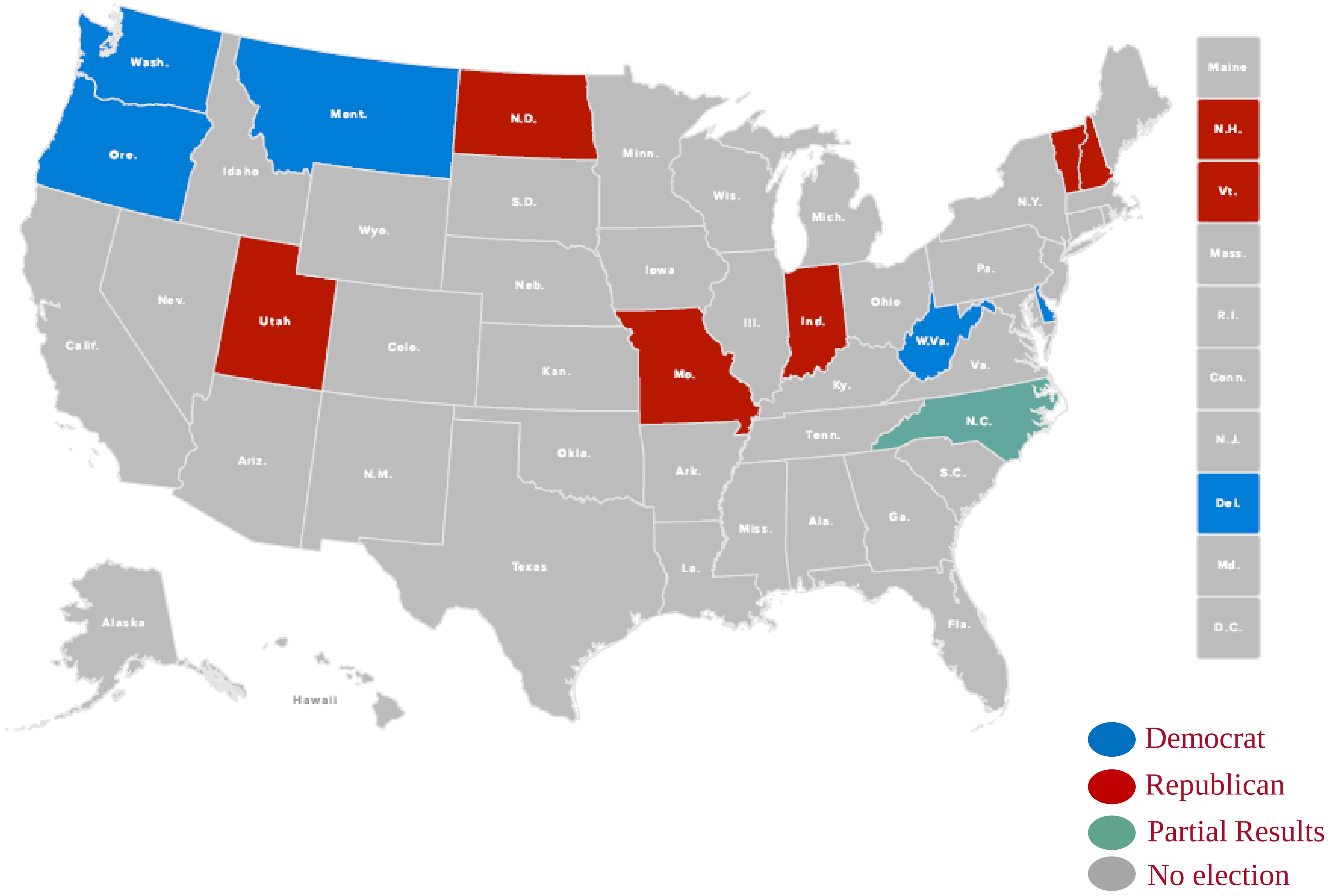
(as of November 9)



Source: National Conference of State Legislatures

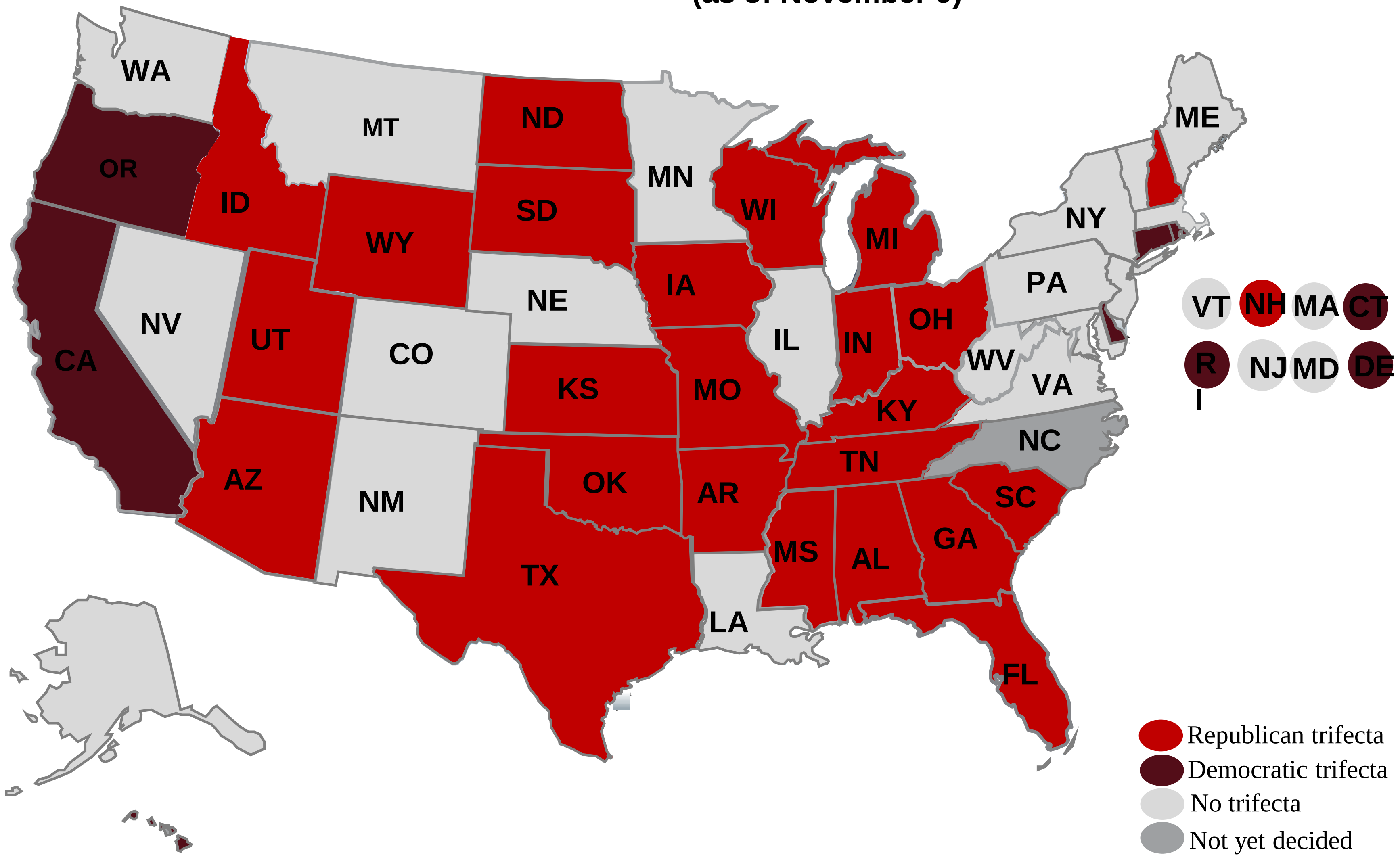
* WA - Republicans will have functional control as one Democrat will caucus with the Republicans.

2016 Governor Election Results



2016 Post- Election Trifectas

(as of November 9)



Source: Ballotpedia

Federal Tax Policies: Implications for State Taxation

Candidate Trump Tax Proposals

	Trump
Corporate tax	15% corporate income tax rate
Small businesses	15% business income tax rate for pass-through entities that retain earnings. (Small business owners won't face double taxation; large business owners will incur dividend taxes.)
International	▸ 10% repatriation rate on accumulated foreign earnings ▸ Unclear if still wants repeal of deferral
Inversions	Lower business taxes will "end job-killing corporate inversions"
Cost recovery	Expensing for manufacturers
Interest expense	Manufacturers who elect expensing lose deductibility of interest expense
General	Most expenditures eliminated, except for R&D Credit

House Tax Reform Task Force Blueprint: Highlights

Corporate tax rate	20%
Business income pass-through tax rate	25%
Taxation of future foreign earnings	Territorial, 100% exemption for dividends paid from foreign subsidiaries *
Taxation of accumulated foreign earnings	8.75% for cash/cash equivalents, 3.5% otherwise
Border adjustability	Exports exempt from tax/imports taxed
Cost recovery	100% expensing
Interest expense	Not deductible on a net basis
Corporate tax preferences	Generally eliminated, except for R&D credit/LIFO
Individual tax rates	12%, 25%, 33%
Investment income	50% deduction, basic rates of 6%, 12.5%, and 16.5%
Individual deductions	Eliminated except for mortgage interest, charitable contributions/Std deduction increased
AMT/Estate tax	repealed

Major Drivers of US Corporate Tax Reform

- **Less competitive US system** means US resident companies may relocate to more favorable jurisdictions through inversions or become vulnerable to acquisition by foreign competitors
- Patent box regimes in other countries lure IP income and R&D jobs from the US, especially given **OECD BEPS** nexus requirement
- BEPS Project, European Commission State aid investigations demonstrate that other nations are concerned about where companies pay taxes
- **EU state aid** investigations are seen as targeting US multinational companies that are accumulating large amounts of tax-deferred income abroad

IRC Section 385 Regulations

- Released in October 2016
- The debt recharacterization regulations address related party debt
- Although generally issued to address international “inversions,” the IRS regulations would apply to all purported debt transactions between related corporations, even where there is no attempted inversion and where the debt is between two domestic corporations
- The regulations recharacterize certain related party-debt as equity, thus limit corporate interest deductions
- The regulations impose onerous documentation requirements to establish bona fide debt

