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# **Revenue and Budget Update**

**Arizona Tax Research Association**

**November 14, 2017**

**JLBC**

# Key Points

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- ❑ '17 revenue growth was below budget; consensus foresees trend continuing
- ❑ New forecast results in projected Baseline cash shortfalls:
  - '18 = \$(24) M
  - '19 = \$(80) M

# How Did We End Up with a Projected Shortfall?

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- ❑ '18 General Fund budget balance had little margin for error – 0.4%
- ❑ At that rate, small forecast shortfall easily pushes us negative
- ❑ 1% variance in forecast yields \$635 M over 3 years

## The Shortfall Could Be Eliminated if . . .

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- ☐ Projected revenue growth improves slightly (signals are mixed)

## The Shortfall Could Be Worse if . . .

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- ☐ We continue \$90 M of 1-time '18 spending in '19

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# Revenue Forecast

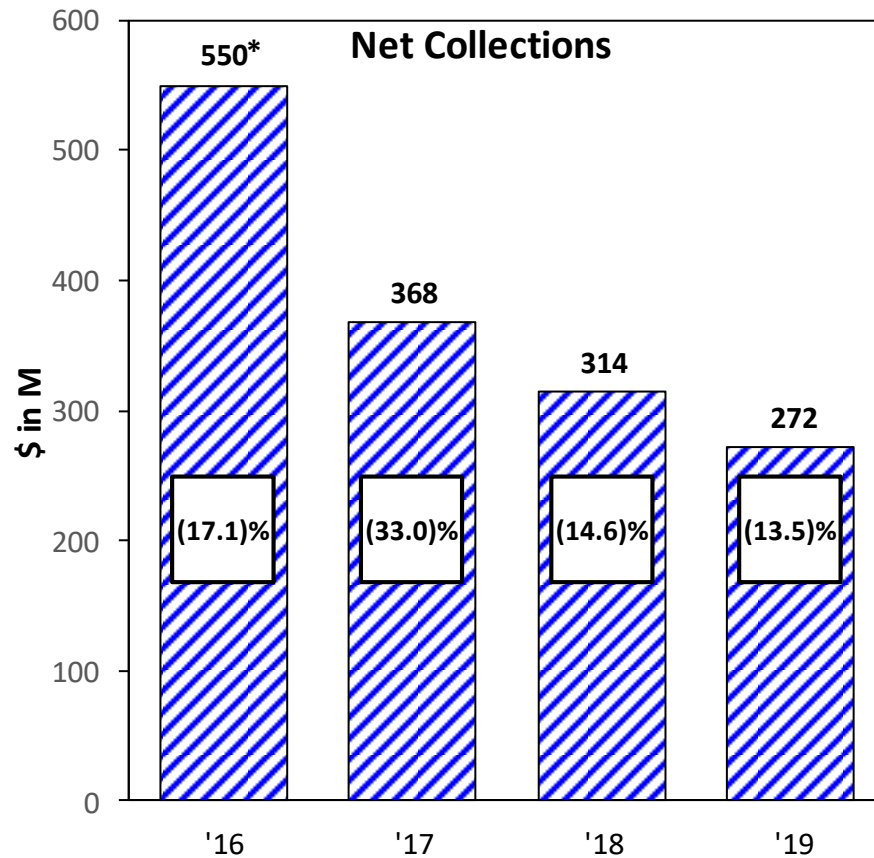
## '17 – Slowest Growth Since '10

	<u>'17 Actual</u>	<u>Forecast Error</u> <u>(\$ in M)</u>
Sales/TPT	4.5%	55
Individual Income	4.1%	12
Corporate Income	(35.5)%	(52)
Insurance Premium	2.8%	(11)
Unclaimed Property/Other	(2.9)%	(23)
Overall	1.5%	(19)

- ❑ '17 Revenues were \$(19) M below forecast; would have been positive \$33 M without Corporate
- ❑ 4.0% growth in 1<sup>st</sup> Quarter of '18, \$17 M above forecast

# Corporate Loss \$52 M Higher Than Expected

- Forecast was \$420 M, ended at \$368 M



- Corporate audit collections declined by \$(27) M
- Flat profit growth may have also contributed to loss
- '18 collections lowest since '93

\* Excludes tax amnesty collections

# Consensus: Modest Growth Through '21

## October Consensus Forecast

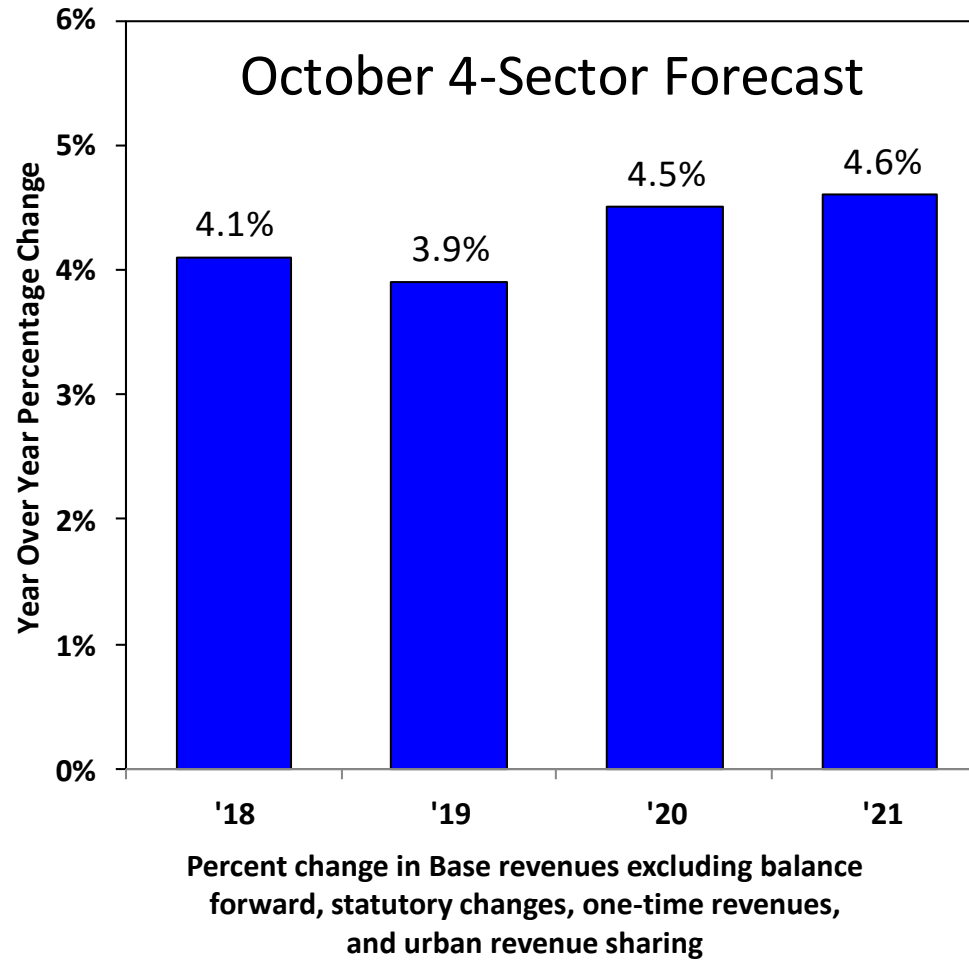
- ❑ Finance Advisory Committee
- ❑ UA model – base
- ❑ UA model – low
- ❑ JLBC Staff

## Chance of Exceeding Forecast

- ❑ 60%

## Long Run Average Growth

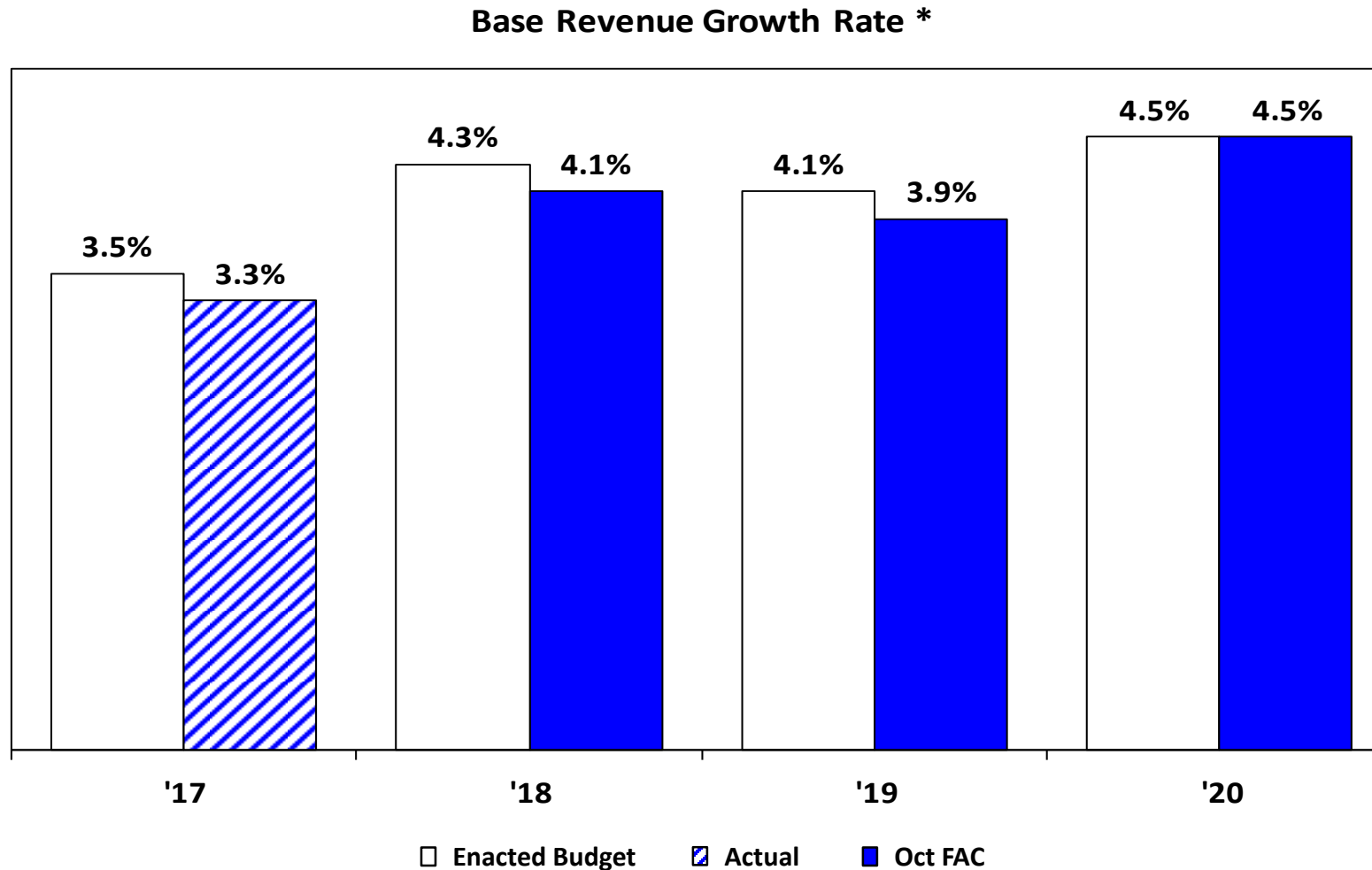
- ❑ 4.6%





# '18 & '19 Forecast Below Enacted Budget

## - Primary Reason for Projected Shortfalls



# Forecasted Net '19 Revenue Growth is 3.3%

## - Net Growth Adjusts Base for Transfers & Tax Cuts

	\$ in M			
	'18	'19	'20	'21
Base Revenue Growth (4.1%/3.9%/4.5%/4.6%)	414	397	482	514
Loss of 1-Time Fund Transfers	(137)	(8)	0	0
Previously Enacted Tax Legislation	(117)	(75)	(6)	(6)
Urban Revenue Sharing	(17)	6	(19)	(16)
Total	143	320	457	492
% Change	1.5%	3.3%	4.6%	4.7%
<b>Total Resources (\$ in B)</b>	<b>9.65</b>	<b>9.97</b>	<b>10.42</b>	<b>10.91</b>

