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# **Revenue and Budget Update**

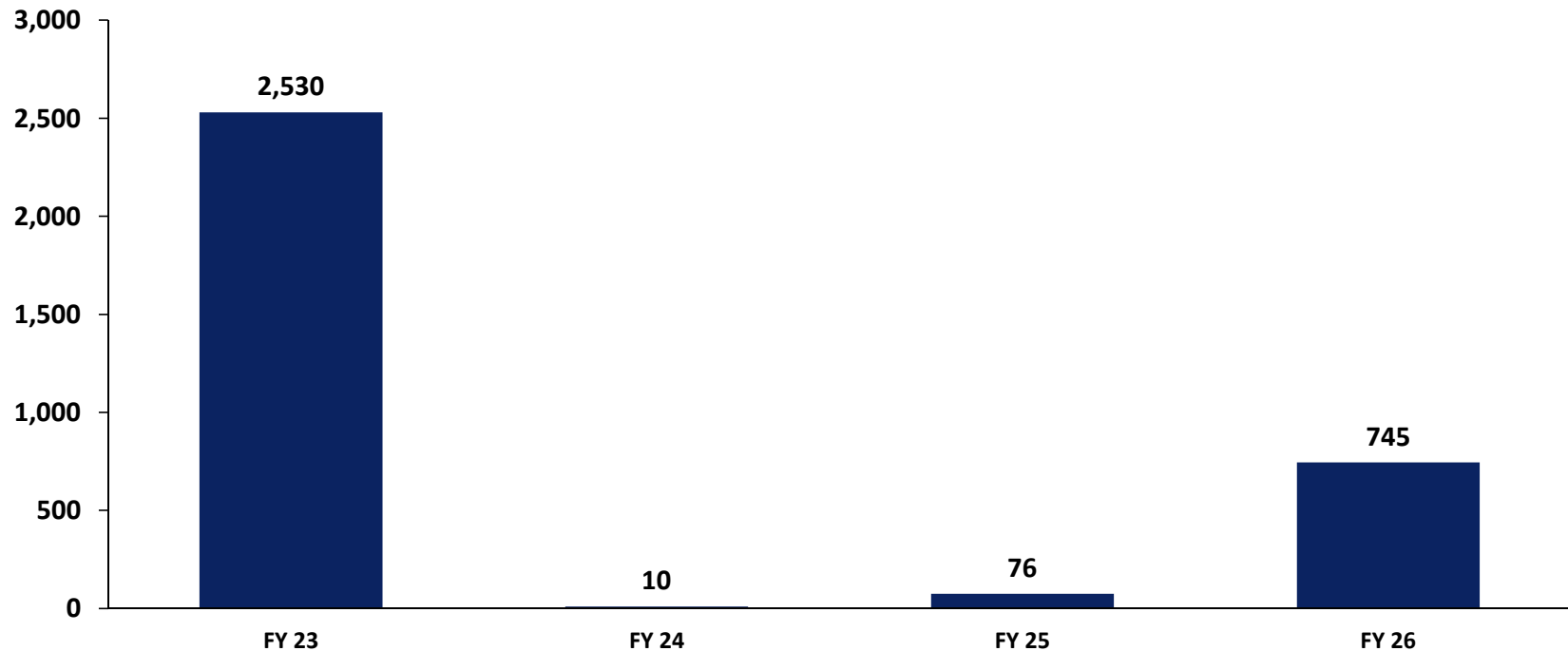
**Arizona Tax Research Association**

**November 17, 2023**



# The **Enacted** FY 24 Budget Had a Projected \$10 M Cash Balance

FY 24 Enacted Budget Ending Balance Estimates  
(\$ in Millions)



## Key Points

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- The enacted budget only had a projected \$10 M General Fund balance at the end of the current fiscal year in June 2024.
- That FY 24 enacted budget also assumed ongoing General Fund revenue growth of 1.9% in FY 24, but revenues have declined by (9.1)% since July.
- The new October forecast projects that revenues will decline (0.6)% for all of FY 24.
- Given the budgeted surplus of \$10 M and declining revenues, the new forecast would result in a projected FY 24 shortfall of \$(400) M.
- The projected shortfall in FY 25 is \$(450) M but is smaller in FY 26 before turning positive in FY 27.

## **October Year-to-Date Revenue: \$(331) M Loss Relative to the Forecast**

### **- Continues Trends from 4<sup>th</sup> Quarter of FY 23**

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- Individual Income Tax collections dropped (30.4)% and were \$(368) M less than anticipated
  - Smaller capital gains/2.0% withholding rate associated with the tax reduction
- Sales Tax growth slowed to 2.7% - a \$(59) M loss relative to the budget
  - Retail sales drives this result, but contracting still posting double digit gains
- Corporate Income Tax growth remains strong at 11.3%, a \$84 M gain to the forecast