IRC Section 385 Regulations

- Changes in the final regulations:
  - Short-term cash pooling exception
  - If lacking documentation, taxpayers can still qualify transactions for “debt” if they overcome a rebuttable presumption
  - No bifurcation of debt and equity by the taxpayer is allowed
- What will the impact be on the states?
  - **Will the regulation apply to domestic debt/equity transactions otherwise eliminated for federal consolidated group purposes?**
  - Potential state tax applications: “push down” debt; debt with entities not included in a state combined group; mergers & acquisitions-related debt; interest expense add back statutes

New Federal Partnership Audit Rules

- In 2015, a federal statute was passed that made significant changes to federal rules for auditing partnerships. The IRS has issue proposed regulations to address these issues
- The new rules significantly alter how certain “large” partnerships are treated for federal tax purposes. The new general rule is that audits will be conducted at the partnership, not the partner, level and amounts will be assessed and collected at the partnership level
- The Multistate Tax Commission, ABA, COST, TEI and other groups are developing a list of state level issues that will need to be addressed. These include:
  - Partnership-level audits
  - Apportionment
  - Composite returns
  - Withholding for non-resident partners
  - Federal changes

Flow Through Entity Taxation Compared with C Corporations

- In 1980, pass through businesses accounted for **20 percent of total business income** in the U.S. In 2012, pass through entities **accounted for about 60 percent of business income**
- According to a study by the National Bureau of Economic Research, **the average federal income tax rate on pass through business income was 19% compared to the average federal income tax rate for C corporations of 31.8%**
- This shift is primarily due to the 1986 federal tax changes (more flexibility with S corporations); the rise of LLC’s and their tax treatment as flow throughs; and the double taxation of C Corporations and shareholder

Federal Tax Reform: Impact on the States

Federal

- CIT marginal rate change
- Base broadening to make proposal revenue neutral
- Reduced rate for repatriation
- Inversions
- Debt equity rule change
- Country by Country Reporting
- Corporate tax integration

States

- No impact/ states have own rates
- Significant revenue increase/ states link to federal deductions
- Minimal impact
- TBD
- Significant change in transactions eliminated for federal purposes
- Unclear if states will get access
- Significant potential change in taxes under both CIT and PIT

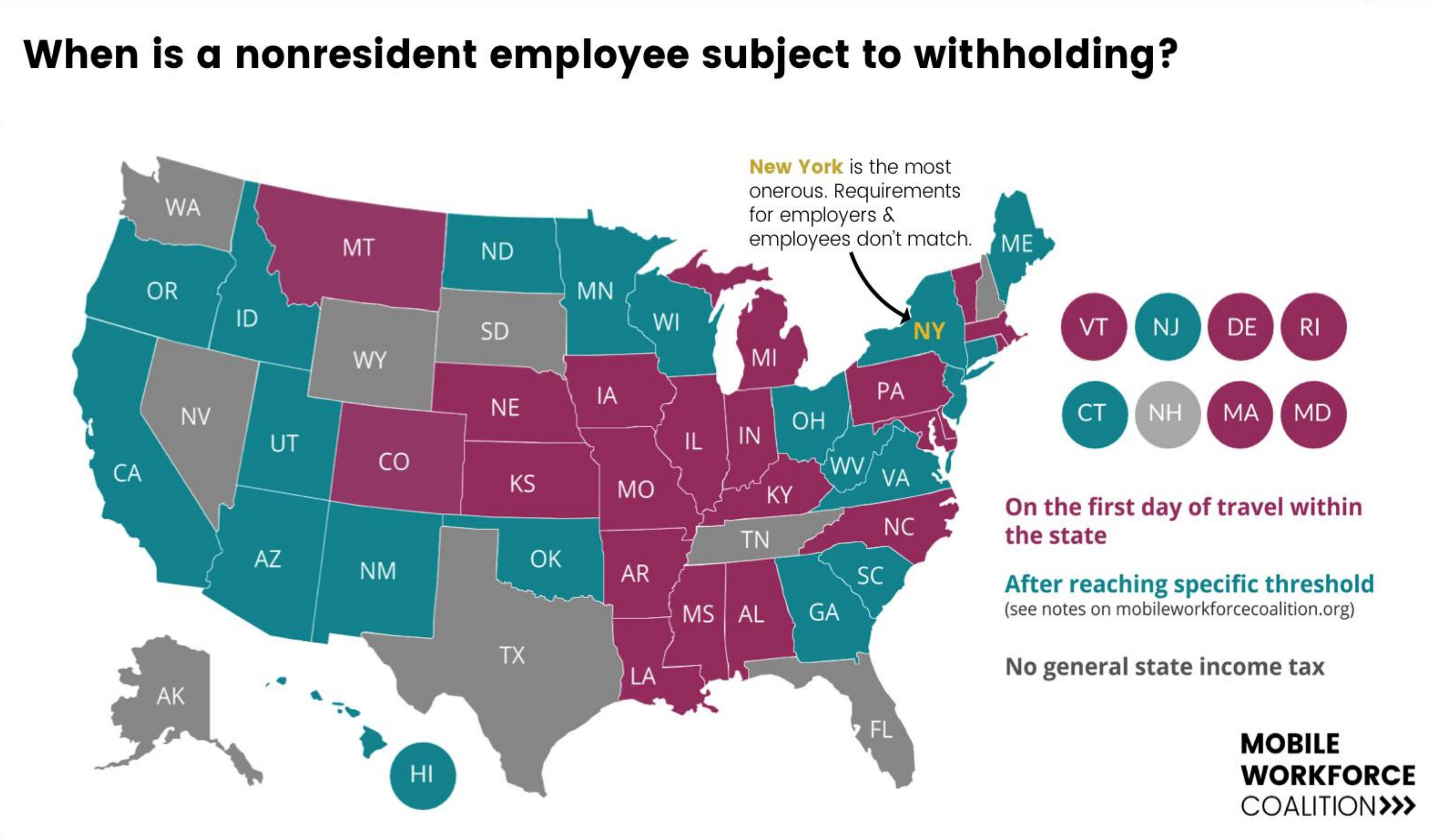
Pending Federal Legislation

Relief for Nonresident Employees

Mobile Workforce State Income Tax Simplification Act of 2015 (MWA)

- S. 386 introduced by Senator John Thune (R-SD) and Senator Sherrod Brown (D-OH), 52 Senate consponsors
- H.R. 2315 introduced by Mike Bishop (R-MI) and Hank Johnson (D-GA)
- House Judiciary Committee passed H.R. 2315 by a 23-4 vote on June 17, 2015, **full House approved by voice vote on Sept. 21** (181 House cosponsors)
  - Would create a bright-line 30-day threshold to determine nonresident income tax liability and employer withholding
  - Exceptions for entertainers, athletes & prominent public figures
  - 308 company and association coalition members

A Patchwork of Nonresident State Income Tax Withholding Laws



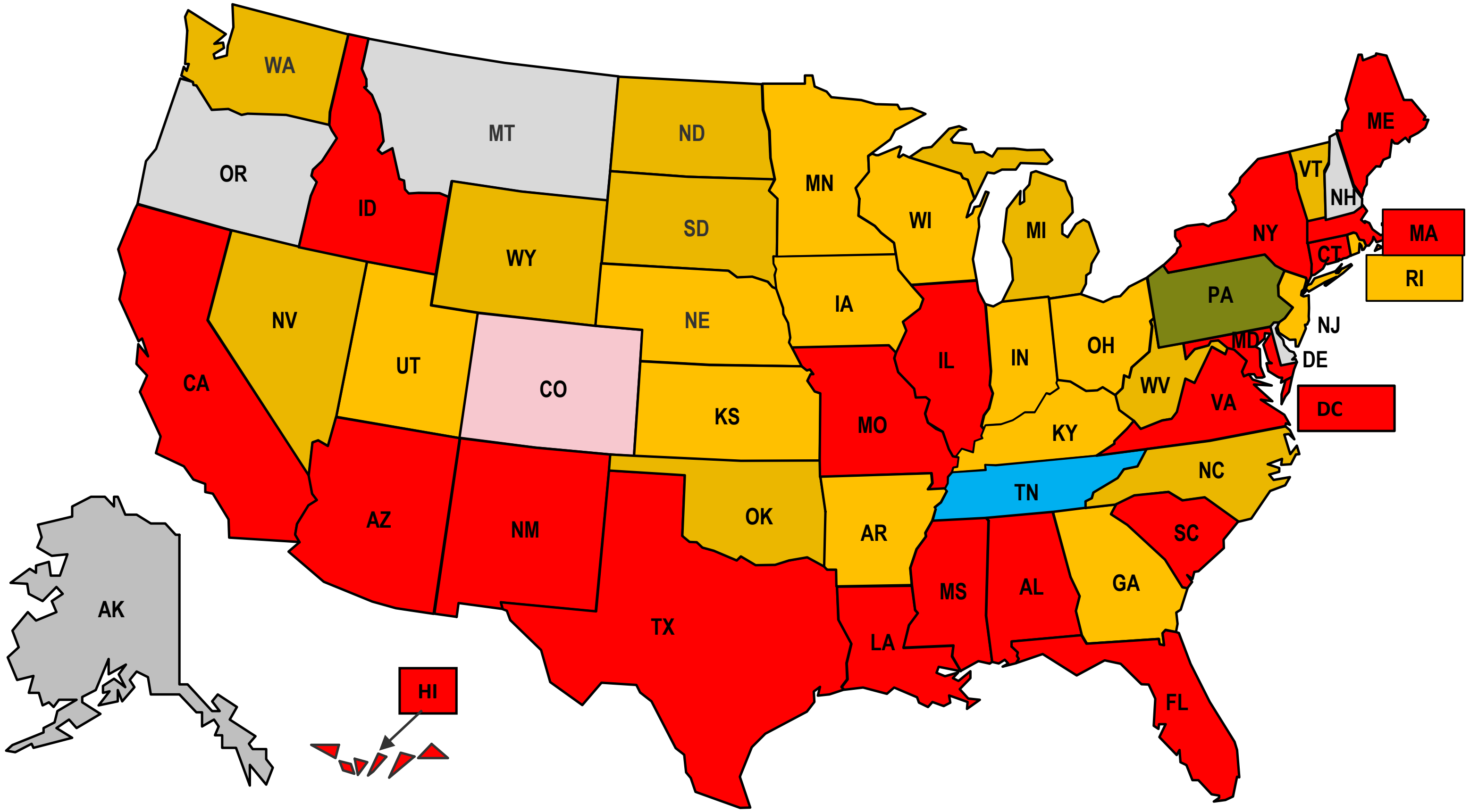
State Remote Seller Collection Authority