Excludes Change in Beginning Balance

# Comparison of '16 vs '17 Tax Credits

- Includes Individual, Corporate and Insurance

\$ in M			
<u>Credit</u>	<u>'16</u>	<u>'17</u>	<u>\$ Change</u>
School Tuition Organizations	155	161	6
Public School Extracurricular	46	46	0
Research & Development	109	109	0
Charitable Organizations	37	71	34
Renewable Energy/Solar	15	15	0
New Employment	9	12	3
Other	26	26	0
<b>Total</b>	<b>397</b>	<b>440</b>	<b>43</b>

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# **Spending Forecast**

# '18 – '21 Baseline Spending Projections

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- ☐ Reflects changes to active statutory and other funding formulas - no discretionary additions
- ☐ Continues annual suspension of \$513 M of inactive formulas and \$931 M K-12 Rollover
- ☐ Excludes conversion to K-12 A-F grades – \$11 M?
- ☐ Baseline includes no '19 HURF shift as agreed to in last year's budget

# Projected Baseline Spending Increases by \$226 M

- '19 Statutory Spending Offset by Elimination Of 1-Times

Spending Above Prior Year	
	\$ in M
	<u>'19</u>
ADE – K12 Formula	148
AHCCCS – Medicaid Formula	112
DES – Medicaid Formula	47
U's – Capital Payment	27
Other	<u>17</u>
<b>Total</b>	<b>351</b>

Spending Below Prior Year	
	\$ in M
	<u>'19</u>
SFB Debt Service	(35)
<u>Loss of 1-Times</u>	
County Assistance – DJC Offset	(8)
DES – DD Prop 206 Minimum Wage	(12)
ADE IT System Support	(7)
SFB Building Repairs	(17)
Universities	(15)
State Employee Health	(25)
Other	<u>(6)</u>
<b>Total</b>	<b>(125)</b>

<b>Total Spending Changes</b>	<b>\$226 M</b>
<b>Total Spending</b>	<b>\$10,041</b>
<b>% Change</b>	<b>2.3%</b>

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# **Cash and Structural Balance Forecast**

## '19 – A Structural Balance But A Cash Shortfall

- ❑ Ongoing revenues exceed ongoing spending
- ❑ Not enough, however, to pay for \$99 M 1-time \$ — primarily SFB
- ❑ Excludes \$460 M Rainy Day Fund Balance

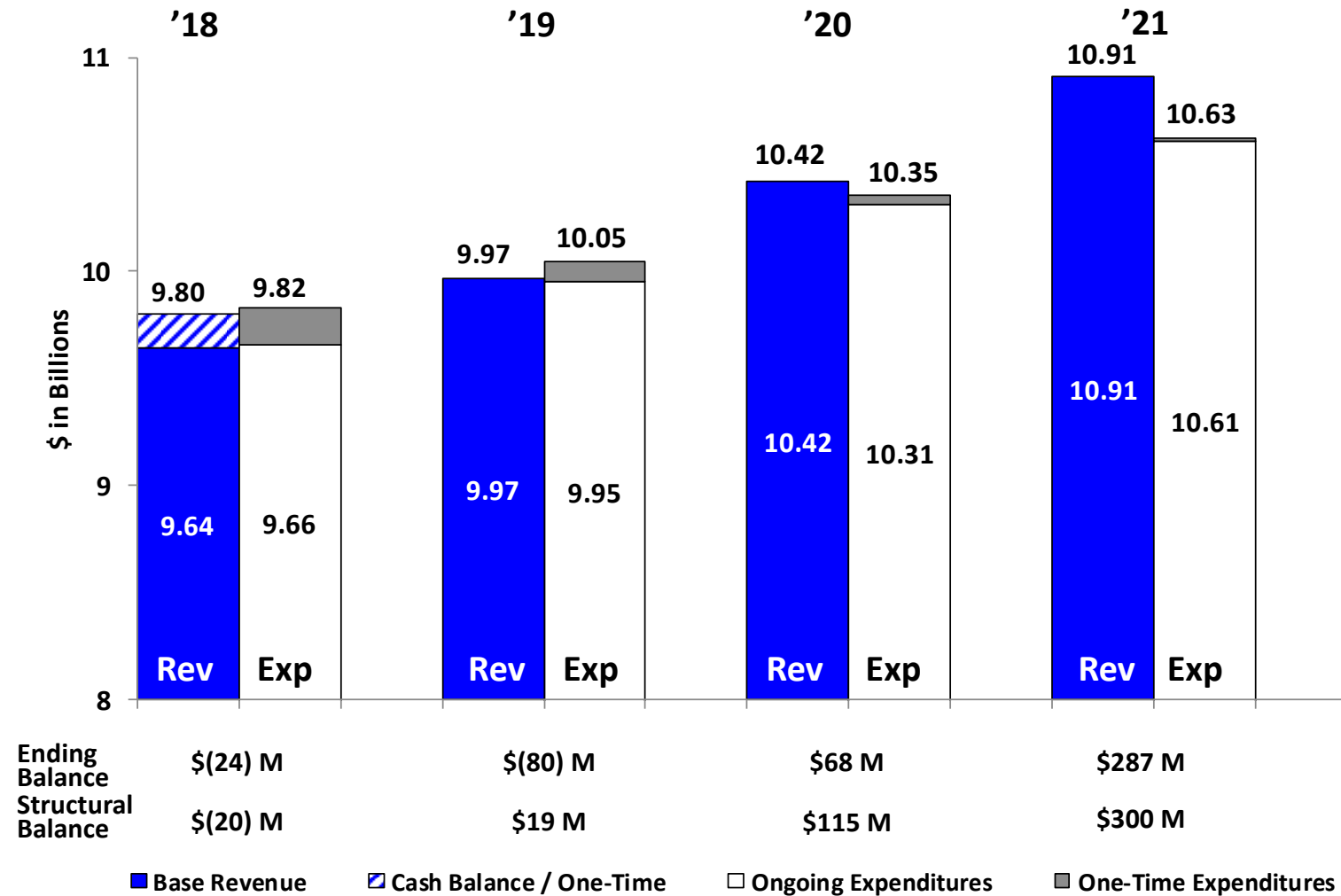
FY 2019 Baseline Projection	
	(\$ in M)
Balance Forward	\$ 0
Ongoing Revenues	9,965
Ongoing Spending	(9,946)
One-Time Spending	(99)
Cash Balance	\$ (80)

\$19 M Structural Balance



# Projected '21 Balance Grows to \$287 M

- Represents Unlikely Scenario



Projected cash shortfalls assumed to be solved  
as part of the budget process

# Forecast Risks

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- ❑ Estimates assume no discretionary changes in next 3 years
- ❑ Assumes no recession through '21; would be longest US expansion on record
- ❑ Impact of federal tax changes – could stimulate growth, but there are state conformity issues
- ❑ Federal health care changes could be revived – debate about \$ impact; likely a loss
  - In addition, state loses \$ if feds do not reimburse us for KidsCare

# '18 Session Considerations

## - Even if They Do Not Work as Shortfall Solutions

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- ☐ Budget Stabilization Fund's \$460 M Balance
  - Could Fill '18/'19 Gap, but Hard to Depend on '21 Surplus Projection
- ☐ Drug Rebate Fund's \$70 M Balance
  - 1-time only, used \$30 M in '17
- ☐ Volkswagen \$57 M Settlement
  - Targeted emission reductions; are fund shifts possible?
- ☐ Medical Marijuana Fund's \$40 M Balance
  - Likely would require a return to the voters



## 2017 Tax Policy Outlook

Property tax update/challenges

Potential sales tax increases?