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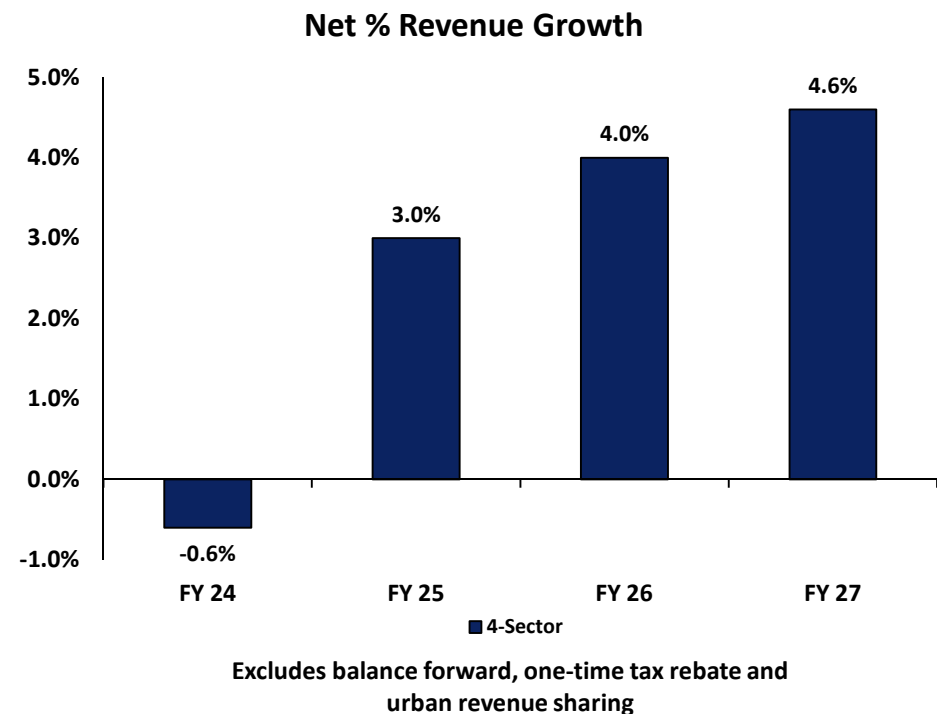
# Forecasting State Revenues

## 4-Sector: Revenue Decline in FY 24

- With Moderate Recovery in FY 25 through FY 27

### 4-Sector Components

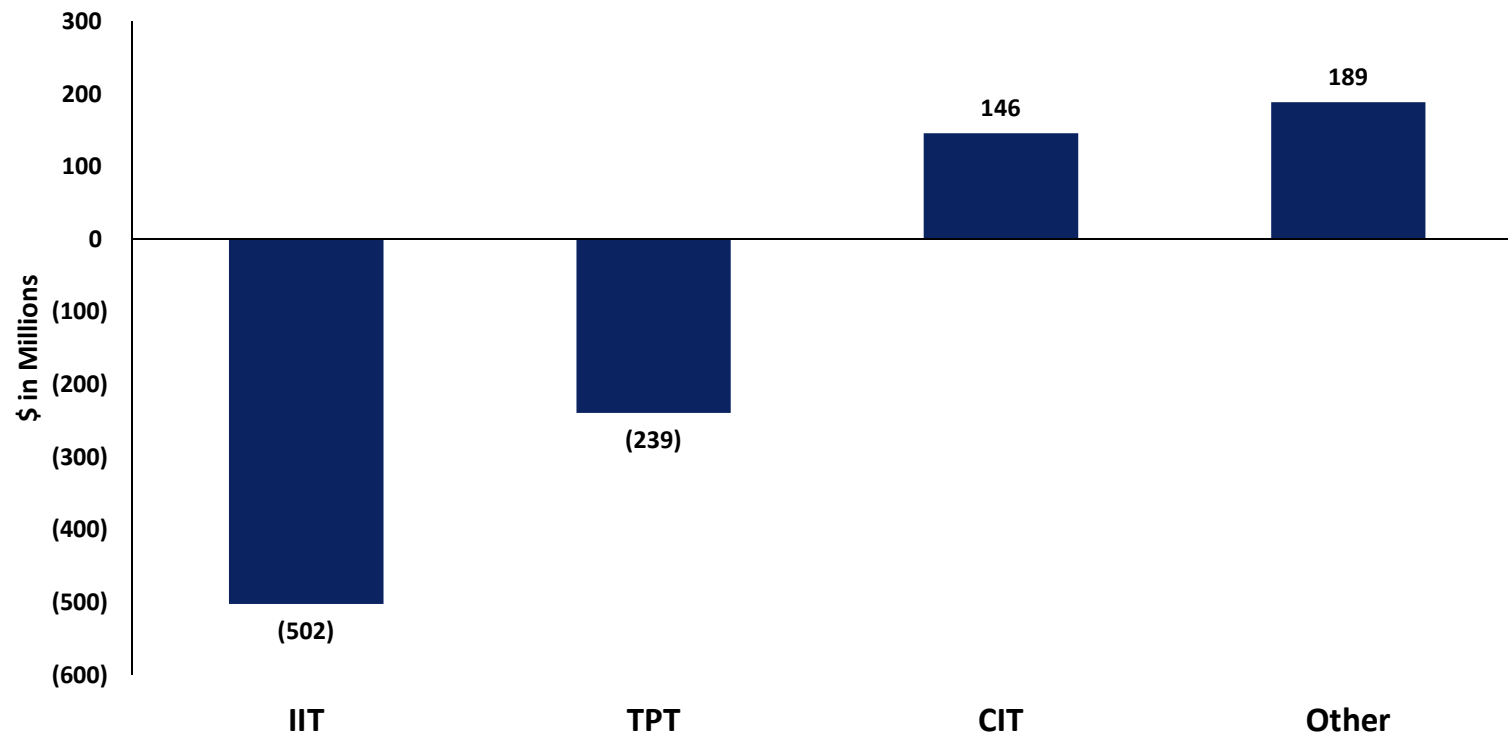
- Finance Advisory Committee
- UA model – base forecast
- UA model – more cautious
- JLBC Staff