Since 2005, the following types of legislative bills have been introduced or proposed:

- Main Street Fairness Acts (MSFA)
- Marketplace Equity Act (MEA)
- Marketplace Fairness Act (MFA)
  - S. 698
    - Retail Transaction Parity Act (RTPA)
      - H.R. 2775
- No Registration without Representation Act (H.R. 5893)
  - Codifies *Quill* standard and repeals all other non-physical presence nexus provisions in all states
- Online Sales Tax Simplification Act (draft)

Green = Actual legislation introduced this session of Congress

Simplification of the Sales, Use or Similar Transaction Tax System – Streamlined State Status, January 1, 2014



Full Member States

Advisory States – Not Conforming

No Sales Tax states

Project States – Not Advisory

Associate Member States – Flex to Full

Non-Participating States

State Tax Reform

2015 State Tax Reform: Why It Happened

- Puerto Rico – significant budget shortfalls, taxpayer non-compliance with the SUT system, need for a more stable revenue source
- Illinois and Pennsylvania – a tale of two states facing very similar issues
  - New governors with opposite party controlling the legislature
  - Severe budget shortfalls
  - Need to reform their tax codes and pension systems , fund education
- Nevada – a need to fund education led to the enactment of the new Commerce Tax
- Kansas – 2012 tax relief that exempted income from a pass-though entity from individual income tax is causing significant budget shortfalls; governor and both houses of the legislature at odds on how to fix
- Connecticut and Louisiana – both states faced significant budget shortfalls; tax increases enacted but was it enough?

2016 State Tax Reform: Where It Could Happen

- We will likely see Oregon consider repeal of corporate income tax and the enactment of an Ohio-style CAT following the defeat of Measure 97.
  - Rumblings of something similar in Connecticut.
- Louisiana’s new governor facing significant budget shortfalls due to decreasing oil revenues, insufficient revenues from tax changes during the 2015 regular session and two 2016 special sessions. Tax reform is likely in the future.
- Illinois and Pennsylvania on repeat…both states are still face budget shortfalls (still have not yet passed budgets) and need to fix their pension systems.
- Will continued under performing revenues and the need to adequately fund education cause Kansas to reconsider rolling-back some of the 2012 tax relief?
- Indian transfer pricing litigation led to combined reporting legislation, which was turned into study. Study released October 1, 2016, showing long term revenue impacts are mixed.
- Potential reform following the election—Kansas reform looking more likely and Kentucky Governor has called for tax reform

U.S. Supreme Court Docket

Crystal Ball for SCOTUS

State and local tax issues that may be reviewed by the Court:

- **Retroactive Legislation**
  - *DOT Foods* – Retroactive Washington B&O tax change
  - *IBM/Gillette* – Michigan's retroactive elimination of MTC apportionment election
- **Discriminatory Laws/ Nexus**
  - *DMA* – Colorado's notice and reporting regulation
  - South Dakota/Alabama – Direct challenge to *Quill*
  - Ohio – Factor Nexus – *Newegg, Crutchfield,* and *Mason Cos*.

The *Carlton* Two Part Test

- In *Carlton,* the U.S. Supreme Court established a two-part test to determine if retroactive tax legislation violates the Due Process Clause of the U.S Constitution (*United States v. Carlton*, 512 U.S. 26 (1994)).
- **First**, the Court looked to whether the legislation was enacted for a "**legitimate legislative purpose** furthered by rational means."
- **Second,** the Court looked to whether Congress "acted **promptly** and established only a **modest period** of retroactivity."
- Petitioners from Washington (*Dot Foods*) and Michigan (the MTC Compact cases) **are seeking certiorari at the U.S. Supreme Court** on the constitutionality of retroactive tax legislation.

The Washington Dot Foods Case

- In **1983**, the Washington Legislature enacted an exemption from B&O tax for certain out-of-state sellers from.
- In **1999**, the DOR changed its interpretation of the provision.
- In **2010**, the Washington Supreme Court ruled the taxpayer was entitled to the B&O exemption and that the DOR’s revised interpretation was contrary to the statute’s plain and unambiguous language.
- In **2010**, shortly after the court decision, the Washington Legislature enacted legislation retroactively reinterpreting the 1983 statute to deny the exemption to the taxpayer (the retroactive period was limited to 4 years by the statute of limitations).
- In **2016,** the Washington Supreme Court upheld the retroactive tax legislation as valid under the *Carlton* precedent.

The Michigan Multistate Tax Compact Cases

- In **2008** (effective date), the Michigan Legislature enacted legislation that allowed taxpayers under the MBT (Michigan Business Tax) to elect to use the Multistate Tax Compact's three-factor apportionment formula .
- In **2011**, the Michigan Legislature replaced the MBT with the Michigan Corporate Income Tax and provided that the Compact's election no longer applied to the MBT retroactive to January 1, 2011.
- In **2014**, the Michigan Supreme Court ruled that for tax years 2008 through 2010, the taxpayers were entitled to use the Compact's election under the 2008 law.
- Shortly thereafter, in **September 2014**, after receiving a DOR revenue loss estimate of $1.1 billion, the Michigan Legislature repealed the Compact (and its election) retroactive to January 1, 2008.
- In **2015,** the Michigan Appeals Court upheld the retroactive legislation as constitutional under the Due Process Clause (and *Carlton* precedent); and, the Michigan Supreme Court declined to review the case.

"*DMA I*"– Applicability of Tax Injunction Act

Direct Mktg. Ass'n v. Brohl, 135 S.Ct. 1124 (Mar. 3, 2015)

- Tax Injunction Act ("TIA") provides that federal district courts "shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." 28 USC § 1341.
- Colorado use tax reporting scheme not an assessment, levy, or collection of tax – so not barred by TIA.
- SCOTUS did not address Comity Doctrine (which counsels federal courts to refrain from interfering with fiscal operations of state governments) – which still creates hurdles to get to federal district courts.
- Justice Kennedy gives "unqualified" concurrence to majority opinion; *however, he goes out of his way to say Quill needs to be reconsidered – it "now harms States to a degree far greater than could have been anticipated earlier."*

DMA II – 10th Circuit Opinion on Remand

- On February 22, 2016, the 10th Circuit, decided "*DMA II,*" reversing the District Court and upholding the Colorado regulations. DMA's petition for rehearing *en banc* was denied on April 1, 2016.
  - The Court concluded that Colorado's remote seller reporting requirements do not discriminate against or unduly burden interstate commerce, even though the regulation only applies to remote sellers with no physical presence in Colorado.
- State Actions targeting *Quill* in 2016
  - 35 bills targeting remote sellers for nexus were introduced in 2016
- *En banc* review denied, case has been appealed to the US Supreme Court.

States with Use Tax Notice Laws

- **Colorado –** *DIRECT MKTG. ASS'N v. HUBER*
- **Oklahoma** – Eff. 10/1/10, if over $100K sales, can give notice via website, no "extra" penalties – OK HB 2531 enacted this year also requires remote sellers provide annual notification by 2/1 of the following year to OK purchasers (still no penalty in the law) and no $ threshold
- **South Dakota** – Eff. 3/14/11, explicitly no penalties
- **Vermont** – Eff. 5/24/11, explicitly no penalties – recently modified by H. 873 (5/2016) which adds penalties and ties to *DMA* decision
- 2016 measures – **Louisiana** H.B. 1121 enacted; Colorado-style notice and reporting (also click-through nexus and expanded affiliate nexus – H.B. 30)

Is *Quill* Dead? States are Frustrated

- **Alabama DOR Regulation** – The AL DOR promulgated a regulation asserting the DOR will now assert nexus against remote sellers that have over $250,000 in sales in the state using the state's existing nexus law
  - *Newegg Inc. v. Ala. Dep't of Revenue*
- **NCSL** – Several state legislators attending a task force meeting on state and local taxation indicated they were preparing to litigate for the Court to overturn *Quill*
- **South Dakota (S.B. 106) –** Tracks NCSL approach; bill includes language that "it is neither unusually difficult nor burdensome for remote sellers to collect and remit sales taxes associated with sales into South Dakota"
  - *South Dakota v. Wayfair et al.*
  - *ACMA & NetChoice v. Gerlach*
- **Vermont** (H. 873)
- **Tennessee** proposed economic nexus regulation for sales tax

Nexus – Factor Presence Statute Challenges

***Newegg, Inc., et. al. v Testa*, Ohio Bd. Tax App. (Feb. 26, 2015); *Crutchfield, Inc., et. al. v. Testa*, Ohio Bd. Tax App. (Feb. 26, 2015); *Mason Companies, Inc., et. al. v. Testa*, Ohio Bd. Tax App. (Apr. 20, 2015)**

- Online sellers with no physical presence in Ohio, but over $500,000 in gross receipts found to be subject to CAT - BTA not authorized to address U.S. constitutional issues
- Ohio was the first state to pass the MTC's factor nexus model legislation with its 2005 tax reform
- Cases have been consolidated and oral arguments held on May 3 – do applets and cookies on customers computer devices create nexus?
- At least nine other states have factor nexus provisions (AL, CA, CO, CT, MI, NY, OK, TN and WA)

Sales Tax Developments: Services and Digital Goods

Legislative proposals and activities surrounding taxing services

Bold indicates an enacted proposal

2013

LA: Broad-based services tax proposed

NE: Broad-based service tax put on hold; study instead

MN: expanded sales tax to certain repair/maintenance, storage services, and digital goods

OH: Broad-based service tax proposed; ultimately only certain digital products taxed