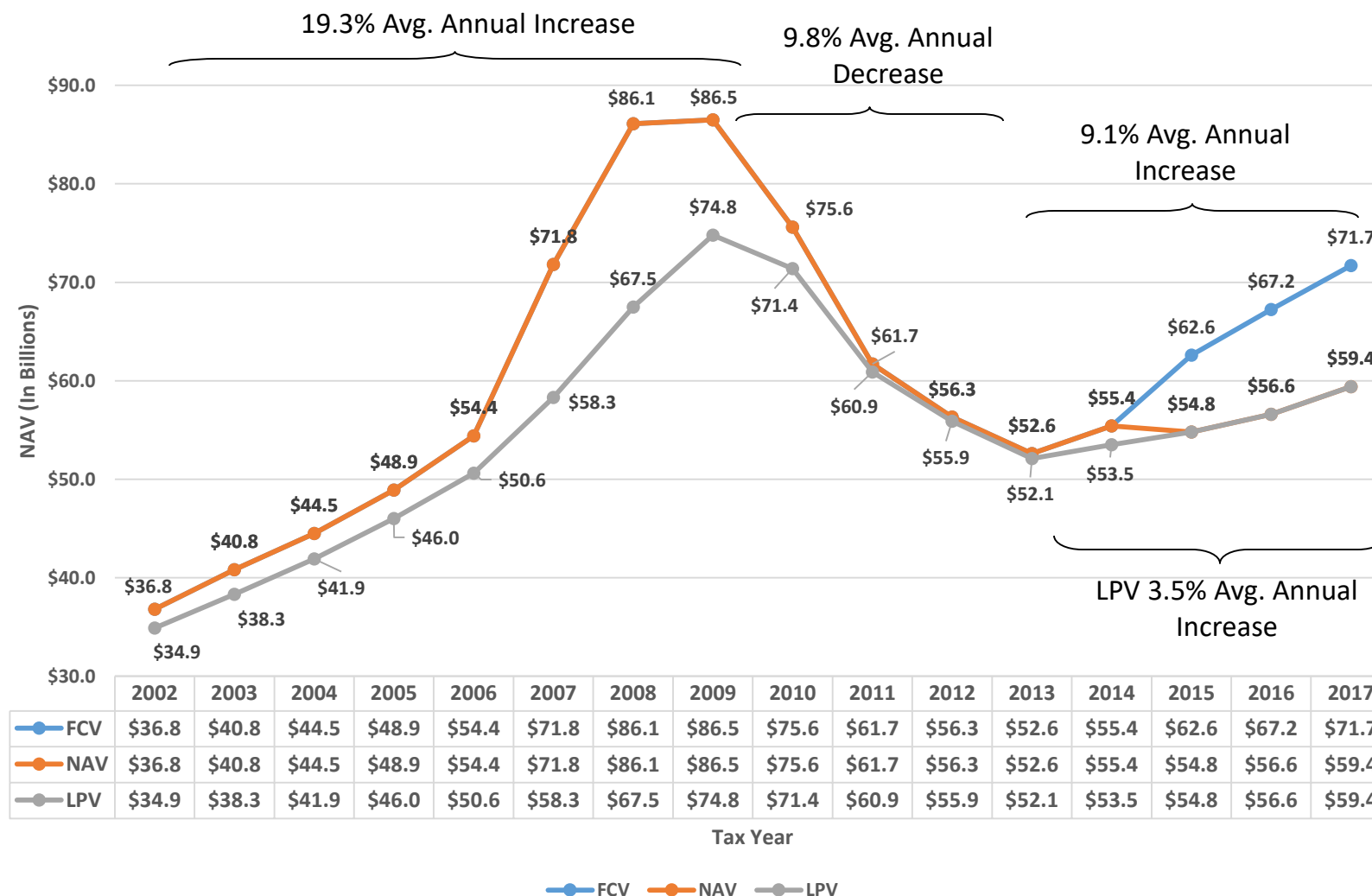
School finance reform

Kevin McCarthy, ATRA President

Jennifer Stielow, ATRA Vice President

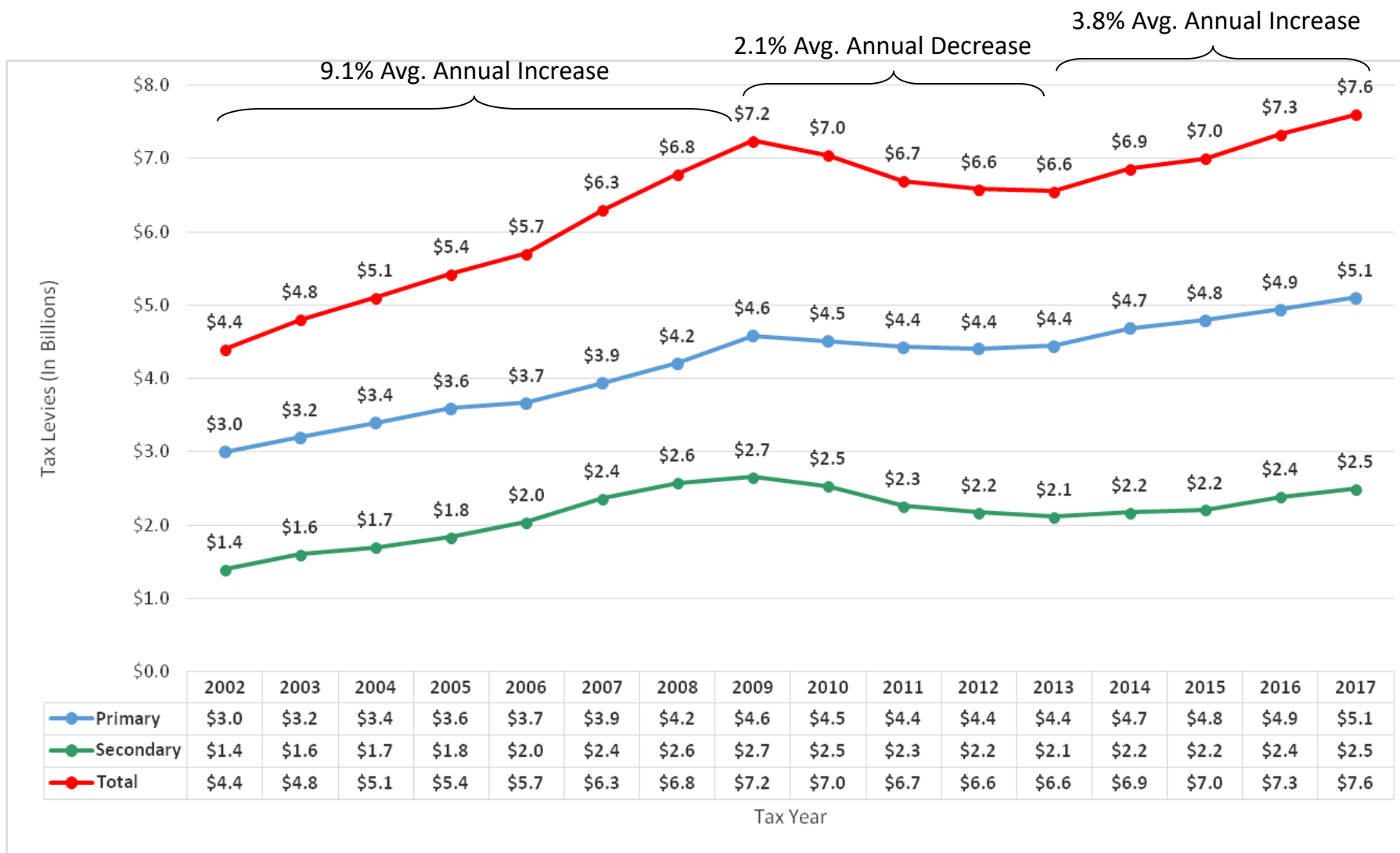


# 15-Year Property Values





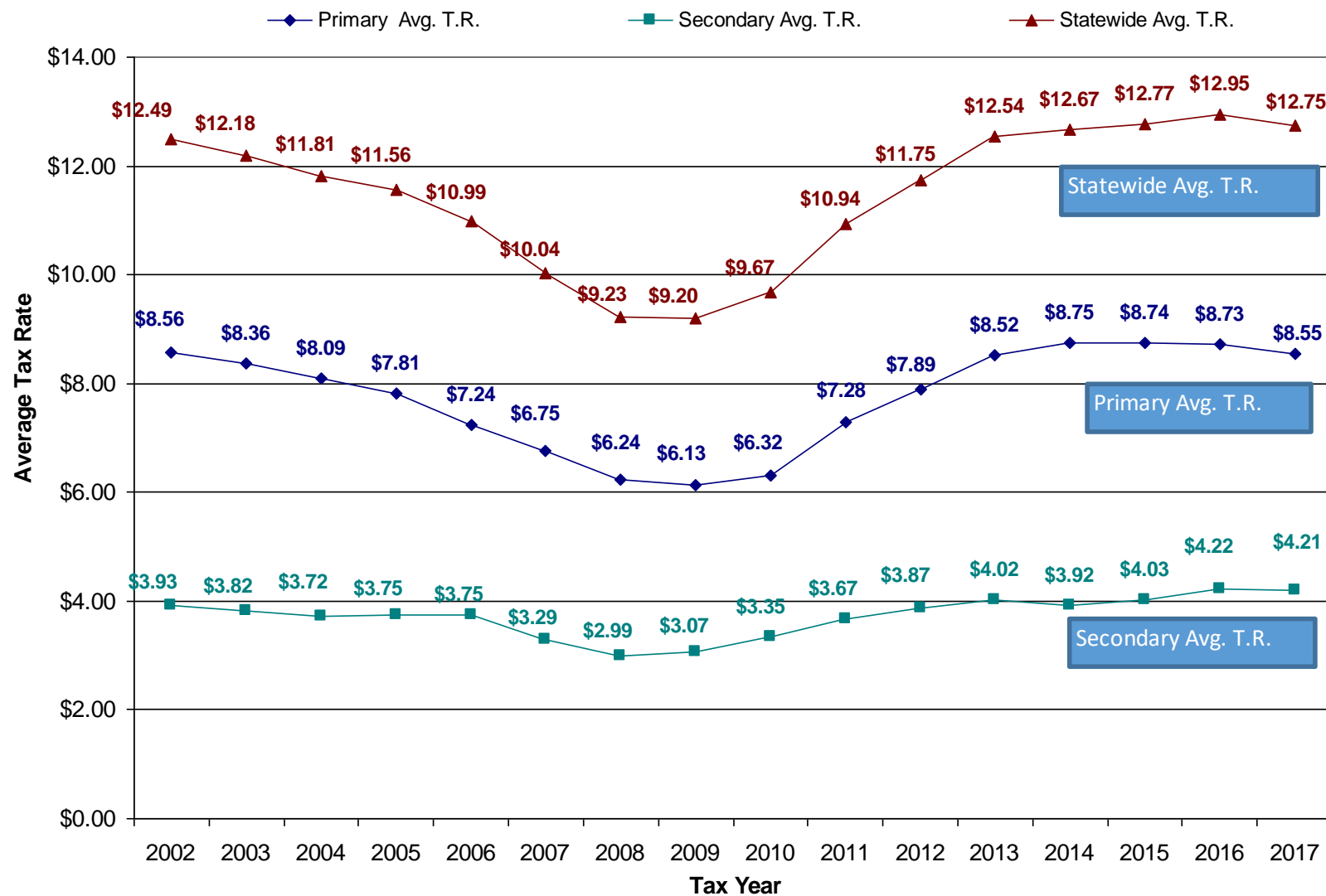
# 15-Yr Property Tax Levies



*The taxpayer's watchdog for over 75 years*



# Statewide Average Tax Rates



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## Prop 117

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- Taxpayer Protection
  - 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
- Stabilize Arizona's Property Tax System
  - Greater predictability for government & taxpayers





## Prop 117: Three Years in the Books

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- Statewide Avg. tax rate down 20 cents
  - Primary average tax rate down: 8.73 to 8.55
  - Secondary average tax rate down: 4.22 to 4.21 (voter approved bonds & overrides)
- Dramatic tax increases no longer on auto-pilot from leaving tax rates the same
- Significant tax increases now transparent
  - Board/Council must actively adjust tax rate upward
  - Pima County increased primary property taxes dramatically (25 cents over TNT) to fund transportation projects



# Residential vs. Industrial Property Rankings

## Minnesota Study-Phoenix

Residential Property Taxes Payable 2016 \$150,000 Land and Building			
Rank	State	NET TAX	ETR
28	Arizona	1,772	1.181%
	<i>U.S. Average</i>	<i>2,196</i>	<i>1.464%</i>

Industrial Property Taxes Payable 2016 \$25,000,000 Land and Building \$12,500,000 Machinery and Equipment \$10,000,000 Inventories \$2,500,000 Fixtures			
Rank	State	NET TAX	ETR
9	Arizona	1,092,164	2.184%
	<i>U.S. Average</i>	<i>825,441</i>	<i>1.651%</i>

## Statewide Average Tax Rate

Residential Property Taxes Payable 2016 \$150,000 Land and Building			
Rank	State	NET TAX	ETR
39	Arizona	1,319	0.879%
	<i>U.S. Average</i>	<i>2,196</i>	<i>1.464%</i>

Industrial Property Taxes Payable 2016 \$25,000,000 Land and Building \$12,500,000 Machinery and Equipment \$10,000,000 Inventories \$2,500,000 Fixtures			
Rank	State	NET TAX	ETR
21	Arizona	849,513	1.699%
	<i>U.S. Average</i>	<i>825,441</i>	<i>1.651%</i>



# Property Classification System

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<b>Class</b>	<b>Property Description</b>	<b>Assessment Ratio</b>
1	Commercial, Industrial, Utilities & Mines	<b>18%</b>
2	Agricultural & Vacant Land	<b>15%</b>
3	Owner-occupied Residential	<b>10%</b>
4	Rental Residential	<b>10%</b>
5	Railroad, Private Car, Airline Flight	<b>15%</b>
6	Residential Historic, Enterprise & Foreign Trade Zones	<b>5%</b>
7	Commercial Historic	<b>1%</b>
8	Rental Residential Historic	<b>1%</b>
9	Possessory Interests, leased property to certain nonprofits	<b>1%</b>



# Effective Tax Rates

## 2016 ETRs

Class	Total Taxable Full Cash Value	Percent of Total	Total Yield	Percent of Total	Effective Rate
1	122,447,516,032	21.11%	2,484,612,711	36.36%	2.03%
2	25,477,419,293	4.39%	360,648,744	5.28%	1.42%
3	287,636,060,921	49.58%	2,536,572,803	37.13%	0.88%
4	135,291,866,106	23.32%	1,375,959,879	20.14%	1.02%
5	1,837,053,248	0.32%	30,622,616	0.45%	1.67%
6	7,107,704,240	1.23%	43,034,526	0.63%	0.61%
7	29,824,808	0.01%	540,988	0.01%	1.81%
8	16,763,245	0.00%	108,562	0.00%	0.65%
9	328,904,821	0.06%	375,150	0.01%	0.11%
Total	580,173,112,714	100.00%	6,832,475,980	100.00%	1.18%

## 2005 ETRs

Class	Total Taxable Full Cash Value	Percent of Total	Total Yield	Percent of Total	Effective Rate
1	77,639,438,613	20.99%	2,067,055,937	40.74%	2.66%
2	24,871,825,014	6.73%	381,472,409	7.52%	1.53%
3	230,354,442,559	62.29%	2,206,080,931	43.48%	0.96%
4	33,300,215,237	9.00%	374,976,334	7.39%	1.13%
5	1,354,696,047	0.37%	31,126,393	0.61%	2.30%
6	2,267,257,439	0.61%	13,012,748	0.26%	0.57%
7	24,753,707	0.01%	440,071	0.01%	1.78%
8	10,413,991	0.00%	88,785	0.00%	0.85%
9	15,731,377	0.00%	11,482	0.00%	0.07%
Total	369,838,773,984	100.00%	5,074,265,089	100.00%	1.37%

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# State Farm on ABOR property

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- High business property taxes continue to drive interest in targeted tax breaks (GPLET & University Leasing)
- Consequences: Targeted tax breaks increase inequities in system & taxes for everyone



# Tax Increases and School Finance

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- Continued calls for tax increases for K12 schools
- Despite \$300 million annual increase (\$3.5 billion) over 10 years
- Regrettably, that \$3.5 billion will be distributed with no recognition for the current inequities in the system
- As soon as the state settled the *Cave Creek* litigation another capital lawsuit is filed
- Lawsuit includes a taxpayer uniformity challenge