# October Forecast Reduces FY 24 Revenue by \$(406) M

## - Compared to Enacted Budget

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# Spending Adjustments



## Baseline Spending Projections

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- Baseline reflects changes to active statutory/other funding formulas
  - ADE, Medicaid and the Community Colleges
- Follows guidance of the enacted budget 3-year plan in terms of \$2.9 B in one-time FY 24 spending
  - Of that amount \$2.2 B was deleted in the FY 25 estimates
  - \$639 M was retained in FY 25, primarily \$333 M of water supply funding and \$193 M in K-12 new school construction
- Some ongoing “one-times” such as school building repair and state health insurance were not continued in FY 25

## FY 25 Baseline Spending Projected To Decrease By \$(1.4) B

### FY 25 Ongoing Spending Changes

	<u>\$ in M</u>
Medicaid Formula	471
ADE – K-12 Formula	325
Other	<u>34</u>
<b>Total</b>	<b>830</b>

**Total Spending Changes      \$(1,414) M**

**Total Spending                \$16,406 M**

**% Change                      (7.9)%**

### FY 25 One-Time Spending Deletions

	<u>\$ in M</u>
One-Time K-12 State Aid Supplement	(300)
K-12 Building Renewal Grants	(183)
State Employee Health Insurance	(73)
Corrections Dept Operating Funding	(113)
Housing Funding	(190)
Other Agency Spending	(607)
Transportation Projects	(620)
Capital Projects	<u>(158)</u>
<b>Total</b>	<b>(2,244)</b>

## ESA Spending Trends

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- The FY 24 budget assumed \$625 M of ESA awards for 68,000 students.
- Actual enrollment is currently 70,000 and awards are \$665 M.
- Net impact on ADE budget depends on whether new ESA students are “switchers” or were always in private/homeschooled settings.
- Current public school enrollment data does not indicate an overall ADE shortfall – but we will need more time to confirm.
- FAC forecast assumes ESA enrollment grows to 75,000 in FY 25 with total awards of \$752 M (same assumptions as FY 24 3-year plan)

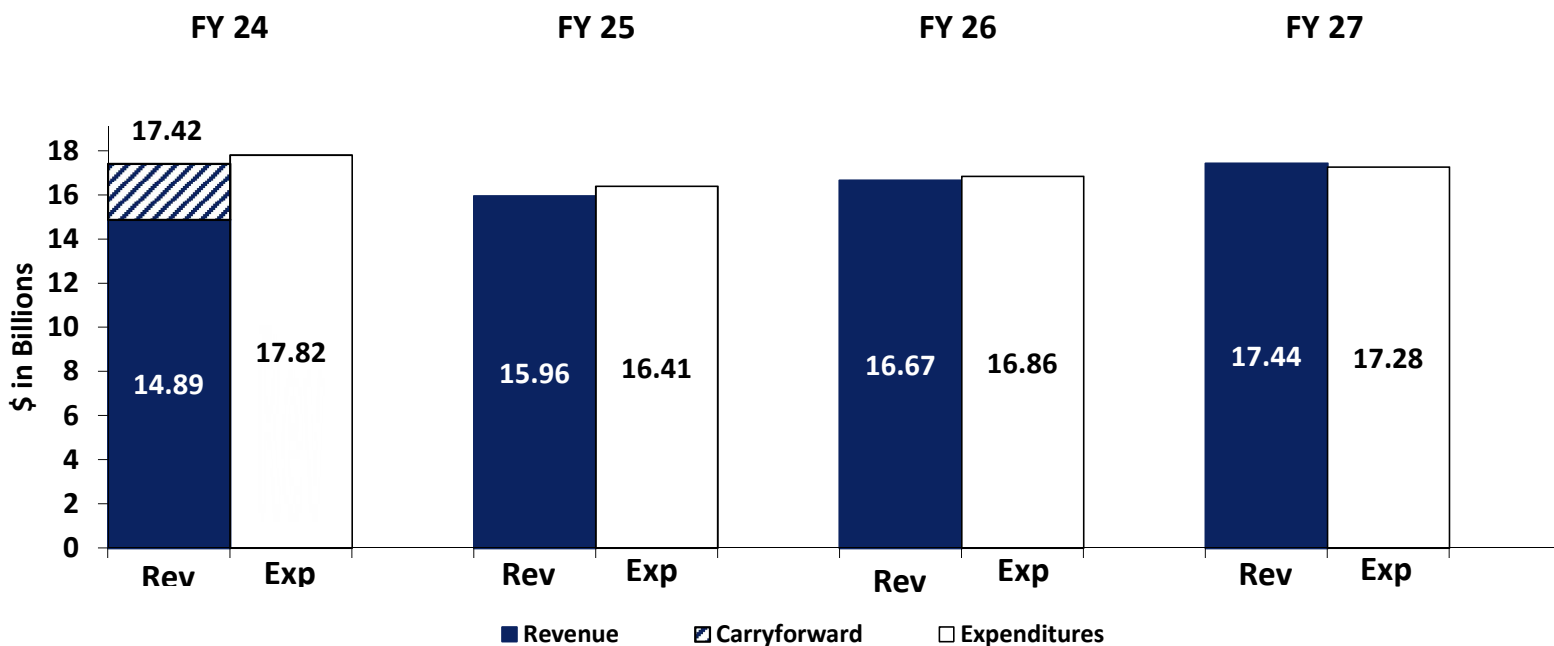
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# Projected Ending Balances