Other states: MA; NC; ME

2014

DC: Expanded sales tax to limited services ("yoga tax")

KY: Tax proposal included taxing certain services

MN: Repealed sales taxes on repair and warehousing services enacted in 2013

VA: HB 729- a comprehensive services tax bill did not advance

2015

CT: Tax expanded to certain website and car wash services

CA: Bill proposed tax on all services (exempting only health and education)

IN: bill introduced to tax numerous services

KY: bill introduced to tax specified services

OH: Governor's budget proposes taxing certain services

ME: Major tax reform proposal includes taxing services

MO: House Joint Resolution would propose constitutional amendment to replace current sales tax with a tax on specified retail sales and services

NC: Bill proposed to tax specified services (repair/maintenance, advertising, veterinary, etc.) **Tax expanded to certain repair and installation services**

PA: Governor's budget proposed taxing services

SC: Fair tax legislation would impose tax on almost all property and services, would provide a family consumption allowance

Significant Base Expansion Enactments—2016 Proposals

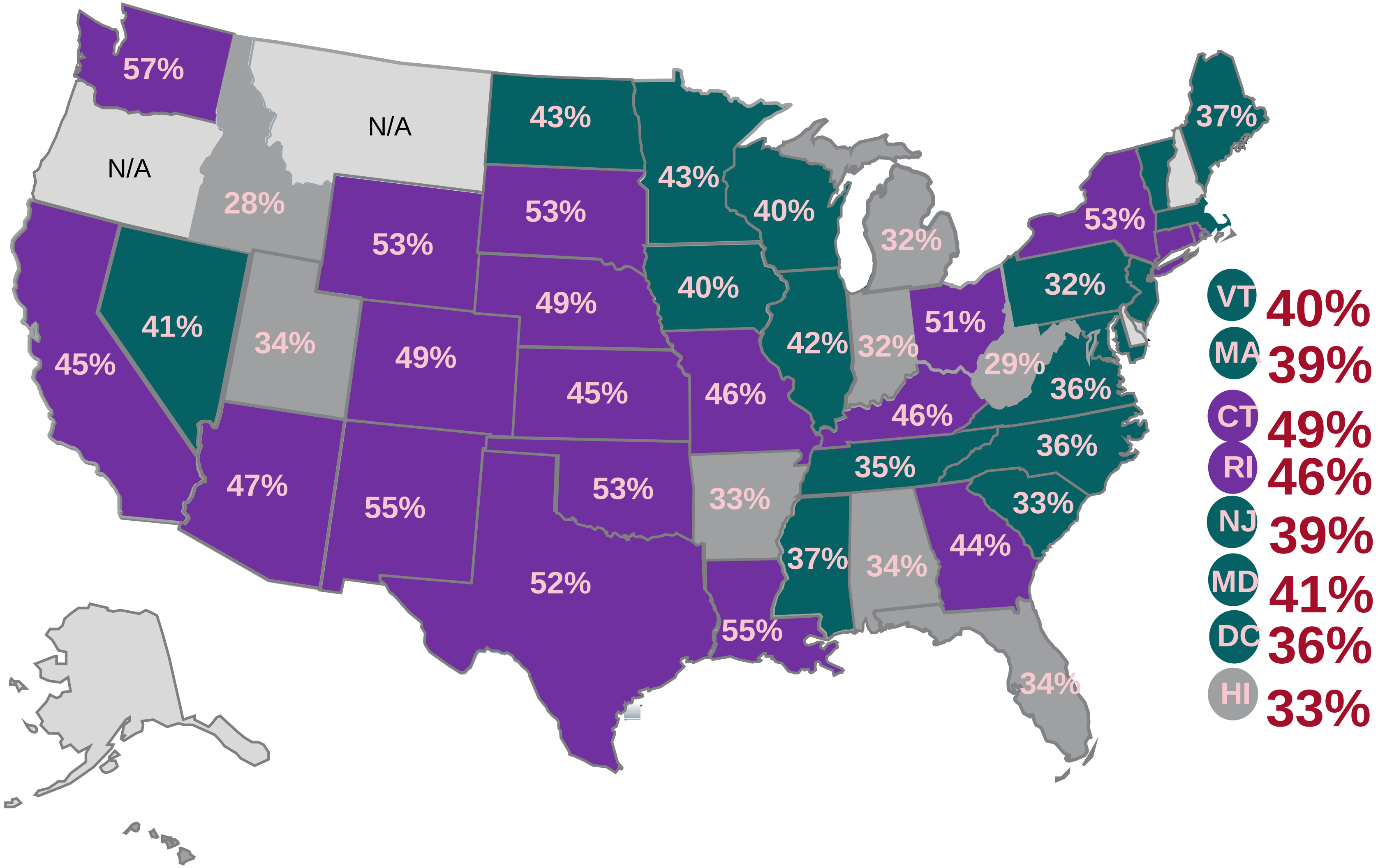
- **Louisiana** – Limits sales tax exclusions and exemptions by applying varying rates (0% to 5%) for varying time periods (Act 25/Act 26)
  - April 1, 2016 – June 30, 2016
  - July 1, 2016 – June 30, 2018
  - July 1, 2018 – March 31, 2019
- **Pennsylvania** – Significant base expansion to digital products/software (Act 84)
  - Taxes digital downloads (including games, books, and apps) and video streaming
  - Provides that canned computer software is taxable tangible personal property
  - Provides that software maintenance, updates, and support for canned software is taxable

Significant Base Expansion Enactments—2016 Proposals cont.

- **California S.B. 8/S.B. 1445, Senator Hertzberg's Proposal**
  - Would establish a "Retail Sales Tax on Services Fund" to collect and distribute the revenue raised by base expansion
  - Concept bill to: "Broaden the tax base by imposing a modest sales tax on services. These changes would more fairly apportion taxes between goods and services and would produce more stable revenues. Local jurisdictions would not be authorized to increase sales tax on services, as they now can do with the sales tax on goods. Health care services, education services, child care, rent, interest, and services represented by very small businesses would be exempted from the sales tax on services…"

Sales Taxation of Business Inputs

State and Local Sales Taxes Imposed on Business Input Purchases



Challenges of Taxing Digital, Global Economy

- Where does consumption take place?
  - Issue for both income tax and consumption tax
  - Location is less identifiable
  - Particular problem with business to business sales
- “Reasonable approximation” sourcing
- Growth of the services and the continued pressure to expand the sales tax base
- Global trade agreements = move to a more global economy
- How do taxpayers comply with all the various taxing systems, different rules
- Use of advance technology to automatically provide data to governments
- Prevent fraud, leakage of information

Sales Tax on Cloud Computing/Digital Goods/SaaS

- **Classification of Goods**
  - Software
    - Method of Delivery
  - Information Services
  - Data Processing Services
  - Hosting Services
  - Lease of Tangible personal property

Taxable/
non-taxable

Sales Tax on Cloud Computing/Digital Goods/SaaS

- **Sourcing**
  - By server location
  - By user location
  - By billing address or headquarters
  - State where purchaser “enjoys” the software regardless of where the seller or servers are located (CT, IN, MA, NY, TX, WA)
    - Location of the server is often default in these states

Sales Tax on Cloud Computing/Digital Goods/SaaS

- **Compliance Issues**
  - Customers may need detailed information regarding users or server location to determine their sales tax exposure
  - Automation of collection of sales and use tax for multiple user location
    - Are look throughs required?

Recent Developments in Digital Goods

- **Membership fees not taxable in Indiana** - Indiana Revenue Ruling ST 14-01 (10/30/2015, released 11/25/2015)
- **Streaming service taxable in Connecticut** - Ruling No. 2015-5, Connecticut Department of Revenue Services (11/3/2015)
- **Digital keys not taxable in Iowa** - Policy Letter No. Document Reference No. 15300041 (9/30/2015, released on 11/2/2015)
- **Electronically delivered reports not taxable in Indian** - Revenue Ruling No. 2013-07 ST (10/2/2015, released 10/28/2015)
- **Online marketing company considered a QHTC in DC** - District of Columbia Declaratory Order, DO 2015-2 (10/19/2015)
- **Streaming services not taxable in Kentucky** - *Netflix Inc. v. Fin. & Admin. Cabinet,* Order No. K-24900; Kentucky Board of Tax Appeals (9/23/2015)