# Property Taxes and School Finance

Inextricably linked

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- Almost half of all Az property taxes are levied by K12 schools –
- \$3.7 billion (49%) of the \$7.6 billion levied
- System that was once designed for equity has developed significant inequities
- Inequities are amplified in Arizona's large school choice system
- School property tax problems lead to larger public finance challenges



## State and Taxpayers face Perpetual Lawsuits

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- Latest capital lawsuit includes a taxpayer uniformity challenge
- Count III: School finance system violates Art 9 section 1 of Arizona Constitution because taxes are not uniform within the State
- Count IV: Tax effort varies from district to district and therefore denies equal privileges and immunities in violation of Art 2 section 13





# Total K-12 Rate Comparisons FY18

Full QTR Districts Total School		Half QTR Districts Total School	
<i>Highest</i>		<i>Highest</i>	
Grand Canyon Uni	\$13.3731	Cartwright Elem	\$11.0462
Hayden-Winkelman Uni	\$11.8875	Isaac Elem	\$10.3922
Bowie Uni	\$11.1018	Laveen Elem	\$8.0437
Sahuarita Uni	\$9.0399	Roosevelt Elem	\$7.5256
San Simon Uni	\$8.9393	Alhambra Elem	\$7.1825
Sentinel Elem	\$8.9393	Phoenix Elem	\$6.9979
Redington Elem	\$8.6853	Pendergast Elem	\$6.8545
Double Adobe Elem	\$8.5783	Glendale Elem	\$6.3771
Ash Fork Uni	\$8.4911	Creighton Elem	\$5.8835
Douglas Uni	\$8.4331	Littleton Elem	\$5.8808
<i>Lowest</i>		<i>Lowest</i>	
Oracle Elem	\$2.5535	Mohawk Valley Elem	\$2.4839
Continental Elem	\$2.4991	Topock Elem	\$2.4606
Round Valley Uni	\$2.4718	Hyder Elem	\$2.4430
Chevelon Butte Elem	\$2.4661	Wellton Elem	\$2.4041
Morenci Uni	\$2.2327	Bullhead City Elem	\$2.3700
Cave Creek Uni	\$2.2122	Yuma Elem	\$2.3541
Ganado Uni	\$2.0911	Red Rock Elem	\$2.3166
Walnut Grove Elem	\$2.0537	Sierra Vista Union	\$2.2679
Eagle Elem	\$2.0234	Antelope Union	\$2.1656
Red Mesa Uni	\$1.6075	Bicentennial Union	\$1.2131

\*\*Lowest of districts that have a rate

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# Desegregation/OCR Expenditures

## Desegregation/OCR Tax Levies FY 2017

School District	FY 2017 Deseg Totals	TY 2016 Primary Rate	Deseg tax rate	FY 2017 RCL	Deseg levy as % of RCL	FY16 ADM	Deseg\$ /ADM
Tucson Unified	\$63,711,047	\$6.3831	\$2.0678	\$245,112,112	26.0%	45,397	\$1,403
Phoenix Union	\$55,800,892	\$3.4056	\$1.2891	\$154,977,258	36.0%	26,580	\$2,099
Tempe Elementary	\$14,178,248	\$3.0866	\$1.0866	\$56,951,039	24.9%	11,137	\$1,273
Roosevelt Elementary	\$13,570,494	\$4.3869	\$2.6086	\$45,455,264	29.9%	9,041	\$1,501
Phoenix Elementary	\$11,151,530	\$4.2675	\$1.8601	\$32,543,574	34.3%	6,516	\$1,711
Mesa Unified	\$8,774,057	\$4.7831	\$0.3258	\$338,069,407	2.6%	60,968	\$144
Scottsdale Unified	\$7,382,169	\$2.8566	\$0.1557	\$123,690,322	6.0%	23,024	\$321
Washington Elementary	\$6,350,000	\$2.8322	\$0.5556	\$117,244,046	5.4%	21,884	\$290
Cartwright Elementary	\$4,628,061	\$4.3281	\$2.2177	\$83,724,372	5.5%	17,437	\$265
Glendale Union	\$6,131,959	\$2.6713	\$0.4378	\$82,655,224	7.4%	15,069	\$407
Isaac Elementary	\$4,951,155	\$6.4029	\$4.1625	\$34,018,444	14.6%	6,855	\$722
Amphitheater Unified	\$4,025,000	\$4.1145	\$0.2799	\$71,794,265	5.6%	13,369	\$301
Holbrook Unified	\$2,517,481	\$3.4865	\$5.9653	\$12,244,001	20.6%	1,969	\$1,279
Flagstaff Unified	\$2,241,322	\$4.3908	\$0.2077	\$52,634,062	4.3%	9,333	\$240
Wilson Elementary	\$1,946,054	\$4.4554	\$2.1355	\$5,874,227	33.1%	1,106	\$1,760
Agua Fria Union	\$999,000	\$2.0845	\$0.0969	\$40,900,300	2.4%	7,506	\$133
Buckeye Elementary	\$1,608,921	\$3.6463	\$0.9394	\$24,302,931	6.6%	4,782	\$336
Maricopa Unified	\$1,291,000	\$4.5039	\$0.5036	\$33,536,728	3.8%	6,082	\$212
<b>Totals/AVG</b>	<b>\$211,258,390</b>	<b>\$4.0048</b>	<b>\$1.4942</b>	<b>\$86,429,310</b>	<b>14.9%</b>	<b>16,003</b>	<b>\$800</b>

**Statewide total \$211m**

Source: JLBC, PTOC

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# Top 10 Small School Adjustments

School District	FY 2018 Totals	TY 2017 Primary Rate	levy as rate	DSL	% DSL
Paloma School District	\$3,193,300	\$5.0625	\$4.0072	\$794,828	401.76%
Pine Strawberry Elementary District	\$1,656,650	\$4.8389	\$2.7323	\$1,104,619	149.97%
Grand Canyon Unified District	\$1,500,000	\$14.7370	\$10.1457	\$1,988,740	75.42%
Gila Bend Unified	\$1,300,000	\$4.0016	\$1.0072	\$2,418,440	53.75%
Ash Fork Joint Unified District	\$1,231,589	\$8.4911	\$4.2435	\$1,595,557	77.19%
San Simon Unified District	\$1,123,667	\$12.0446	\$7.5818	\$855,905	131.28%
Seligman Unified District	\$1,054,775	\$7.7237	\$3.0673	\$963,110	109.52%
Bowie Unified District	\$932,838	\$11.1018	\$6.6369	\$765,524	121.86%
Hayden-Winkelman Unified District	\$816,100	\$11.8875	\$5.5708	\$1,885,287	43.29%
Hyder Elementary District	\$757,582	\$2.4430	\$1.1236	\$817,705	92.65%
Young Elementary District	\$756,000	\$6.5216	\$4.1661	\$308,211	245.29%
Maine Consolidated School District	\$749,537	\$5.2916	\$2.5492	\$1,130,018	66.33%
Cochise Elementary District	\$700,000	\$5.1560	\$2.5429	\$585,097	119.64%

DSL = District Support Level (Formula M&O Budget)

Statewide total: \$25 million



# TRCL-TSL (Transpo Delta)

## Top 10 Districts with Highest TRCL-TSL Levy

- Local “hold harmless” tax
- As districts contract in size or drive fewer miles, the TRCL-TSL delta (& the tax levy) grows
  - FY09: \$60M
  - FY14: \$75M
  - FY18: \$79M
- Un-equalized; monies levied outside the RCL
- Paid 100% by local property taxpayers

Name	TSL	TRCL	TRCL-TSL	Diff per ADM	Rate
Tucson Unified District	\$14,484,377.00	\$19,484,449.71	\$5,000,072.71	\$113.64	0.1555
Flagstaff Unified District	\$4,276,168.00	\$5,819,851.51	\$1,543,683.51	\$170.60	0.1352
Scottsdale Unified District	\$5,020,461.00	\$8,101,259.69	\$3,080,798.69	\$146.70	0.0612
Phoenix Union High School District	\$5,375,871.00	\$9,337,670.46	\$3,961,799.46	\$158.47	0.0838
Deer Valley Unified District	\$5,747,182.00	\$8,694,165.80	\$2,946,983.80	\$77.06	0.1205
Window Rock Unified District	\$846,818.00	\$2,839,769.98	\$1,992,951.98	\$900.37	*16.3805
Ganado Unified School District	\$1,650,358.00	\$3,530,580.37	\$1,880,222.37	\$1,350.77	*9.7526
Mesa Unified District	\$17,122,898.00	\$20,329,349.00	\$3,206,451.00	\$53.22	0.1103
Yuma Union High School District	\$3,325,142.00	\$4,718,120.49	\$1,392,978.49	\$131.08	0.1337

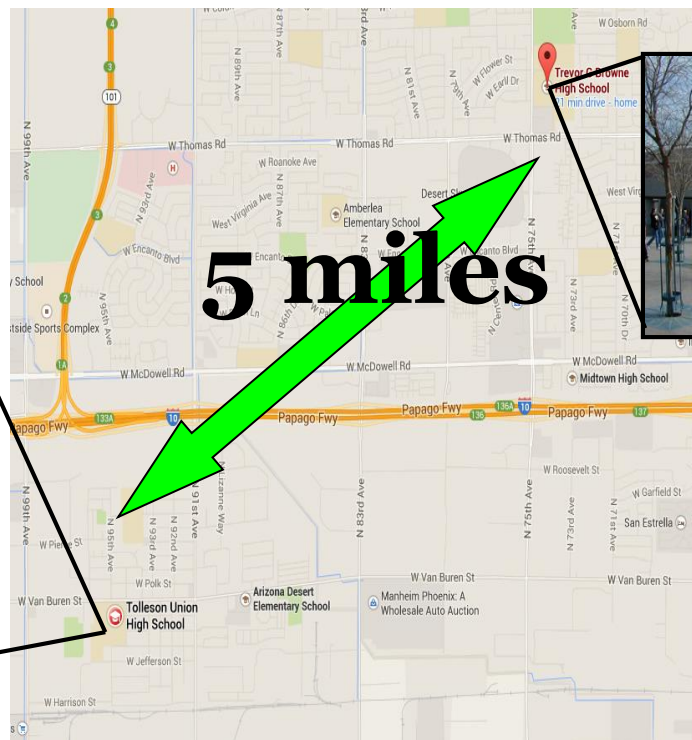
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# Examples of Inequity

## Tolleson Union District

## Phoenix Union District



Total Per Pupil Spending: \$7,558  
Avg Teacher Pay: \$44k  
Avg Teacher Exp: 8 yrs  
Admin per pupil: \$654

Total Per Pupil Spending: \$10,365  
Avg Teacher Pay: \$61k  
Avg Teacher Exp: 13 yrs  
Admin per pupil: \$932  
Deseg money: \$55.8m

Per 2016 Auditor General report & ADE Supt Report

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# School Property Tax Problems Lead to Larger Public Finance Challenges

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- Extraordinarily high rates create major economic development challenges
  - High overall rates in Phoenix and Tucson create pressure for more tax abatement. Phoenix now with the highest rates of any urban city
  - High overall rates continue to aggravate the 1% Cap problem in Phoenix and Tucson. Statewide taxpayers continue to subsidize the Deseg programs through increasing 1% cap payments



# ATRA Position

## New Funding Must Target Equity Reforms

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- Policymakers acknowledge equity issues, see them as problematic
- However refuse to act without money to smooth the cuts to nonformula expenditures
- Some will argue for no reform, just new money
- Taxpayers must demand reform and some safe harbor from the perpetual general and uniform lawsuits