Excludes \$1.5 B in Budget Stabilization Fund

# Projected Shortfall of \$(401) M in FY 24 & \$(449) M in FY 25

- Assumes Each Year's Shortfall is Resolved and Not Carried Into the Following Year



Cash Balance      \$(401) M

\$(449) M

\$(188) M

\$166 M

## Other Considerations

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- Our estimate of the FY 24 balance will likely change considerably as we go throughout the fiscal year.
- We will monitor economic conditions and the spring 2024 income tax filing season, either of which could significantly increase or decrease the shortfall.
- Based on current data, we have not revised the enacted FY 24 funding formula spending. We will review K-12 & Medicaid data in the months ahead to determine the accuracy of the original FY 24 estimates.
- The FY 25 Baseline removes \$2.2 B in 1-time spending in line with the FY 24 budget's 3-year plan. Some of those issues will likely be reexamined as part of the FY 25 budget discussion.



# ARIZONA TAX RESEARCH ASSOCIATION

## Update on Major Public Finance and Tax Issues

Kevin McCarthy, *ATRA President*

Jennifer Stielow, *ATRA Vice President*

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# Update on Major Property Tax Issues

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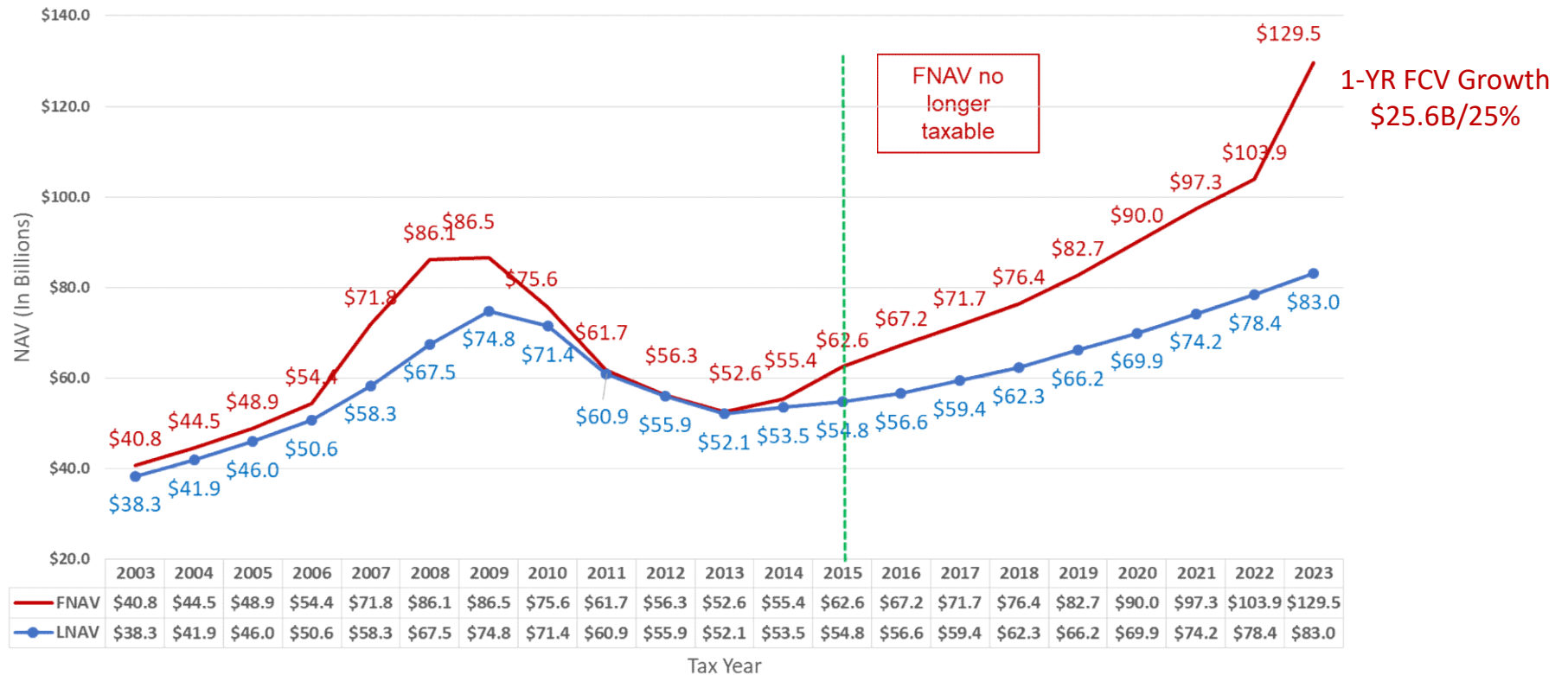
- Arizona has moved from a high tax/low growth state to low tax/high growth state over last 30 years
- 2023 saw record growth in property tax base
- GPLET deals still happening despite court rulings
- Personal property tax relief should continue
- School finance flaws continue to drive high tax rates