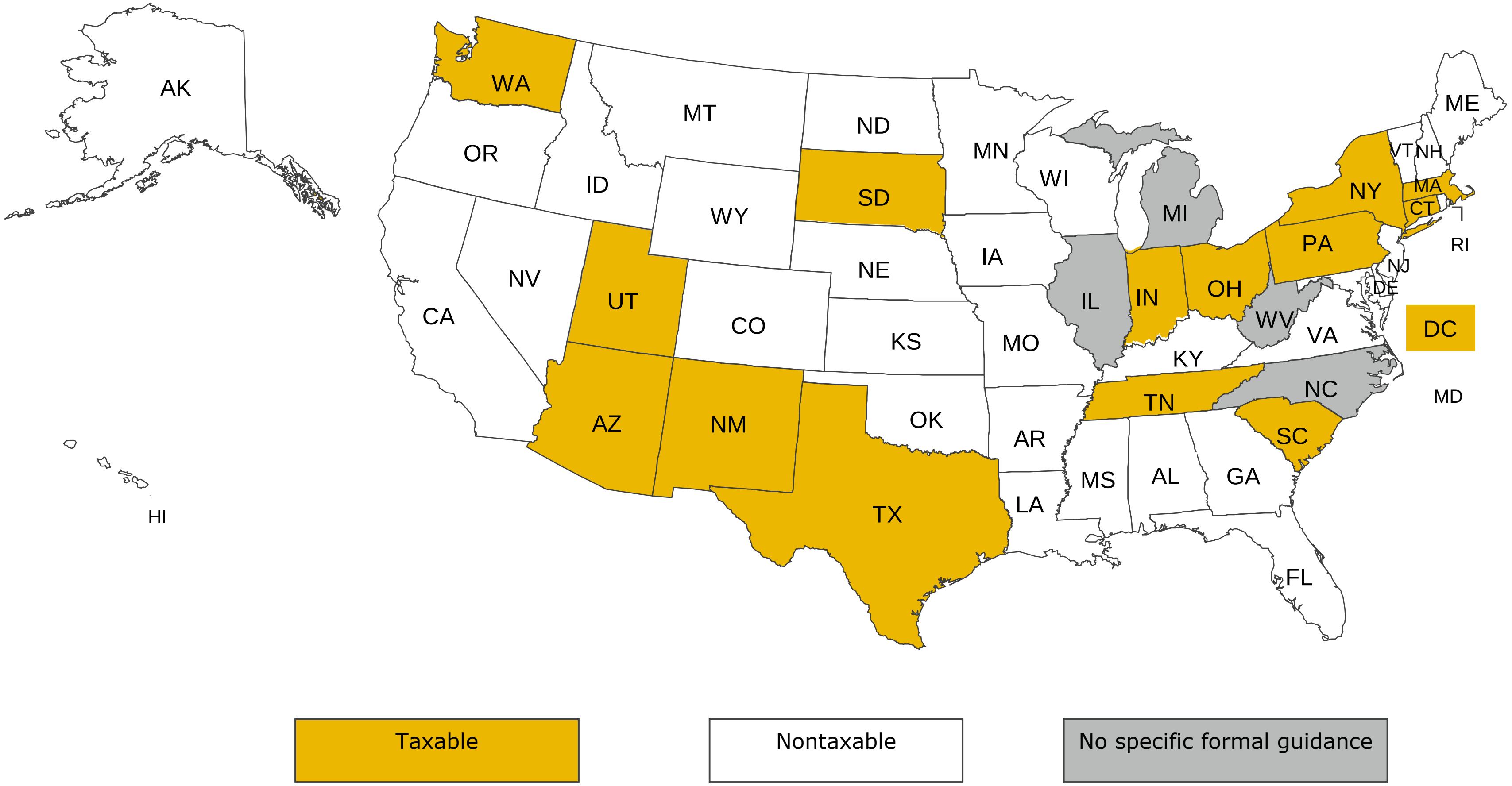
Recent Developments in Digital Goods

- **Electronically delivered photographs not taxable in South Carolina** - Revenue Ruling No. 15-10, South Carolina Department of Revenue (8/3/2015)
- **Alabama withdraws amendment taxing digital transmissions** - Rule 810-6-5-.09, Leasing and Rental of Tangible Personal Property, effective 10/1/2015
- **Membership fee subject to tax in New York** - TSB-A-15(15)S, New York Commissioner of Taxation and Finance (3/24/2015; released 6/10/2015)
- **Chicago extends amusement tax to online amusements** - Chicago Dept. of Revenue Amusement Tax Ruling No. 5 (6/9/2015)
- **Video game software taxable in New York** - TSB-A-15(25)S, New York Commissioner of Taxation and Finance (6/3/2015)
- **Subscription fee taxable in Arizona** - Arizona Private Taxpayer Ruling LR14-001 (4/14/2014, released 5/28/2015)

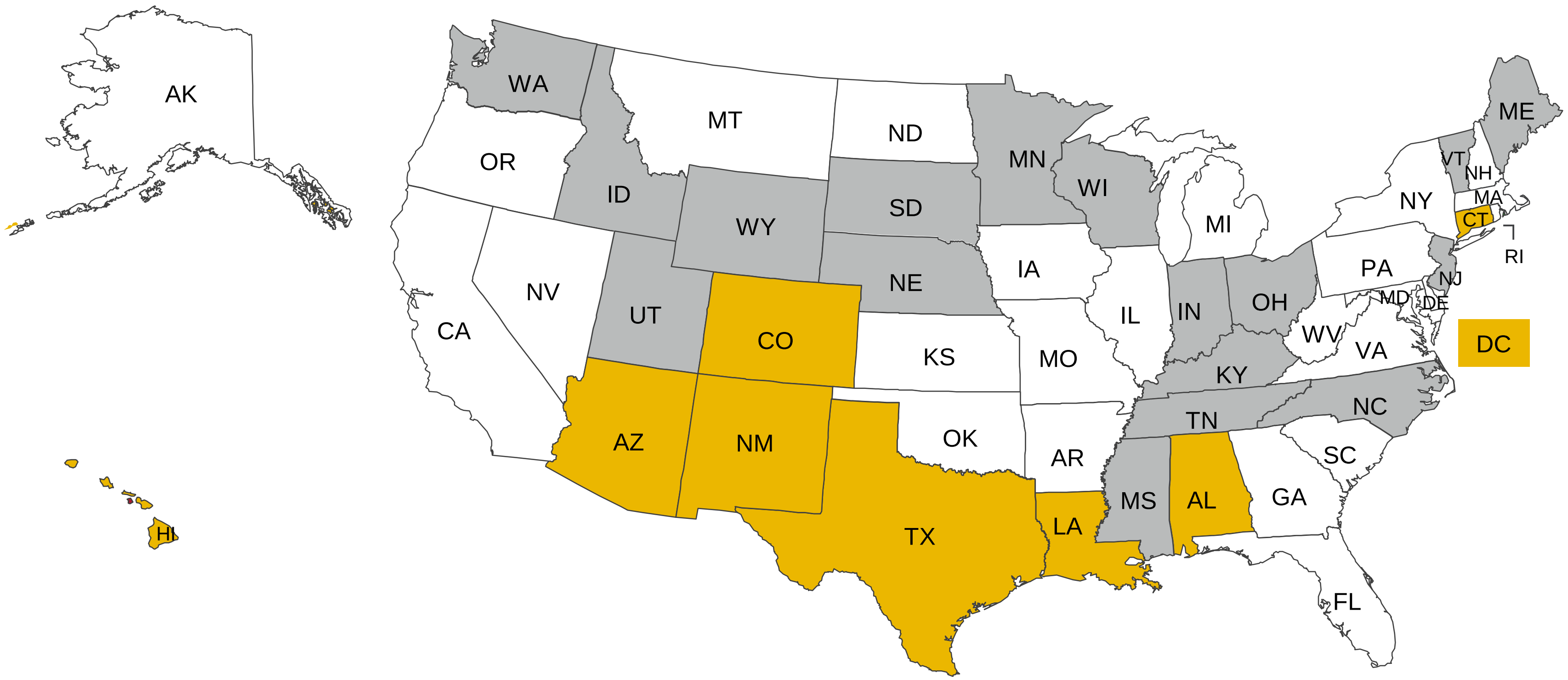
Recent Developments in Digital Goods

- **Access to video game digital products taxable in Tennessee** - HB 644, enacted 5/20/2015; See also Important Notice No. 15-13, Tennessee Department of Revenue (6/1/2015)
- **Domain name registration taxable in Washington** - Tax Topics: Domain Name Registration Services, Washington Department of Revenue (5/7/2015)
- **North Dakota to exempt internet access service** - SB 2096, signed by Governor 4/1/2015
- **Streaming services not taxable in Idaho** - HB 209, signed by Governor on 3/30/2015; See also Temporary Rule 35.01.02.027, Idaho State Tax Commission, effective 6/10/2015
- **Kansas issues guidance on sales of online gaming products** - Private Letter Ruling No. P-2015-001, Kansas Department of Revenue (revised 3/25/2015)

Sales Tax on Sales as a Software (SaaS)



Sales Tax on Sales as a Digital Goods



Digital Goods Taxed by DOR Position or Case Law

Digital Goods Non-Taxable

Digital Goods Taxed by Statute

COST®
COUNCIL ON STATE TAXATION

QUESTIONS?

THANK YOU!

2016 Outlook Conference

ATRA Staff

Government Property Lease Excise Tax (GPLET)

Kevin McCarthy

GPLET Definition

- Mechanism to tax private concerns on certain government properties
- Officially an “excise” tax that is based on the square footage & use of a building rather than property value
- Enacted in 1996 to replace tax on possessory interests that was repealed in 1995
- GPLET is levied on property that is owned by a city, town, county or county stadium district and leased to a private concern

GPLET - How did we get here?

- Early 80's, cities began to aggressively use their tax exempt status to shield private development from property tax
- Legislature enacted a possessory interest tax in 1985 - a property tax on privately held improvements on government-owned property
- Newly created tax provided exemptions to existing deals created prior to April 1, 1985
- In 1993, Court struck down exemptions as unconstitutional in the Scottsdale Princess case

GPLET Enacted in 1996

- The Legislature stated the purpose was to:
  - Be an excise tax, and not an *ad valorem* tax
  - Address the problems that existed with the possessory interest tax (i.e. exemptions)
  - **Make whole the taxing jurisdictions that depended on revenues under the prior law**

GPLET 1996 Structure

- Applied to cities, counties and county stadium districts
- Based on square footage & type of building - not its value
- Exemptions found unconstitutional under the possessory interest tax included as exemptions under GPLET
- GPLET collections distributed to taxing jurisdictions as follows:
  - Schools 73%, Counties 13%, Comm Colleges 7%, Cities 7%
- Maintained 8-year tax abatement in central business district

GPLET-Shortfalls of 1996 law

- Despite legislative intent GPLET fell well short of goals
- GPLET became an incentive not a hammer
- Huge tax advantage compared to possessory interest tax
- Rates reduced 20% every 10 years until reaching zero in the 50th year
- By late 90's, dramatic expansion of GPLET got attention of policymakers
- Citizens Finance Review Commission recommends significant reforms:
  - Expand to all government jurisdictions
  - After abatement property should pay tax commensurate with the property tax in the area

Where are we now? 2010 GPLET Reforms:

- Maximum lease 25 years, including 8-year abatement
- Rates nearly doubled but still lower than property taxes
- Rates adjusted annually by new construction inflation index
- CBD defined-single & contiguous geographical area within slum/blight, no larger than > of 5% of total land area or 640 acres
- City required to notify all taxing entities 60 days prior to approval, provide economic fiscal benefit analysis 30 days prior
- GPLET lease filed with County Recorder, Treasurer, and DOR