# **Taxability of Digital Goods, Software and other Electronic items In Arizona**

*For: Arizona Tax Research Association 2017 Outlook Conference*

*14 November 2017 | Litchfield Park, AZ*

*By: Dr. Grant Nülle, Deputy Director  
Arizona Department of Revenue*

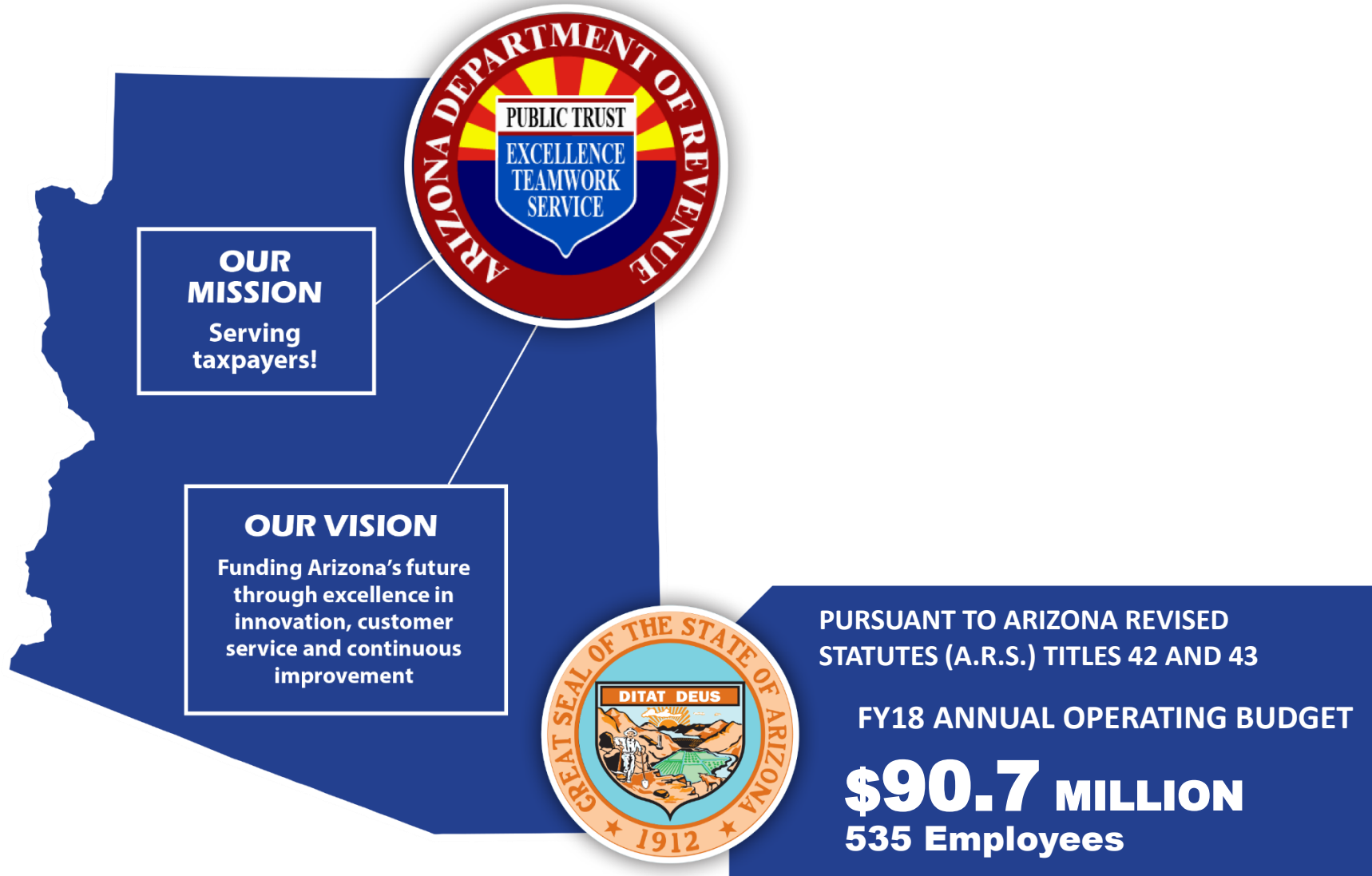


# Agenda

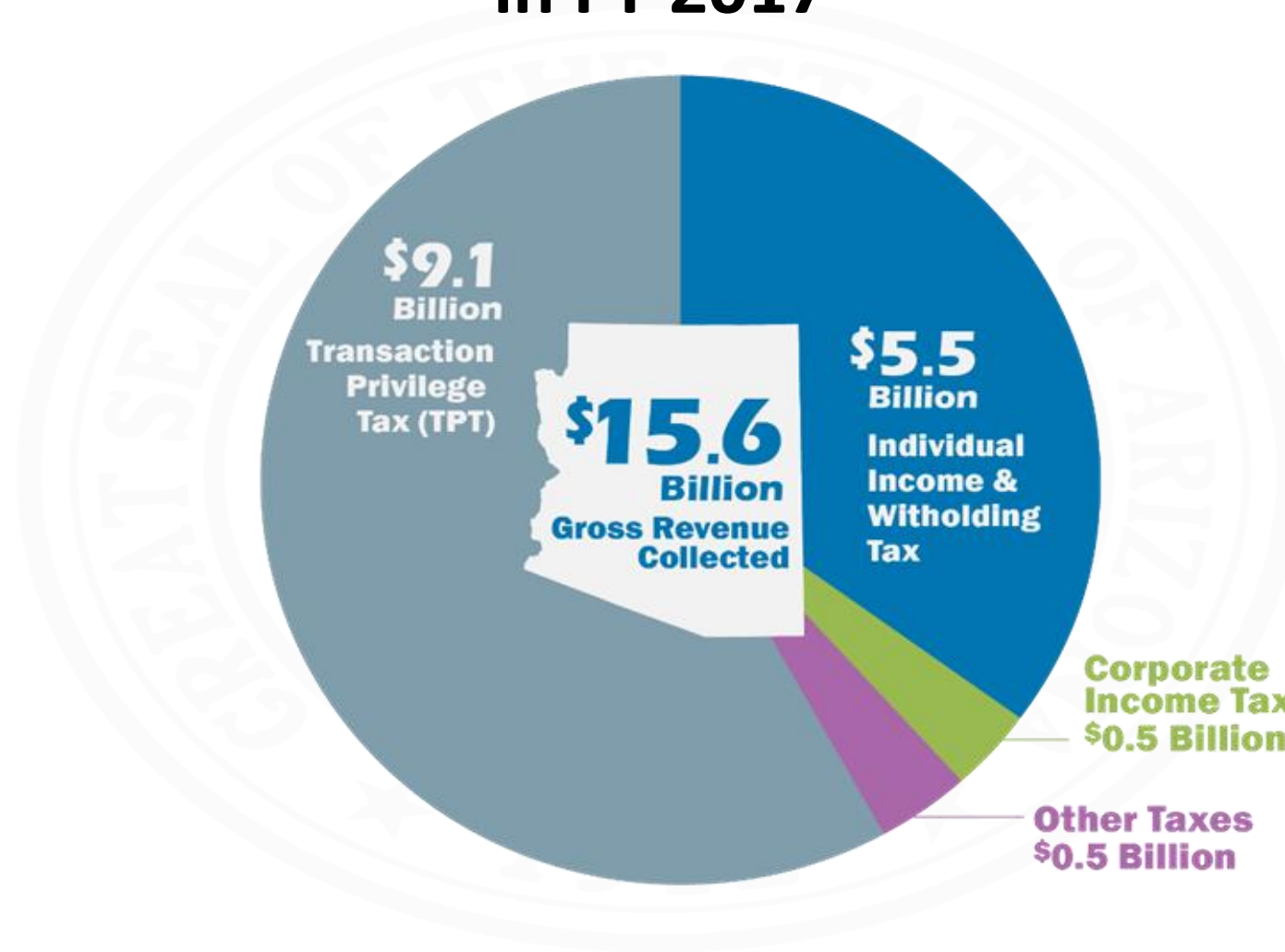
- ADOR Mission, Vision, & High-level Summary
- Explain TPT classifications relevant to software and digital goods
- Explain Arizona definition of Tangible Personal Property and its expansiveness relative to other states
- Explain why clarity is needed in the law & why it is important