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# 20-Year Property Values



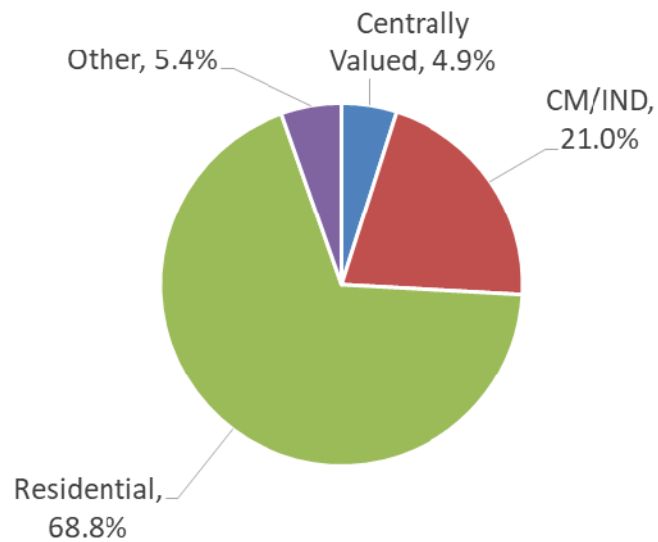
- 2003-2023: FNAV Increased 217.4% or 10.9%/YR & LNAV increased 116.8% or 5.8%/YR.
- 2003-2008: FNAV increased 111% or 22.2%/YR & LNAV increased 76.2% or 15.2%/YR
- 2018-2023 (Post 117): FNAV grew 69.5% or 13.9%/YR & LNAV grew 33.3% or 6.7%/YR

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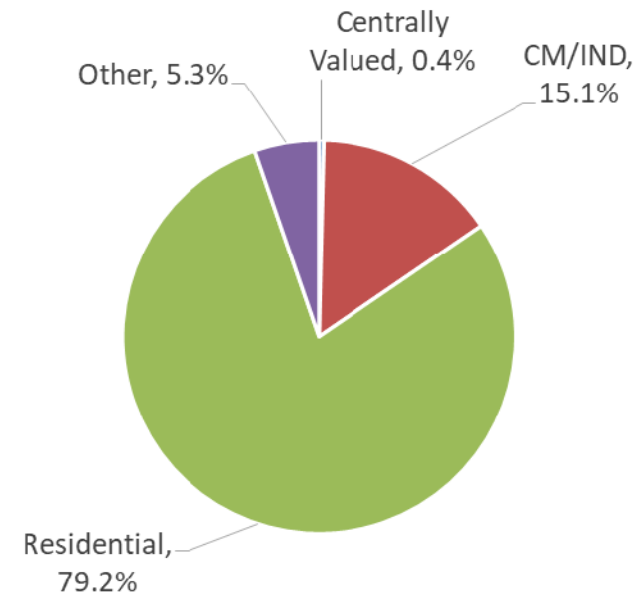


# Statewide Full Cash Value (FCV) NAV

Percentage of Total FCV (TY 2023)



Percentage Change in FCV (TY 2022-2023)

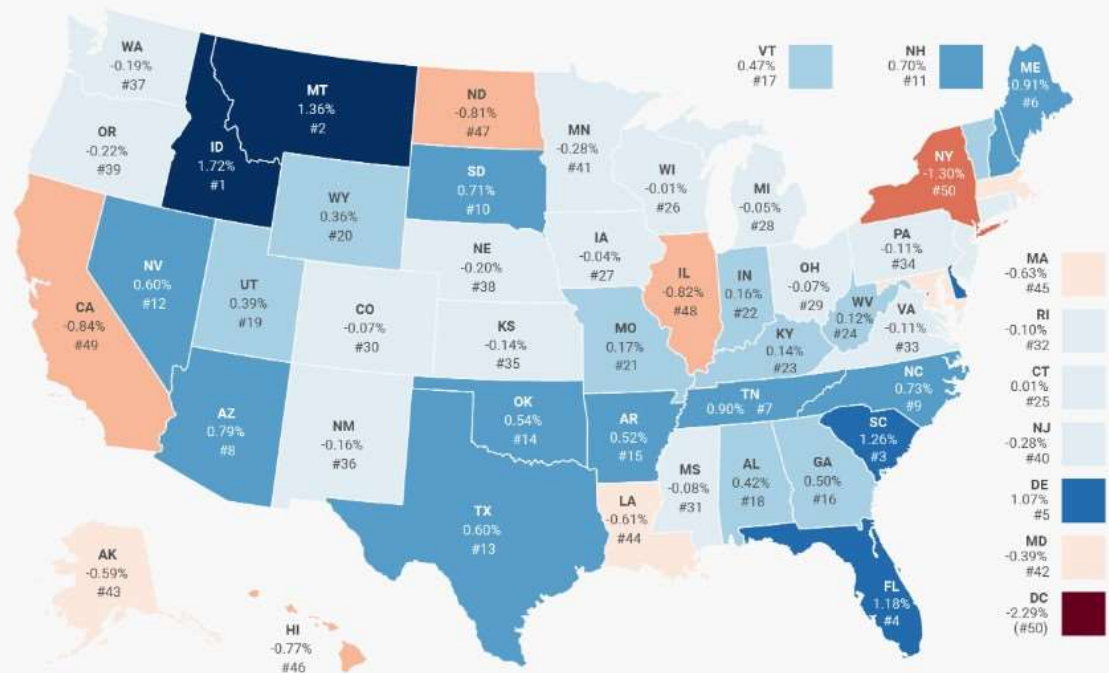


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# State Population Changes Attributable to Interstate Migration, 2020-2021

Net Gain/Loss of Residents from Interstate Migration  
as Share of 2020 State Population



Note: D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would have ranked if included.  
Source: Internal Revenue Service Migration Data 2020-2021; Census Bureau 2020 population estimates; Tax Foundation calculations.