AG 2015 Audit Revealed Major Flaws

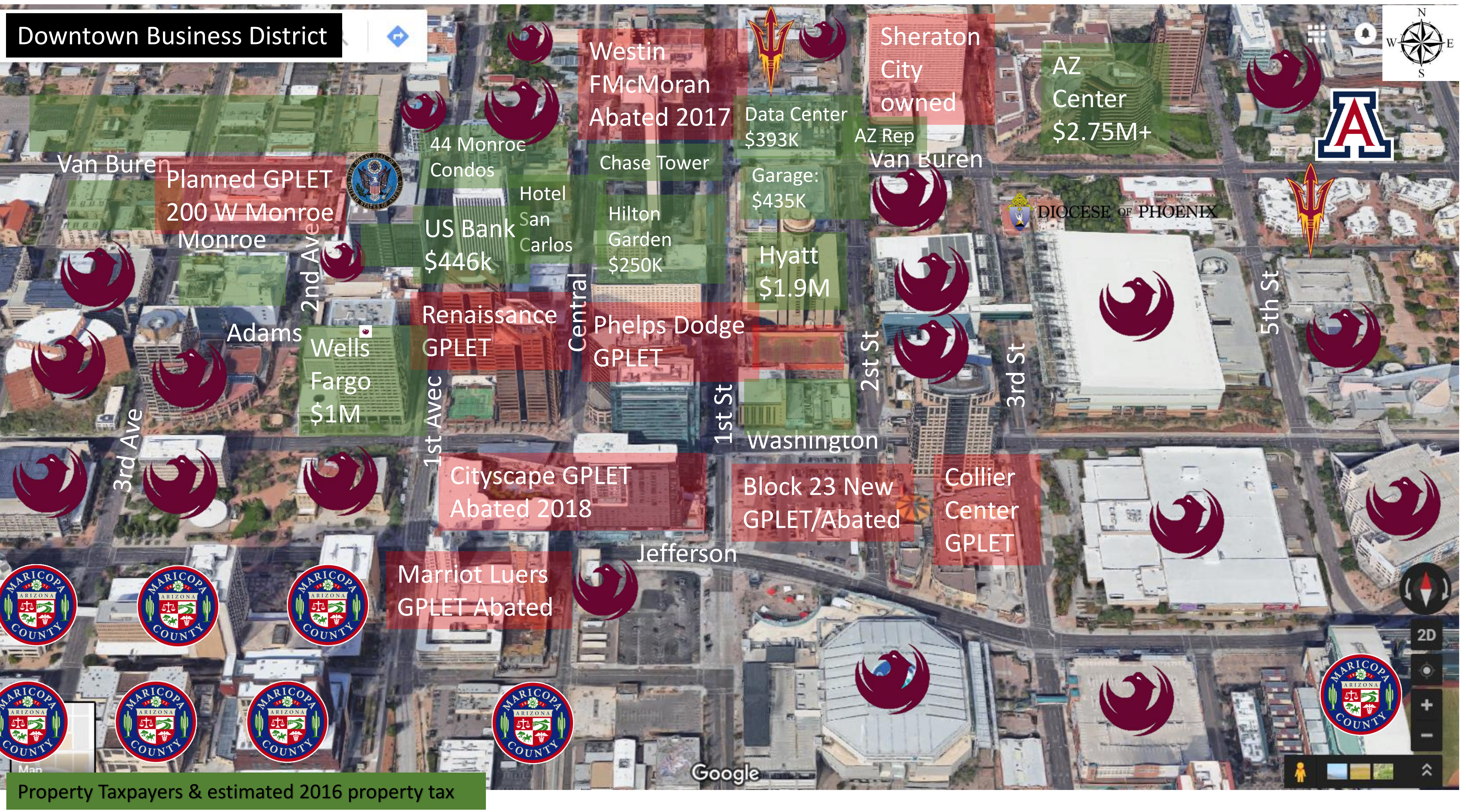
- 2010 revisions have not resulted in increased revenue as expected
  - Nearly half of 268 leases are under 8-yr abatement
  - 45% paying GPLET under old rate structure/only 6% pay new rates
- Many cases in which GPLET incorrectly calculated
- GPLET distributions to jurisdictions done incorrectly
- Only 3 of 7 counties with GPLET reported GPLET values to ADE
- County Treasurers failed to assess penalties and interest on delinquent GPLET payments-loss of revenue to counties
- Overall, governmental entities indicated a general lack of understanding of GPLET requirements
- Success of tax abatement in promoting redevelopment unknown

Why is this so important?

- Central planners picking winners & losers
- GPLET increases state aid payments to school districts – impacting all taxpayers statewide
- Higher property tax rates on other properties
- Increased 1% Cap costs for state GF

Cities picking winners & Losers

- There is no clear criteria for who receives a GPLET and who is denied
- Path dependency leads to more GPLETS
- Similarly situated businesses put on dramatically uneven playing fields
- Central planners – not the free market – decide which developments succeed and fail


Downtown Business District
Westin FMcMoran Abated 2017
Sheraton City owned
AZ Center $2.75M+
Data Center $393K
AZ Rep
44 Monroe Condos
Chase Tower
Van Buren
Van Buren
Planned GPLET 200 W Monroe
Monroe
Garage: $435K
DIOCESE OF PHOENIX
Hotel San Carlos
US Bank $446k
Hilton Garden $250K
Hyatt $1.9M
2nd Ave
Renaissance GPLET
Central
Phelps Dodge GPLET
Adams
Wells Fargo $1M
5th St
2st St
3rd St
1st Avec
1st St
Washington
3rd Ave
Cityscape GPLET Abated 2018
Block 23 New GPLET/Abated
Collier Center GPLET
Jefferson
Marriot Luers GPLET Abated
Google
Property Taxpayers & estimated 2016 property tax

Multifamily Housing Roosevelt Row

State aid to schools

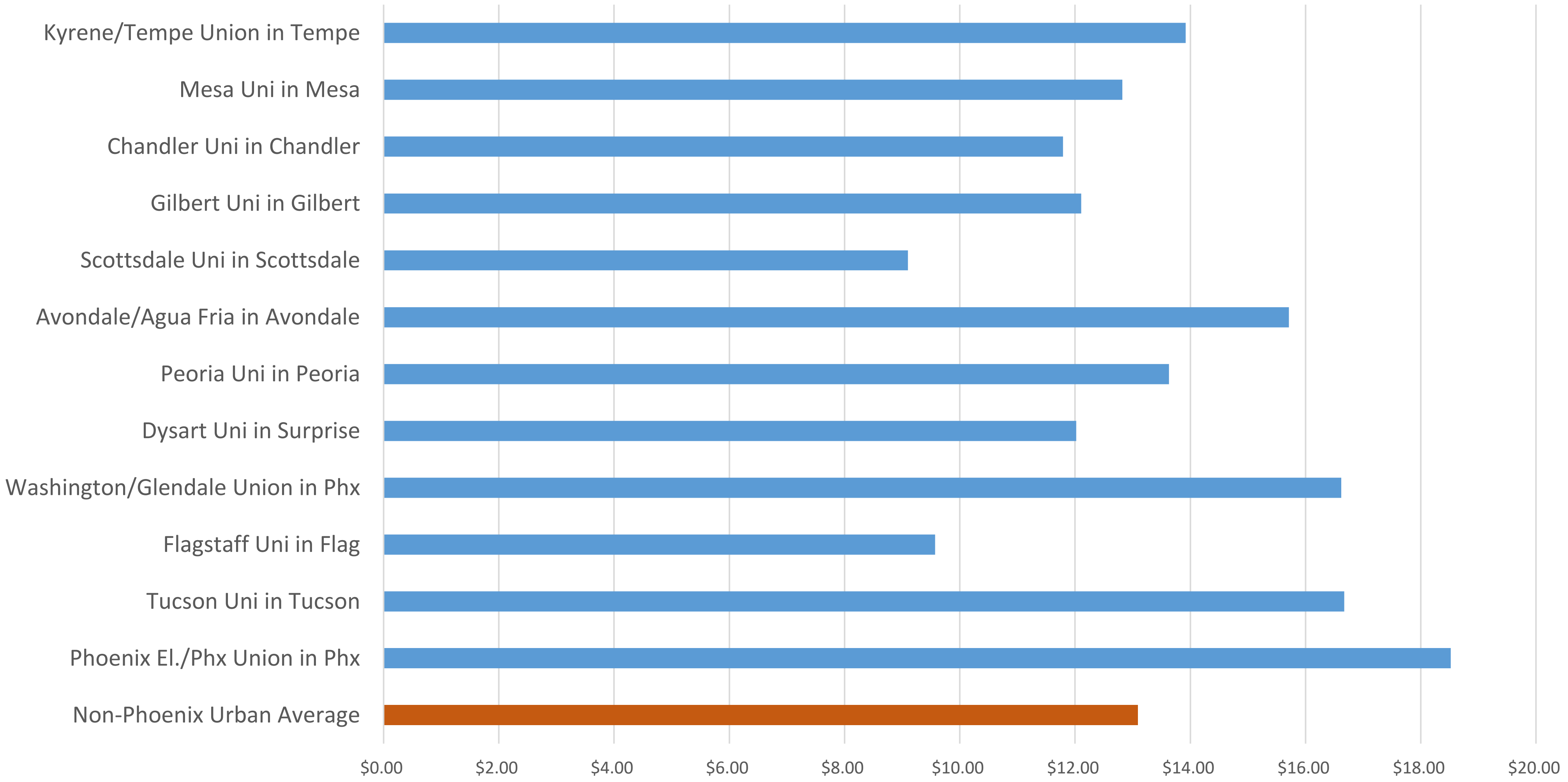
- State aid to school districts varies depending on district property values

- GPLET/Tax abatement increases state aid payments to school – exporting that burden to other jurisdictions

Higher property tax rates

- Loss of property value on tax roll leads to higher tax rates for schools, counties, community colleges and cities
- Total tax rate for Phoenix Elementary/Phoenix Union/City of Phoenix has climbed from $14.41 to $18.52 in 10 years – a 29% increase