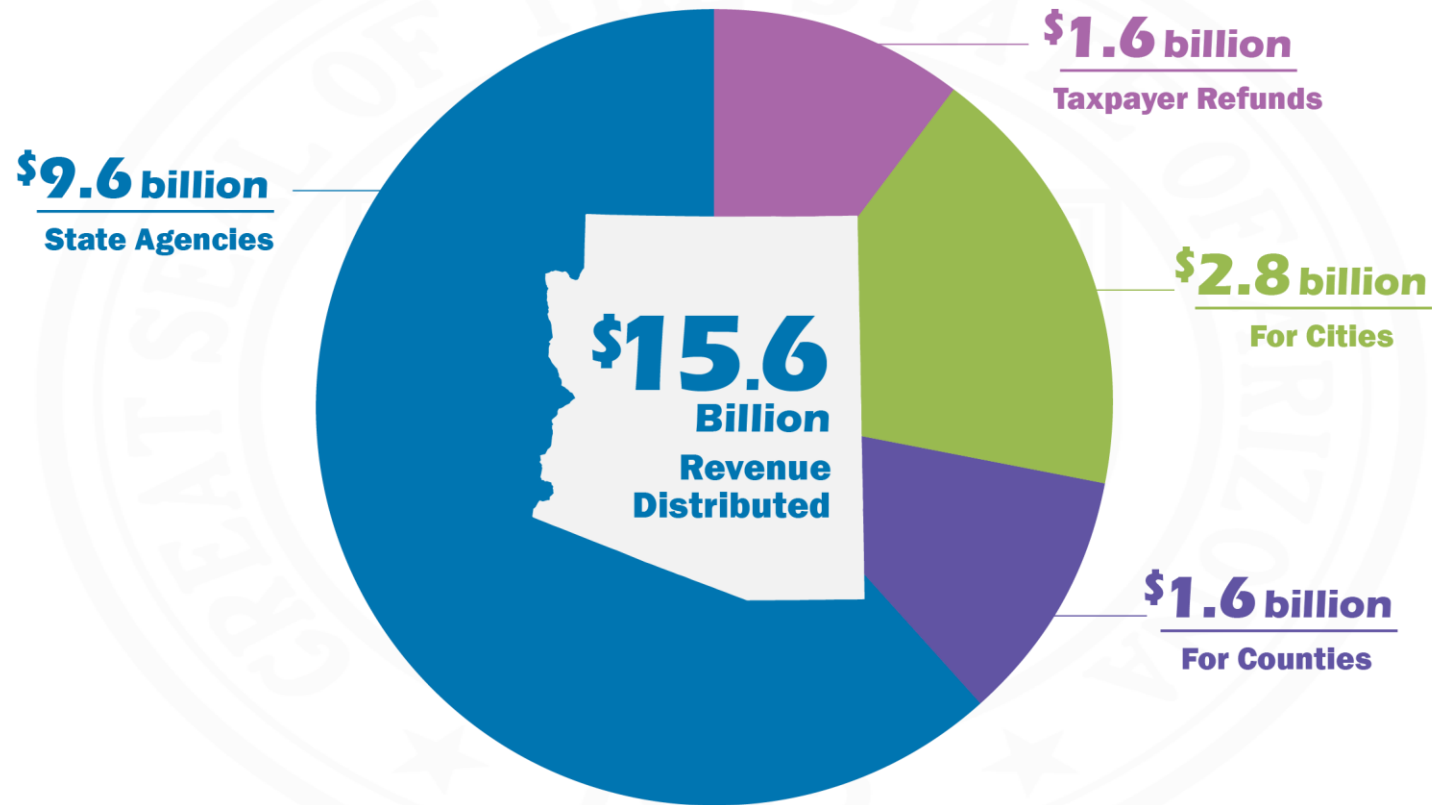
# Mission & Vision



# Revenue collections approached \$16 billion in FY 2017



# Revenue distributions primarily fund State operations, cities/towns, & counties



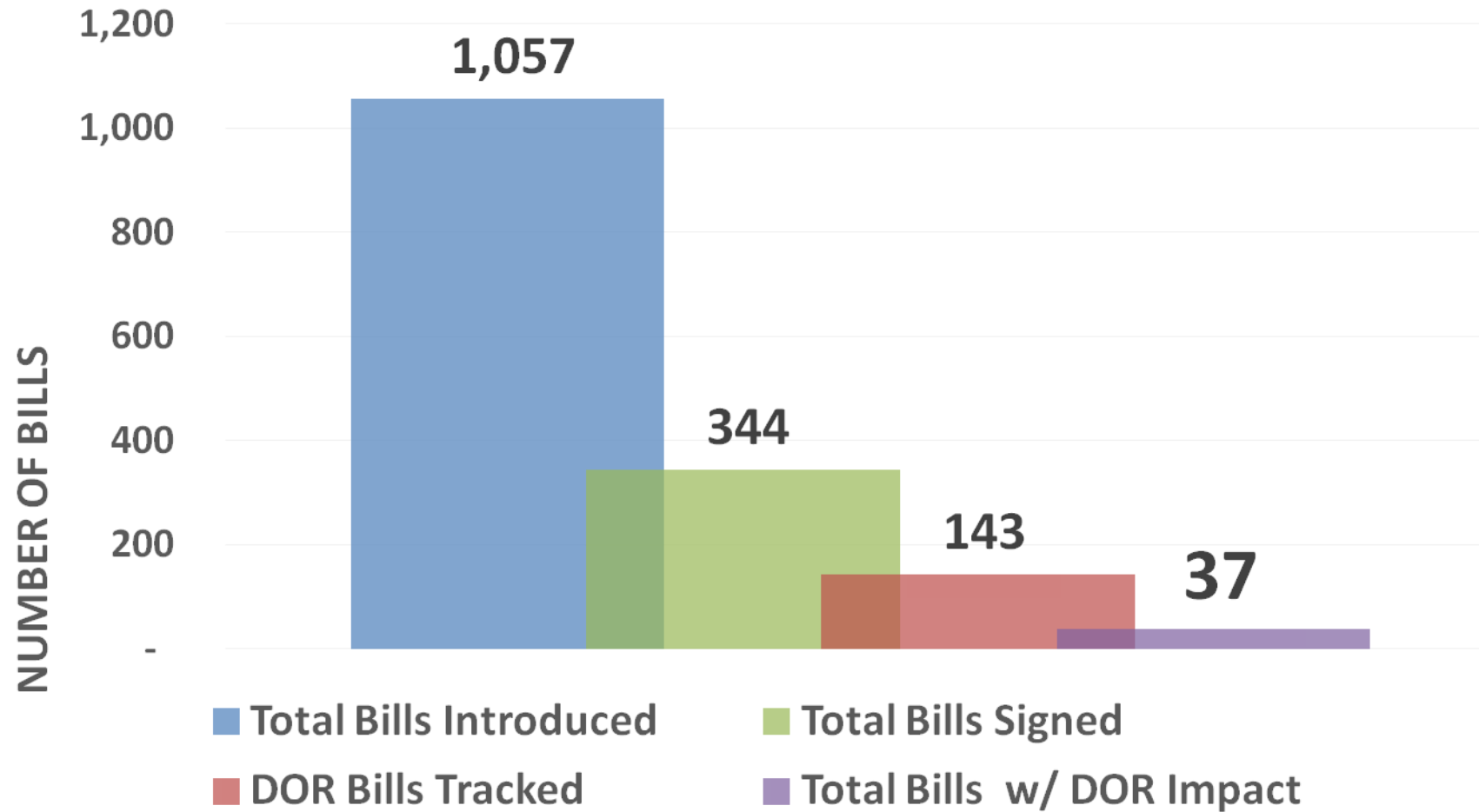
# ADOR's multi-faceted operations touch every part of Arizona - FY17 Highlights

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- **Nearly 5.9M Tax Returns Processed**
  - 1.7M+ Transaction Privilege Tax
  - 193,000+ corporate returns
  - 3.3M individual income tax returns
  - 2.1M individual income tax refunds
- **\$25.9 million in Individual Income Tax Fraud Stopped**
- **40,000+ new TPT licenses issued**
- **\$57 million in Unclaimed Property Returned**
- **Property Tax Unit valued 963 Centrally Valued Properties & Trained more than 100 Certified County Appraisers**



# 1 in 10 bills enacted in 2017 are being implemented by ADOR





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## **Overview of Transaction Privilege Tax and its Applicability to Digital Goods**

# Arizona Transaction Privilege Tax (TPT) General Overview

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- **Tax on the privilege of conducting business in Arizona**
  - Seller or vendor taxable
  - Seller may pass economic expense to purchaser
- **Generally all of a business' gross income within one or more of 16 business classifications is taxable unless specific exemption or deduction exists**
- **Exemptions or deductions only available for the specific classification under which the deduction is provided**
  - Deduction under one classification does not apply under another classification unless specifically provided
- **Tax Statutes are construed strictly against a party who claims an exemption**





# TPT Classifications & Digital Goods

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- Currently 16 different classifications
- For software and digital goods only two classes are generally implicated:

**Retail**



**Rental of Tangible  
Personal Property**



# Tangible Personal Property Defined

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- What is TPP?

- Defined as “personal property which may ***be seen, weighed, measured, felt or touched*** or ***is in any other manner perceptible to the senses.***” A.R.S. § 42-5001(17).

- *Very Broad*

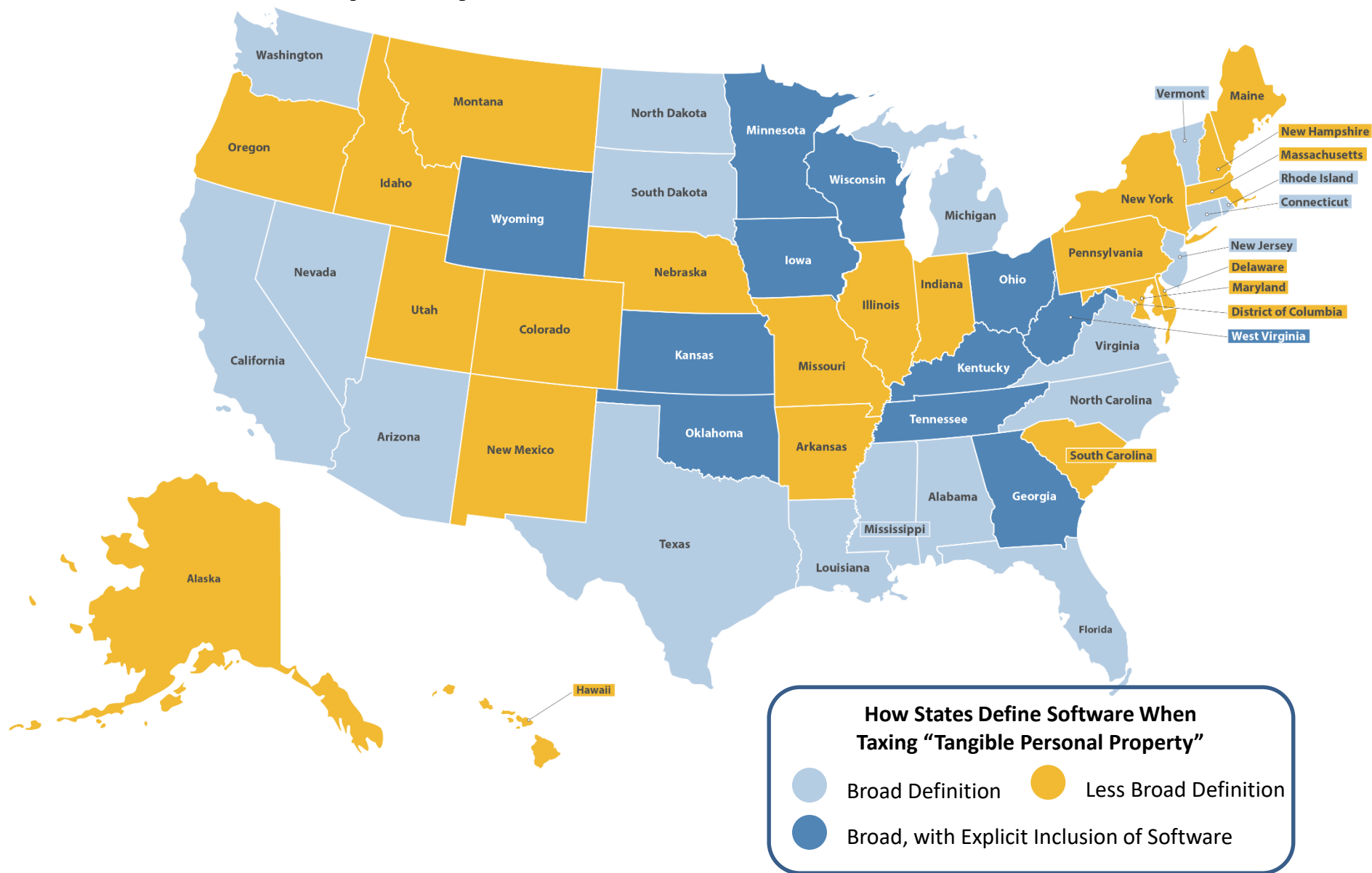
- *Obvious examples:*

- Paper, pens

- Computers, CDs, DVDs etc.



**17 States have definition of TPP as broad as Arizona, and another 11 explicitly include software in its broad TPP definition**



# Does TPP include software & other digital goods?

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- ADOR analysis based on statutory definition of TPP and case law
- Broad statutory definition includes things *other than* physical goods
  - Music played from a jukebox (*State v. Jones*, 60 Ariz. 412 (1943))
- Arizona case law *suggests* it is TPP
  - Software considered machinery and equipment (“M&E”) used in manufacturing (*CCI Europe, Inc. v. AZ DOR*, 237 Ariz. 50 (2015))
- Based on above, the Department has concluded that it does
- Nevertheless, no Arizona statutes or cases definitive on the issue.



# A Counterfactual Experiment underscores the analytical challenges of this issue

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- Suppose Tangible Personal Property remained defined as “personal property which may *be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses.*”
- However, decades ago the Legislature exempted everything that met this definition of TPP from taxation.



# Counterfactual Experiment

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Should Digital goods therefore be treated as:

- A) Taxable, as these technologies are radically different from what the Legislature defined as TPP decades ago.**
- B) Non-taxable, as the Legislature employed an expansive definition that was meant to exempt new goods & business models across time.**

If you choose A), it is intellectually consistent with the present-day argument that digital goods should be addressed by new statutes.

If you choose B), then you understand the Department's interpretation of a broadly-written statute.



# Is the current law satisfactory?

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- **No**, the limited statutory guidance creates immense uncertainty for taxpayers & ADOR.
  - The current law forces ADOR to engage in a fact-intensive analysis of every taxpayer's business model, which is a **complex, inefficient & ineffective** undertaking.
  - Taxpayers are unclear what is taxable and what is not, resulting in a **multitude of compliance & equity issues**.
- A **technically sound & administratively feasible** set of laws are needed: 1) To define what is taxable and what is not; 2) Furnish framework concerning what factors will be considered to determine taxability of emerging technologies.