## Maricopa County Appeals History

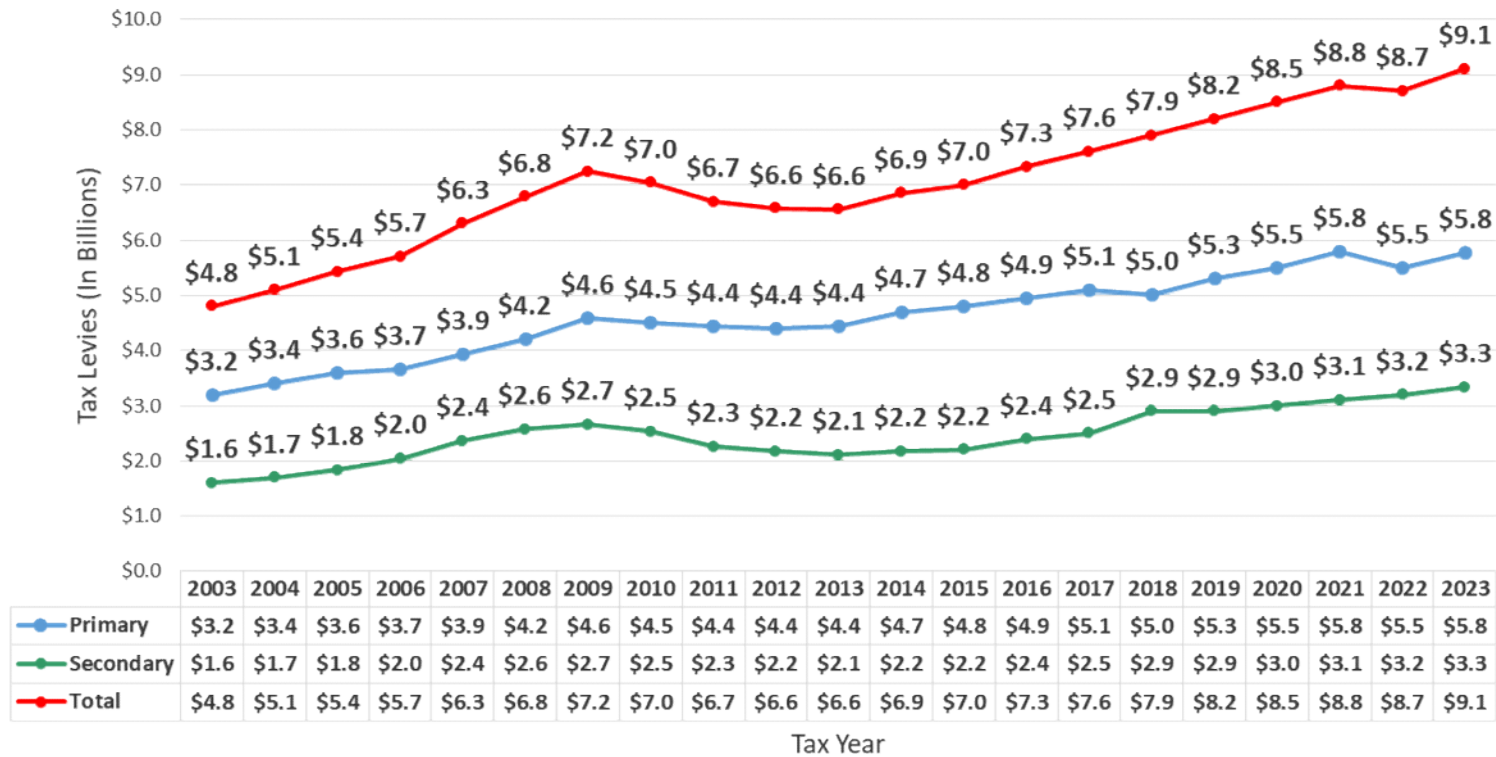
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Appeal Level	# of Appeals	
	2013	2023
Assessor	12,125	1,359
SBOE	5,155	406
Notice of Change	181	114