FY 2017 Combined Property Tax Rates Urban AZ



Increases 1% cap costs to GF

- The rate to be a 1% cap district in 2016 is $11.96
  - Roosevelt El/Phx Union: $12.2679
  - Phoenix El/Phx Union: $12.1485
  - Isaac El/Phx Union: $14.2839
  - Wilson El/Phx Union: $12.3364
  - Cartwright El/Phx Union: $12.2091

State Farm on ABOR property

Where Should We Go? More Reforms Needed

- Prospectively require all GPLET's to pay K12 school taxes during abatement period
- Repeal 2010 Grandfathering provision – all new GPLET's fall under 2010 rates
- Add all state & local governments to the Lessor Definition
- Government lessor calculates GPLET tax – not lessee

Deseg/OCR Update

Sean McCarthy

Deseg: Brief Intro

- $4.5 billion levied for Deseg/OCR since 1986
  - 18 School Districts
  - More than half to Phoenix Union & Tucson Unified
  - 97% goes to metro Phoenix & Tucson schools
- $211 million levied annually via primary property taxes
- Not equalized by state; outside RCL
- Capped in 2009, not tied to pupils or inflation
- Not voter approved; no planned phase out

Highlighted as the most problematic inequity issue for K-12 finance

Deseg: The Good News

- Debate has shifted
  - Nearly all stipulate that Deseg/OCR has run its course
  - District reps no longer misleading on legal implications
- Focus is how and when to phase it out
  - Districts asking for new, targeted funding
  - Hold harmless phase out
  - ELL & poverty weights
- Bad news: no real progress; taxpayers suffer

2017 Deseg Bill Concepts

- TNT hearings required for FY18, FY19
  - Transparency to district; explain Deseg/OCR levy
  - Standard TNT reporting & board hearing requirements
- Voter approval for all Deseg/OCR levies, 5 yr renewal
  - Beginning with the FY20 levy (Nov '18 election)
  - Shifts Deseg/OCR levies to secondary property tax
  - Alleviates 1% cap issue
- New cap: lesser of current cap or an override
  - 15% of RCL, same as M&O override: improves equity
  - 6 of 19 districts would phase out delta over 5 yrs

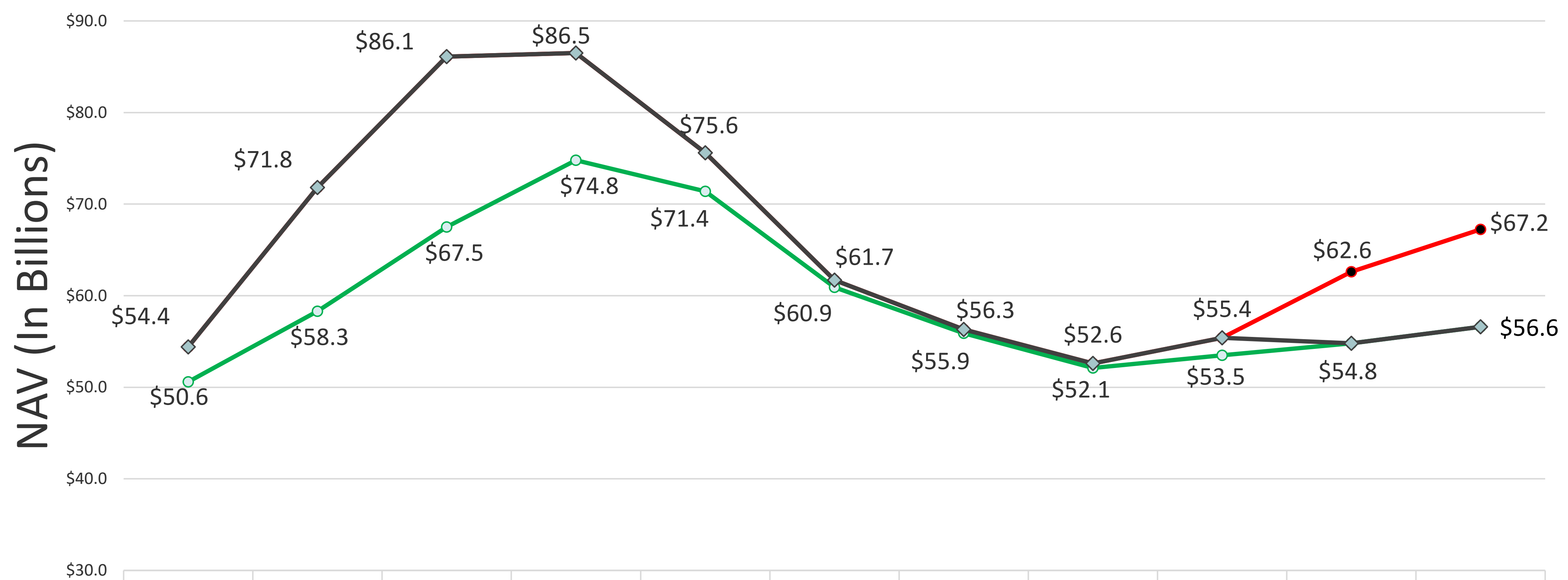
Property Tax Update

Jennifer Stielow

Prop 117

- Stabilize Arizona's Property Tax System
  - Greater predictability for government & taxpayers
- End the roller-coaster
  - Insulate taxpayers from dramatic swings in tax bills due to major fluctuations in R.E. market
- Simplify Property Tax System
  - From dual to single valuation taxation-5% limit

10-Year Property Values

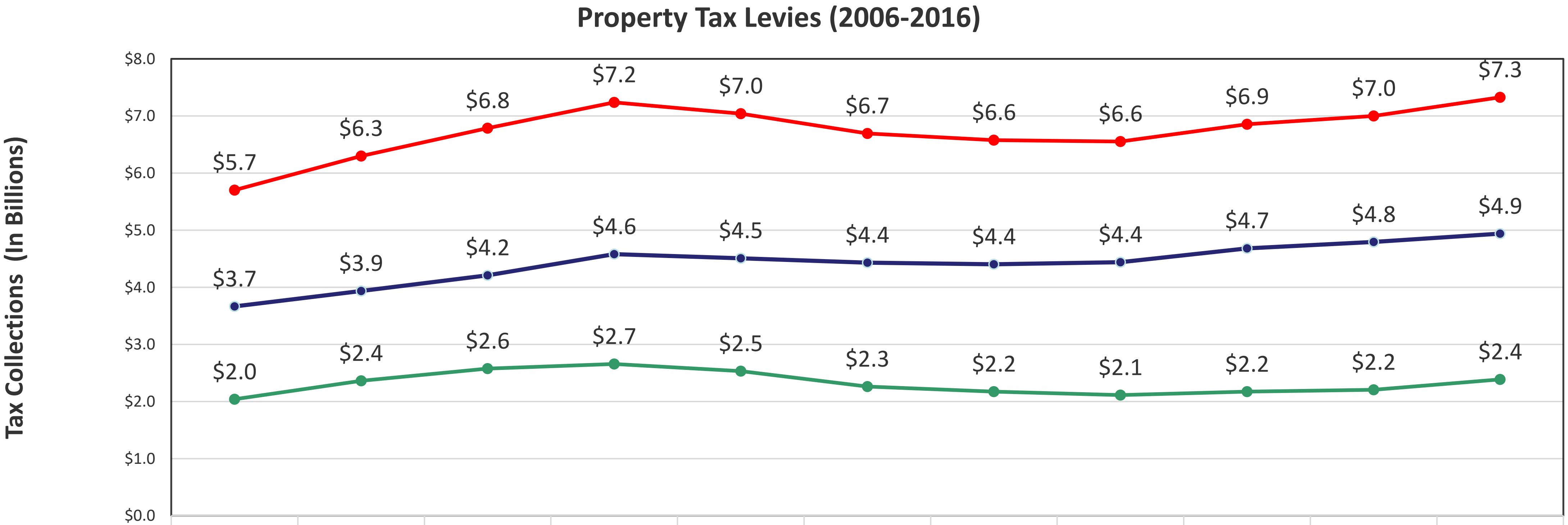


	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
FCV	$54.4	$71.8	$86.1	$86.5	$75.6	$61.7	$56.3	$52.6	$55.4	$62.6	$67.2
LPV	$50.6	$58.3	$67.5	$74.8	$71.4	$60.9	$55.9	$52.1	$53.5	$54.8	$56.6
NAV	$54.4	$71.8	$86.1	$86.5	$75.6	$61.7	$56.3	$52.6	$55.4	$54.8	$56.6