# Why is legislative clarity critical to ADOR?

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- **Clarity in the law enables more taxpayers to voluntarily comply with Arizona tax laws.**
- **More voluntary compliance frees up capacity at ADOR to Serve Taxpayers faster, smarter, and better**
- **ADOR stands ready in good faith to help draft, analyze, and implement a better set of laws around digital goods than exist today.**





# Serving Taxpayers by Creating Capacity: Major ADOR Projects

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- Finish TPT Reform – *Completed Calendar Year 2017*
- Partner with ADOT to simplify Vehicle Use Tax administration – *Completed Nov. 1, 2017*
- Residential Rental Tax E-File Solution – *To be completed Jan. 2018*
- Electronic Self-Serve 1099-G – *To be completed by Jan. 2018*
- IT Infrastructure Modernization – Deploy \$11 million State Investment – *To be completed by June 30, 2018*
- Consolidating tax return processing and Cloud storage of tax filings – *To be completed in 2018*
- Deploy Corporate E-File Solution – *Target completion January 2019*





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**THANK YOU!**



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# Taxation of Digital Goods & Services in Arizona

Sean McCarthy, ATRA Senior Research Analyst

- Status Quo
- Other States?
- Policy Options
- Vision



# What Are We Talking About?

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- Subscription downloaded software
  - Subscription downloaded books, videos, music (content)
  - Perpetual downloaded software
  - Perpetual downloaded books, videos, music
- 

- PaaS
- IaaS
- SaaS



Cloud Services



Digital Goods



## What Are We NOT Talking About?

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- Taxes on digital sales: (retail goods purchased online)
  - Existing nexus problems await federal action or new court ruling
- Quill remains law of the land
  - State's may not mandate collection unless seller has physical presence
  - South Dakota is presenting a new challenge to Supreme Court
- Non-custom software sold at retail
  - Long considered taxable by DOR via rule



## Bottom Line

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- AZ among a few states who don't define digital goods/services
  - AZ is one of the ONLY states using our definition of TPP who taxes without a legal mandate, rule or case law
  - Taxation of digital goods/services TPT is based on ADOR interpretation
- Massive taxpayer confusion and uncertainty
- Taxpayers concerned about back taxes and interest
- Legislative clarity required



## Status Quo

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- No explicit state law regarding TPT applying to digital goods and services
- Non-custom software sold at retail has long been taxable by regulation
- § 42-5071 covers personal property rental classifications and exemptions
  - No definition or classification for digital goods/services or leased/subscribed software
- § 42-5001(16): ‘Tangible personal property’ is “personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses
  - Definition does not indubitably capture all digital goods/services or leased/subscribed software
- No binding court judgement making digital goods/services taxable under TPT
- Some taxpayers pay TPT while others do not for similarly situated circumstances
  - Individual taxpayer rulings
  - ADOR guidance: apply TPT on nearly all digital services (October 2015 Directors Decision )



## Dept of Revenue Position

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- Digital services are taxable under the personal property rental classification
  - Anything digital is “tangible” because it can be viewed on media in some form
  - “Accessing” digital services is the same as renting/leasing tangible personal property
  - Any service provided along with a taxable activity is also taxable (R15-5-1502)
- Tax base is the gross proceeds until the contrary is established by taxpayer
- Only exempt from TPT if software was uniquely created for customer (TPR 93-48)
  - “The provision of a canned computer program, whether or not characterized as a license agreement, is considered to be a taxable retail sale. Leases or rentals of this type of computer software are taxable under the personal property rental classification...” TPR 93-48





# ADORs Legal Interpretation

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- Each perspective of existing law maximizes taxation of digital goods and services
  - Tax reporting agencies direct taxpayers to pay in nearly all circumstances
  - Case law demands that existing tax laws not be construed to new activities
- **Tangible personal property:** any digital product or service, regardless of medium
- **Exclusive use:** Customer has unique access via login; content doesn't need to be exclusive to the customer, simultaneous use is disregarded
- **Control:** Any manipulation ability of content establishes control; all business controls or inputs are described as irregular, minimal, troubleshooting, etc
- Legal position relies on linking the business models of coin-op laundries to digital services in *Peck* and insisting upon significant employee interfacing in tanning salons in *Energy Squared* in order to distance digital goods from that ruling

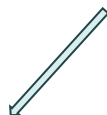


# Evolution in Arizona

1993: ADOR  
rules prewritten  
software  
taxable at retail.  
Custom is  
nontaxable



2005: ADOR  
updates rule that  
software is taxable  
“regardless of the  
method to  
transfer”



Feb 2013 LR: Cloud  
Storage declared  
not taxable: did not  
meet “exclusive use  
and control”



2014: DOR  
Decision states  
SaaS product  
(online research  
index) is taxable



May 2015 LR:  
SaaS declared  
taxable under  
rental of ‘TPP.  
“Constructive  
Possession”  
philosophy  
adopted using  
Alabama court  
ruling



March 2016: LR  
overturning 2013  
ruling stating cloud  
storage is taxable



## What about other states?

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- 18 states like Arizona have not statutorily defined taxation of digital goods/software; most do not apply a tax to cloud services or digital goods
- Many states have attempted to define and tax digital goods/services
- Some states have defined and exempted cloud services only or both
- Several states tax all digital goods/services but exempt data processing like data entry, payroll services, inventory control
- AZ 1 of only 3 states to tax digital goods without a law change (AL & LA used rule making). AZ ONLY state to tax SaaS, cloud services without a law change (not counting gross receipts tax states like NM & HI).

## Digital Goods Taxed by DOR Position or Case law

Digital Goods  
Non-Taxable

Digital Goods Taxed by Statute

## *The taxpayer's watchdog for over 75 years*





# Critical Taxpayer Issue Reaching Boiling Point

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- Most states have attempted to address the issue in state law
  - No one state is deemed as a model; no silver bullet strategy
  - Difficult to define; digital services are a moving target
  - Arizona has made no attempt
- Tax analysts are telling companies AZ taxes all digital goods/services
  - Though there is no legal basis, ADORs private letters influence
  - Companies one by one being told they owe back taxes
- Massive taxpayer confusion
- AZ cannot possibly be a leader in IT under present circumstances

From taxjar.com

For example, some states consider SaaS a service. So if services are generally taxable in the state - such as in Arizona - then SaaS is considered taxable. In most states, where services aren't taxable, SaaS also isn't taxable. Other states, like

*The taxpayer's watchdog for over 75 years*



## Charge to Lawmakers

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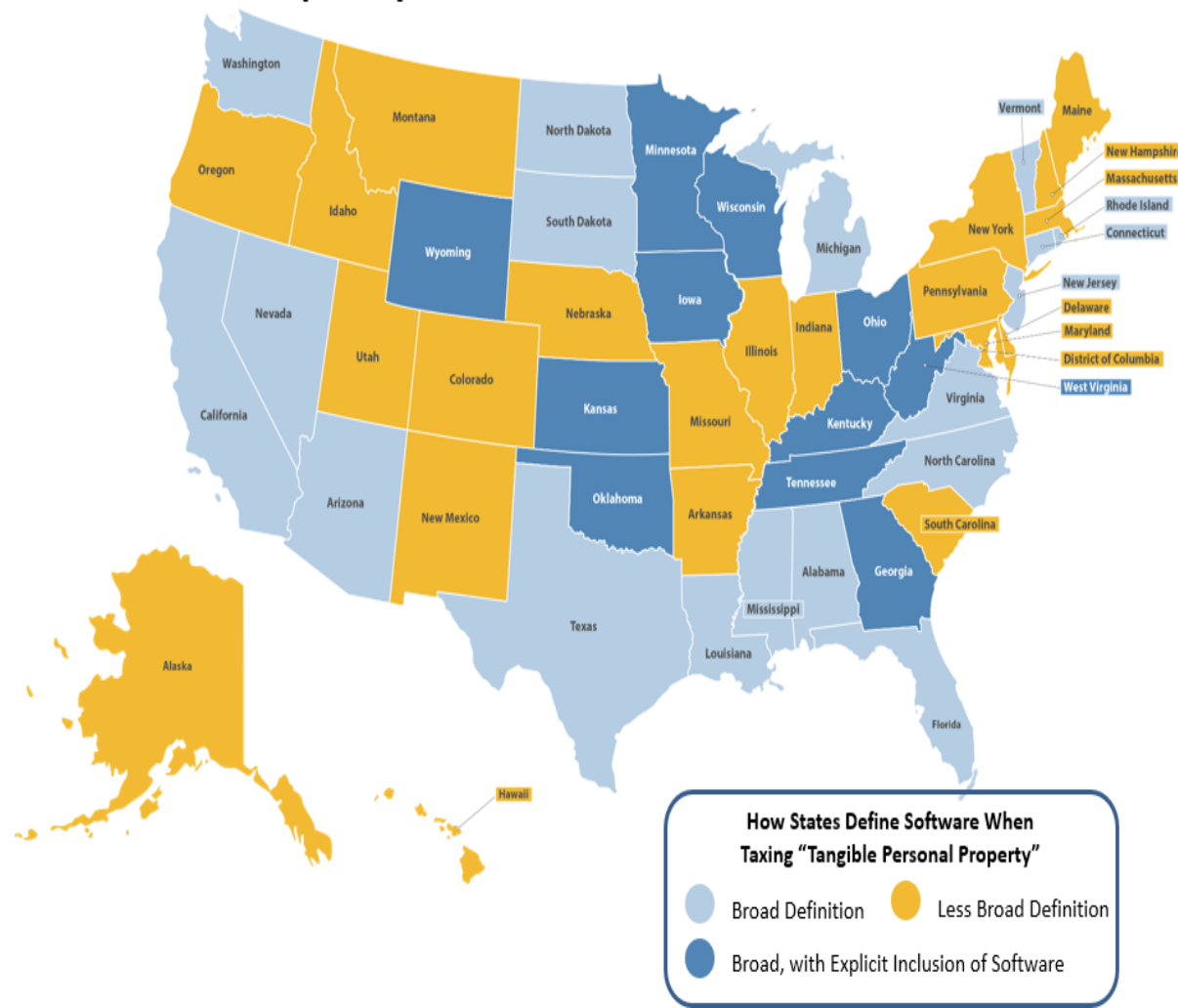
- Provide clarity in law to fullest extent possible
- Tax the activity you think is taxable, exclude the remaining
  - Do not leave the decisions to administrators
  - Use precise language; don't leave room for language straining
- Make the difficult policy choices now
  - Difficulty level compounds with time as digital grows
  - Inaction leaves the state legally liable
  - Inaction leaves taxpayers in a precarious position



# Is Arizona an Outlier?

**17 States have definition of TPP as broad as Arizona, and another 11 explicitly include software in its broad TPP definition**

- ADOR suggests
  - 17 states like AZ
  - Similar definitions of TPP
- Legal situations are very diverse across the 17
- Arizona has a rule for taxation of retail software sales (perpetual right)
- No other law or rule







## What are the 17 doing?

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- 11 have updated definition of TPP in state law to add software
  - Taxability of various digital goods/services flows from law change
  - Most have taxed perpetual & subscription software and exempted SaaS
  - South Dakota & Washington have taxed all digital services w/ law changes
- 3 without law changes have exempted all transactions
  - California, Florida, Virginia
- AZ, LA, & AL only states to tax of the group w/out law change
- LA & AL have administrative code/rule, AZ does not
- AZ only taxes SaaS without a law change (AZ has neither a law or rule)



# Exclusive Use & Control: “constructive possession”

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- *State Tax Commission v. Peck* (1970)
  - AZ Supreme Court estab. rule of “exclusive use & control” for rental of tangible personal property
  - Coin-Op laundries were taxable because customer had exclusive use of machine, no personal services
- In *Energy Squared* (2002), Court of Appeals ruled tanning salons do not cede requisite control over devices, citing *Peck* and are not taxable under rental of personal property and are a service
- DOR:
  - Access to digital services is “exclusive” by virtue of a unique login & password
  - This “subscription” allows “exclusive” use of software content or digital platform, satisfying *Peck*
  - Actual possession of or a license granting “control” of software unnecessary to meet definition
  - “License to view” digital software provided online enough to satisfy “control” for leasing purposes
  - Ability to browse, search, extract, etc is enough to establish “control” = “constructive possession”
  - *Energy Squared* doesn’t apply to digital services because customers access it “without assistance”



## 2016 TPR exempts electronic payment processing

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- In a reversal, TPR 16-011 declares gross receipts for electronic payment processing is not subject to TPT
- Web software interface is ‘tangible personal property,’ but
- ‘Exclusive control’ under *Peck* not established
  - Vendor is involved in transactions, requests payments, updates data etc
- Customer is not ‘renting’ software because charges are relative to dollar amount in transaction and not subscription based
  - New legal consideration not found in Arizona case law