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# 20-Yr Property Tax Levies

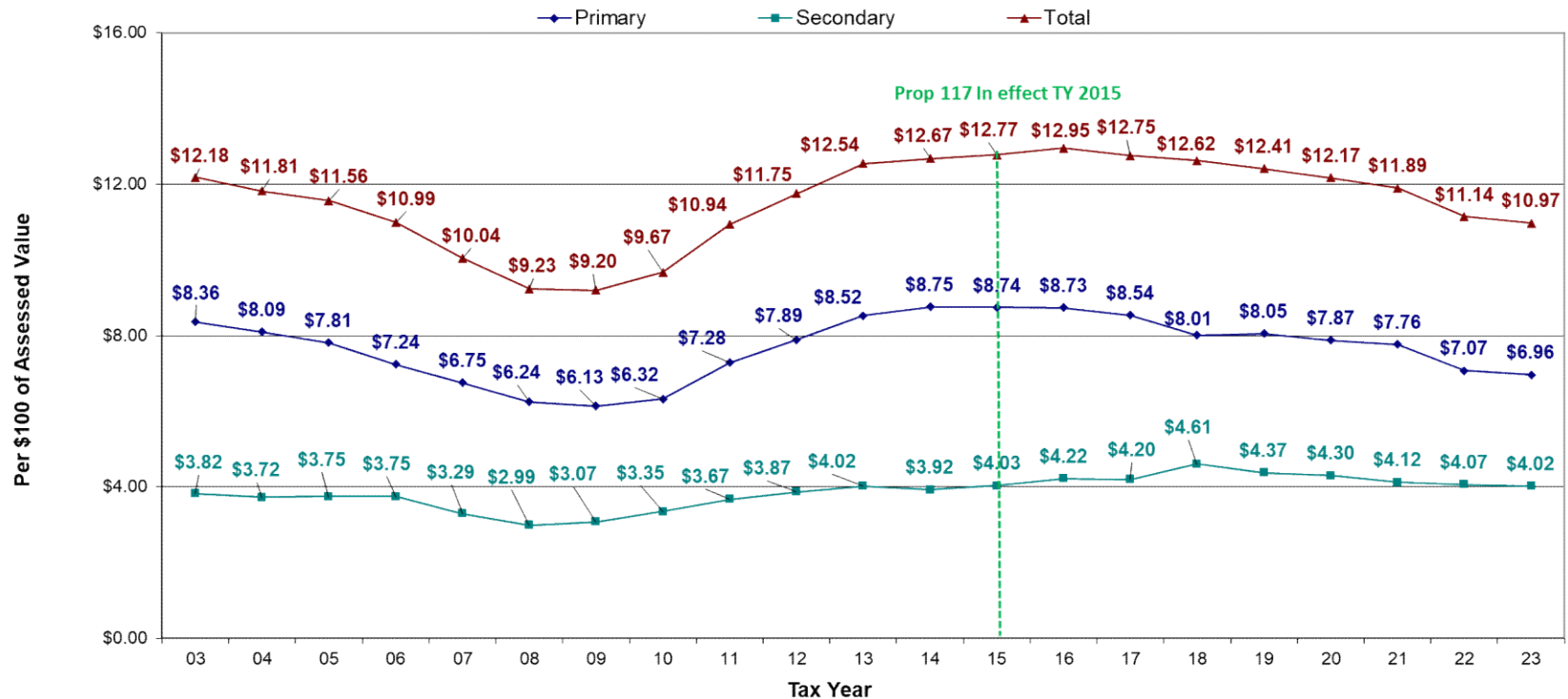


- 2003-2023: Total Levies up 89.6% (4.5%/YR): Secondary levies up 108.4% (5.4%/YR) & Primary up 80.5% (4%/YR)
- 2003-2008: Total Levies up 41.4% (8.3%/YR): Secondary Levies up 61% (12.2%/YR) & Primary up 31.6% (6.3%/YR)
- 2018-2023 (Post 117): Total Levies up 15.2% (3%/YR): Secondary up 15% (3%/YR) & Primary up 15.5% (3.1%/YR)

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# Statewide Average Property Tax Rates