Tax Year

The taxpayer's watchdog for over 75 years

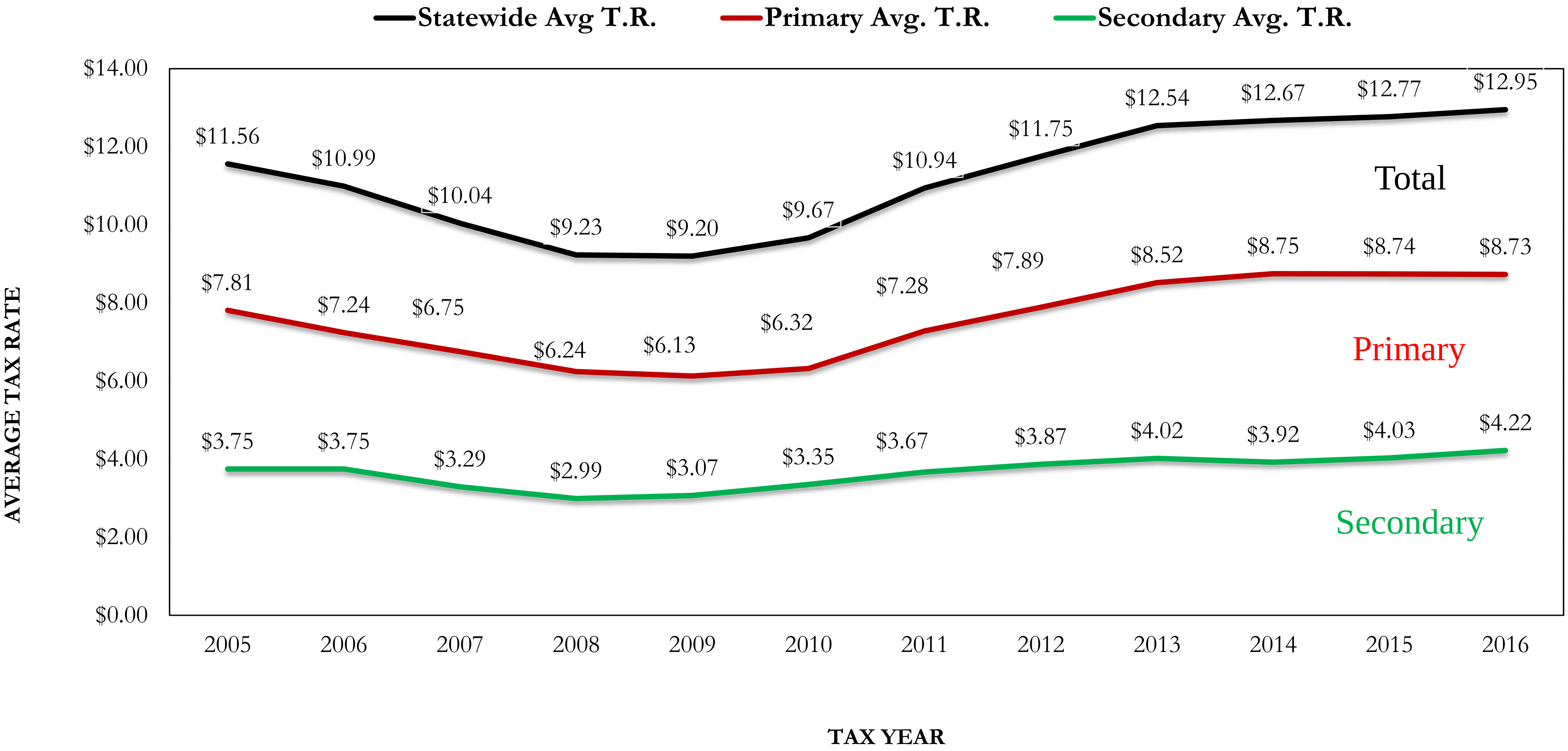
10-Year Property Tax Levies



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Primary	$3.7	$3.9	$4.2	$4.6	$4.5	$4.4	$4.4	$4.4	$4.7	$4.8	$4.9
Secondary	$2.0	$2.4	$2.6	$2.7	$2.5	$2.3	$2.2	$2.1	$2.2	$2.2	$2.4
Total	$5.7	$6.3	$6.8	$7.2	$7.0	$6.7	$6.6	$6.6	$6.9	$7.0	$7.3

Tax Year

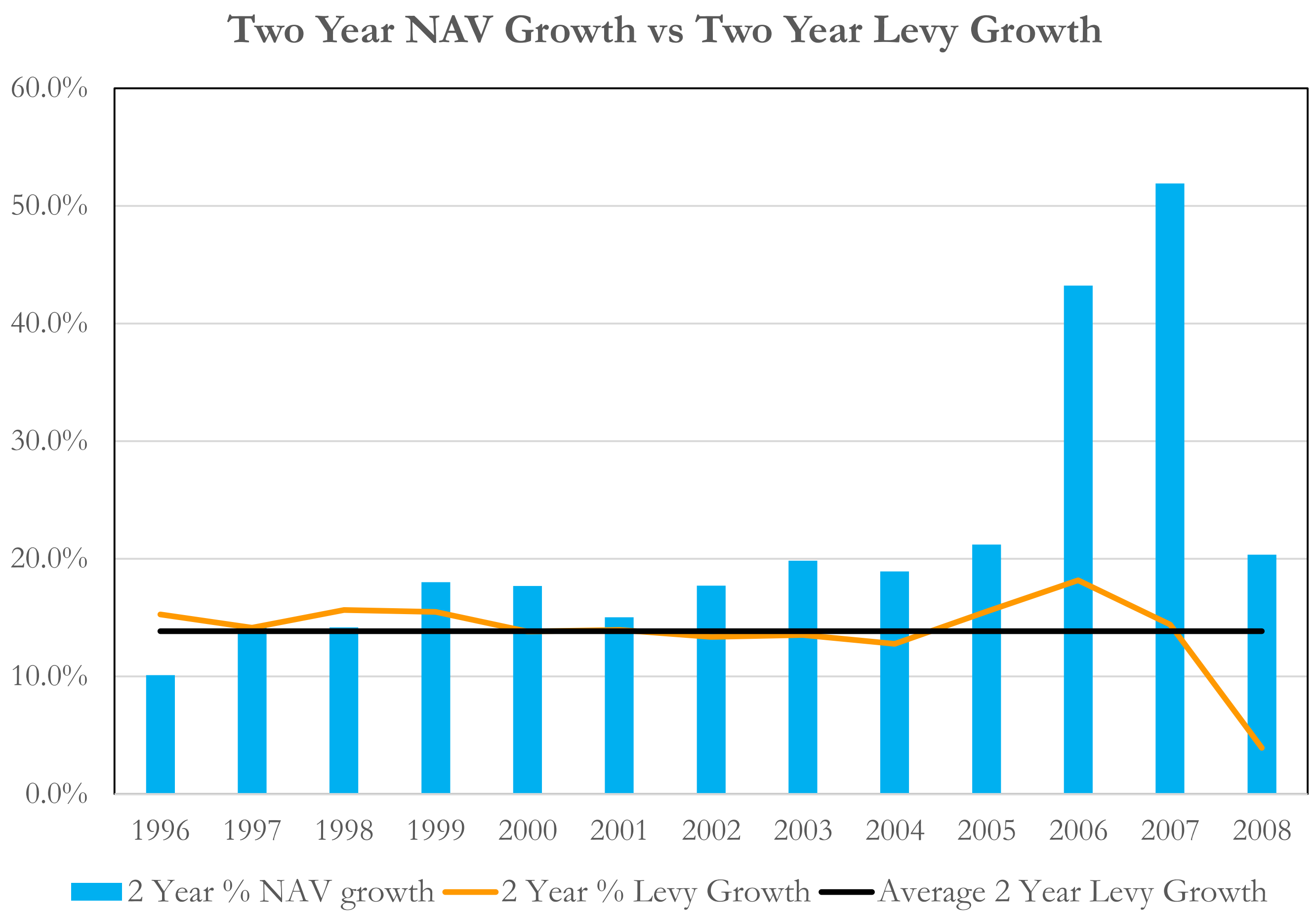
Statewide Average Tax Rates



The taxpayer's watchdog for over 75 years

Levy Growth during NAV Growth

- ‘96-’08: Boom years
  - Strong, steady growth in values
  - Levy growth averaged 14% over 2 years
- Last two years:
  - FCV grew 22%
  - NAV up only 5.7%
  - Levy growth 6.9%



Prop 117: What We Thought Would Happen

- First two years of Prop 117 in the books
  - Primary statewide property tax rate flat: 8.75 to 8.73
  - Most increases voter approved: 3.92 to 4.22
- Levy growth HALF that of historical rate
  - 6.9% over last two years down from 14% average
- Tempered growth slows tax increases
- “Leaving the rate the same” no longer an avenue to significant tax increases
- Significant tax levy increases will require transparent and public rate increase hearings
  - Examples: City of Phoenix, Town of Gilbert

1% Homeowner Cap

- 1980 Constitutional reform to protect homeowners
- Total **primary** property taxes cannot exceed 1% of limited property value
  - Limited to $10 rate per $100 of assessed value
  - Includes all jurisdictions: State, K-12, City, County, Community College
- Protects no other class of property
  - Renters, ranchers, farmers, businesses, etc.
- Insulates capped homeowners from tax increases
- Incomplete version of California Prop 13
- State “picked up the tab” for 35 years (statutory)

1% Homeowner Cap

State City College County K-12

Exempt from amount in excess

$10 rate
(1%)

Homeowner

All other taxpayers have no $10 cap

Renters, Businesses, Agricultural, etc

They pay the full primary and secondary tax rate

**All taxpayers pay the full secondary tax rate*

All other

Managing the 1% Cap

- For decades, ATRA has encouraged lawmakers to avoid changes which collide with the 1% cap

- System designed to minimize 1% Cap violations
  - School QTR follows changes in assessed value
  - Homeowner rebate intended to decrease the primary rate
  - Caps on rate growth for cities, counties & community colleges
  - State rate is low ($0.50)

- Policymakers must consider 1% cap implications in all property tax reforms

What Drives the 1% Cap?

- High Tax Counties: Pima, Pinal
- High Tax School Districts: Deseg, Small Schools
- High Tax Cities: Maricopa, Superior

- If addressed, the vast majority of 1% cap costs are eliminated

1% Homeowner Cap Struck Down

- Governor Ducey's 2015 budget intent: end the unlimited state subsidy of high taxing jurisdictions
  - Shift responsibility to local taxing authorities with above average tax rates
  - PTOC would calculate penalties
- July: Superior court struck down entire law
  - Concurred with plaintiffs: PTOC inappropriate lever
  - "Impermissibly delegating the legislative power of taxation"
  - Result: State GF back on hook financially
  - Other plaintiff claims not addressed

Taxpayers Need a 1% Cap Fix

- ATRA predicted new formula would simply raise tax rates
  - Tax rate increases from several 1% cap liable jurisdictions
    - Pima County, Pinal County, Pinal County Community College District (Central AZ College), Town of Superior
  - Homeowners insulated from increases again
  - As rates rise, liability for 1% cap also rises
  - Property taxpayers put in death spiral
- Fix necessary
  - 1% cap fix shouldn't expose non-class 3 properties to even higher taxes
  - Precedent: Maximum school tax rate law for high rates in 1% cap areas

ATRA Recommendations

- Direct Approach: Address High Primary Taxes
  - Deseg Levies
  - Small Schools
  - High Tax Rate Cities
  - Pima County Sales Tax Change
- Indirect Approach: Taxpayers Need Protection with Rate Caps

ARIZONA TAX RESEARCH ASSOCIATION

Questions?

1814 W. Washington Street
Phoenix, Arizona 85007
(602) 253-9121

www.arizonatax.org
atra@arizonatax.org

The taxpayer's watchdog for over 75 years