State	Definition of TPP	Software - Perpetual (Delivered Electronically)	Software - Subscription (Delivered Electronically)	Software-as-a-Service (Hosted or ASP)	Other Digital Goods
Arizona	Ariz. Rev. Stat. § 42-5001 (17) "Tangible personal property" is property that can be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses." MCTC does not define TPP.	Taxable - Retail (Ariz. Admin. Code R15-5-154 canned software is TPP regardless of how delivered - this regulation applies to the retail classification only)	Taxable - TPP Rental (DOR Interpretation)	Taxable - TPP Rental (DOR Interpretation)	Taxable - Retail or Rental depending upon terms (DOR Interpretation)
California	Cal. Rev. and Tax Code § 6016 "Tangible personal property" means personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses.	Exempt (BOE interpretation)	Exempt (BOE interpretation)	Exempt (BOE interpretation)	Exempt (BOE interpretation)
Nevada	Nev. Rev. Stat. § 372.085 "Tangible personal property" means personal property which may be seen, weighed, measured, felt or touched, or which is in any other manner perceptible to the senses. Nev. Rev. Stat. § 360B.485 "Tangible personal property" includes, but is not limited to, electricity, water, gas, steam and prewritten computer software. The term <b>does not include any products that are transferred electronically to a purchaser.</b>	Exempt (Nev. Rev. Stat. § 360B.485)	Exempt (Nev. Rev. Stat. § 360B.485)	Exempt (Nev. Rev. Stat. § 360B.485)	Exempt (Nev. Rev. Stat. § 360B.485)
Texas	Tex. Codes 151.009 "Tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner, and, for the purposes of this chapter, <b>the term includes a computer program</b> and a telephone prepaid calling card. Tex. Codes 151.010 "Taxable item" means tangible personal property and taxable services. Except as otherwise provided by this chapter, <b>the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status.</b>	Taxable (Tex. Codes 151.009)	Taxable (Tex. Codes 151.009)	Not taxed as TPP 20% exemption as data processing services (Comptroller interpretation of Tax Code Ann. Section 151.0101(a)(12))	Taxable (Tex. Codes 151.010)



## Example: Utah, Taxable by State Law

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- §59-12-103 Sales tax on purchaser on the purchase or sales price for:
- (M) amounts paid or charged for a sale:
  - (i)(A) of a product transferred electronically; or
  - (B) of a repair or renovation of a product transferred electronically; and
- (ii) regardless of whether the sale provides:
  - (A) a right of permanent use of the product; or
  - (B) a right to use the product that is less than a permanent use, including a right:
    - (I) for a definite or specified length of time; and
    - (II) that terminates upon the occurrence of a condition
- Gross proceeds: All costs including services whether sold, used, consumed or leased
- Non-nexus Sellers not required to collect; buyers should pay use tax
- Sourcing: location the customer receives goods/services at 1<sup>st</sup> payment



## ADORs Scope Widening

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- Digital services heretofore deemed untaxable are now taxable
- Effectively, nearly all digital services are now considered taxable
- March 2016 Directors Decision reversed earlier rulings
  - No law change or binding court ruling; ADOR relying on new analysis
  - Ruling: digital “cloud” storage now deemed taxable
  - ADOR doesn’t view the service as sufficiently customized/tailored to the customer
  - ADOR presumes digital services only require service when “customer has issues...”
  - Services provided are “minimal” and do not rise to standard set in *Energy Squared*
  - ADOR previously agreed customers did not have sufficient rights to control or possess software



# Shifting legal target “exclusive use & control”

Both TPRs are for Cloud Computing Activity

2015

However, when customers browse, search, print and arrange Taxpayer’s content, they control Taxpayer’s software to manipulate the presentation of the content. At that point, the customers control the manual operation of their searches, and they generally perform their searches without requiring assistance or guidance from Taxpayer’s personnel. Contrary to the tanning bed customer in *Energy Squared*, who “typically knows nothing about how to get what he wants using the taxpayer’s equipment,”<sup>1</sup> Taxpayer’s customers browse and search Taxpayer’s database independently.

“Constructive Possession Philosophy”

2016

\*\*\*’s servers are necessary. After the end user customer information is uploaded, payment requests are made continuously and automatically based on the information on \*\*\*’s servers without any further input from clients unless updates or changes are needed.

Both \*\*\* and its clients use the software; \*\*\* stores end user customer payment data on its servers after it is uploaded by the client, then it uses that information to request payment. In addition, \*\*\* updates information on the portal either manually or automatically so that the client may see the status of payments processed and other analytical information. Thus, there does not appear to be the type of exclusive control required by Peck to constitute the rental of tangible personal property (software). Additionally, payments to \*\*\*

“Exclusive Use & Control Philosophy”

*The taxpayer’s watchdog for over 75 years*





## Five Primary Legal Questions

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1. Is the digital service or good “tangible” personal property?
2. Does the renter or lessee have “exclusive use AND control”?
3. What are the gross proceeds of transaction?
4. How is nexus established for purposes of TPT remittance?
5. How is TPT sourced (which jurisdiction gets the tax?; All of it?)





# Guiding Legal Principles

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- Due Process
  - AZ Court of Appeals rejected a city’s attempt to impose taxes because the tax laws’ “existence must at least be made reasonably knowable.” *APS v San Luis*, 2017
- Tax compliance; AZ Supreme Court has stressed:
  - “the duty imposed by [a statute] must be prescribed in terms definite enough to serve as a guide to those who have the duty imposed upon them,” and “it must be definite and certain enough to enable every person, by reading the law, to know what his rights and obligations are and how the law will operate when put into execution.” *Duhamel v. State Tax Comm’n*, 1947
  - “it is especially important in tax cases to begin with the words of the operative statute,” and “such words will be read to gain their fair meaning, but not to gather new objects of taxation by strained construction or implication.” *State Tax Comm’n v. Staggs Realty Corp.*, 1959



# Exempting digital good prewritten software

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- California Regulation 1502 (f)(1)(D) states that: “The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.”
- Georgia, Arkansas and Nevada followed California’s lead
- Georgia: 48-8-3 (91) Sales Tax Exemptions: “The sale of prewritten software which has been delivered to the purchaser electronically or by means of load and leave”
- At least 21 other states have codified the opposite policy position and tax these transactions similarly to retail transactions



# Expanding statutes to tax ‘leased’ cloud services

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- New York promulgated the term “constructive possession” to apply to Software as a Service (SaaS) transactions:
  - “Transfer of possession with respect to a rental, lease or license to use, means that one of the following attributes of property ownership has been transferred:
    - 526.7(e)(4)(i) custody or possession of the tangible personal property, actual **or constructive**;
    - 526.7(e)(4)(ii) the right to custody or possession of the tangible personal property;
    - 526.7(e)(4)(iii) the right to use, or control or direct the use of tangible personal property
- Infrastructure aaS: rental of cloud computers/servers
- Platform aaS: rental of deployed applications



## Future Issues

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- Advancements will outpace government's ability to react
- Where is the bright line between a digital good and service?
  - How much vendor-customer interaction qualifies the activity a service?
- What if digital currency replaces exchange of legal tender?
- How can broad taxation of digital services be fairly audited given nexus & sourcing issues? Will local vendors be audited first?



## Nexus & Sourcing Complications

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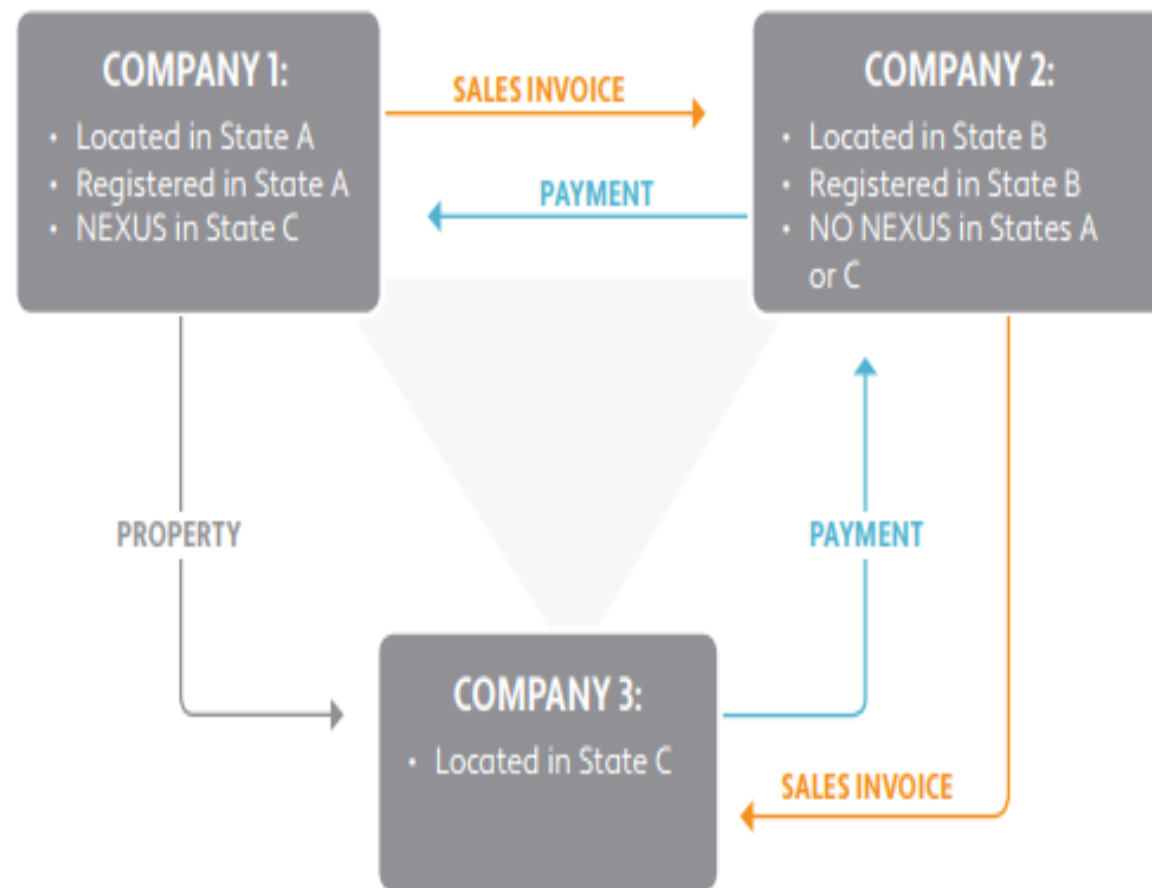
- Sally is on a plane bound for Chicago, originating in Denver.
- She pays Apple (Cupertino, CA) \$4.99 to stream a movie off a server located in Newark, New Jersey. There is no possession or control (except play/pause)
- Her AppleID is registered to her home in Scottsdale, AZ.
- Is this taxable under Arizona's TPT and why?
- Is City of Scottsdale entitled to TPT?

**The seller may have no idea where the receipt of the item takes place or where the item is used.**



# Sourcing Issue: Drop Shipments

- Company 1 avoids sales tax in State C
  - It has nexus
  - Routes through Company 2
  - Drop Shipment voids nexus





## Sourcing: Multiple Points of Use (MPU)

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- SST provides guidance on digital sourcing (single point)
- Few states have attempted to codify clarity on digital sourcing
- Mass. and Colorado provide partial MPU exemptions
  - Require completion of MPU forms to seller for apportionment
  - Mass will apportion to other states based on MPU forms
  - Colorado will reduce tax owed based on apportionment/use



# Institute Professionals in Taxation:

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Some states have begun publishing taxability guidance on cloud computing services. In other states, there is **limited published information in the statutes** and regulations regarding this latest phenomenon of web-hosted services, i.e., the remote access to and use of software, servers, or development tools. While logic would indicate that these contracts should be analyzed under the services statutes, and not as the acquisition of personal property, **the taxability determination appears to be more complex in those states that have included prewritten software in their definition of tangible personal property.** In fact, some states conclude the taxpayer has constructive receipt of tangible personal property even though no physical transfer of custody takes place.





# Legislative Proposals 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



# Which one of these is taxable?

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*The taxpayer's watchdog for over 75 years*



# Which one of these is taxable?



## Storage

Fee typically by month  
Homogenous service  
Defined as a “service”  
Not taxable under AZ TPT



## Digital Storage

Fee typically by month  
Homogenous service  
Defined as a “service”  
Taxable under ADOR interpretation