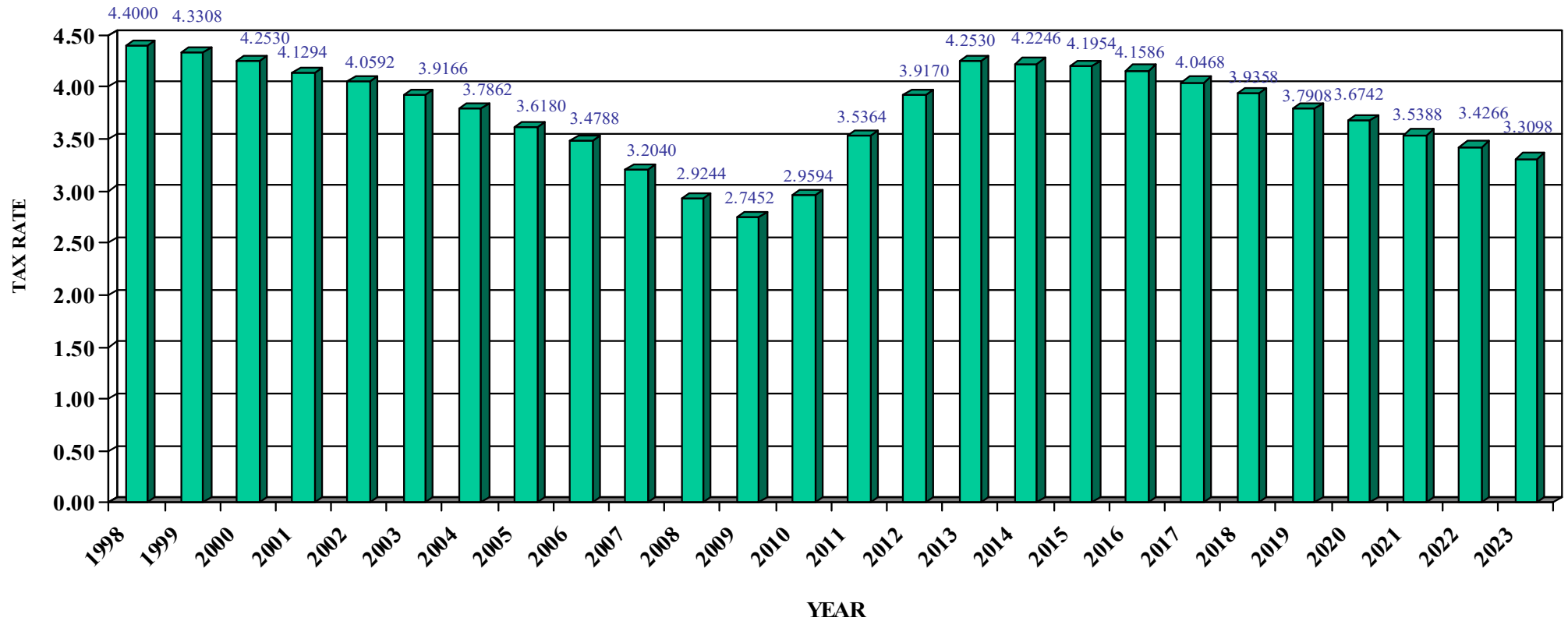


- No massive swings in the statewide average tax rate since Prop 117
- Statewide tax rate down \$1.80 (14%) to \$10.97 since 2015:
  - Primary average tax rate down \$1.78 to \$6.96
  - Secondary average tax rate down 1 cent to \$4.02

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# Qualifying Tax Rate (1998 – 2023)



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# Highest Total Property Tax Rates

Rank	Top Jurisdictions by Prop Tax Rate	Total Rate
1	Red Mesa Unifed in Apache County	\$33.9329
2	Hayden Winkelman Unif/Hayden/Gila	\$30.3298
3	Hayden Winkelman Unif/Winkelman/Gila	\$24.4992
4	Bowie Unif/Bowie FD/Cochise	\$19.2626
5	Cartwright El/Phx Un/Phoenix	\$19.1859
6	Cartwright El/Phx Un/Glendale	\$18.6493
7	Maricopa Unif/City of Maricopa/Pinal	\$18.5948
8	Eloy El/Santa Cruz Un/Avra Valley FD/Pinal	\$17.9278
9	Grand Canyon Unif in Tusayan FD	\$17.8551
10	San Simon Unif/San Simon FD/Cochise	\$17.7466
11	Isaac El/Phx Un/Phoenix	\$17.6147
12	Vail Unif/Corona de Tucson FD/Pima	\$16.7242
13	Laveen El/Phx Un/Laveen FD/Phoenix	\$16.6998
14	Laveen El/Phx Un/Phoenix	\$16.6949
15	Ash Creek El/Elfrida FD/Cochise	\$16.6517
16	Elfrida El/Elfrida FD/Cochise	\$16.6247
17	Marana Unif/Avra Valley FD/Pima	\$16.3832
18	Marana Unif/Picture Rocks FD/Pima	\$16.3629
19	Superior Unif/Superior/Pinal	\$16.3367
20	Vail Unif/Rincon Valley FD/Pima	\$16.3240
21	Pendergast El/Tolleson Un/Phoenix	\$16.2361
22	Sahuarita Unif/Arivaca FD/Pima	\$16.2146
23	Pearce El/Sunsites-Pearce FD/Cochise	\$16.1984
24	Santa Cruz El/Nogales Suburban FD/Santa Cruz	\$16.1529
25	Eloy El/Santa Cruz Un/Eloy FD/Pinal	\$16.1483
26	Vail Unif/Sonoita Elgin FD/Pima	\$16.1442
27	Flowing Wells Unif/Northwest FD/Pima	\$16.0030

**\*Statewide Average Tax  
Rate is \$10.97**

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# K-12 Primary Tax Rate Comparisons

Unified Districts (Full) QTR (\$3.3098)	
District	Total School
<b><i>Highest</i></b>	
Red Mesa Unif	\$31.7482
Hayden-Winkelman Unif*	\$11.8296
Grand Canyon Unif*	\$10.9210
Bowie Unif*	\$10.6939
Double Adobe El*	\$10.2332
San Simon Unif*	\$8.9393
Redington El*	\$8.2011
Mobile El*	\$7.9735
McNeal El*	\$7.8007
Sentinel El*	\$7.7679
<b><i>Lowest</i></b>	
Eagle El	\$1.6549
McNary El	\$1.6549
Cave Creek Unif	\$1.6724
Sedona Oak Creek Unif	\$1.6773
Fountain Hills Unif	\$1.6979
Chevelon Butte El	\$1.7794
Ganado Unif	\$1.8302
San Fernando El	\$2.0313
Continental El	\$2.1046
Williamson Valley El	\$2.2302

El/Un Districts (Half) QTR (\$1.6549)	
District	Total School
<b><i>Highest</i></b>	
Wenden El*	\$5.3886
Isaac El*	\$5.3378
Hyder El*	\$4.7580
Ash Creek El*	\$4.6060
Elfrida El*	\$4.5790
Sonoita El	\$4.4223
Pearce El*	\$4.1597
Salome El*	\$4.0737
Bouse El*	\$4.0412
Cartwright El	\$3.7603
<b><i>Lowest</i></b>	
Arlington El	\$0.9236
Riverside El	\$1.2909
Bicentennial Un	\$1.3555
Yuma Union	\$1.6728
Tolleson Union	\$1.6858
Murphy El	\$1.6881
Litchfield El	\$1.6910
Crane El	\$1.7015
Tempe Union	\$1.7028
Mingus Union	\$1.7076

## Formula Inequities:

- Deseg
- Transpo Delta
- Small School Adjustment

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## November Bond & Override Elections

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- \$3.6 billion in K12 Bonds
- \$1.0 billion in City Bonds
- Millions in K12 Overrides
- 64 Questions – 50 Passed
- State law requires these tax increases to be voter approved.  
However many campaigns cloaked in a narrative they aren't tax increases

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## Property Tax Recommendations

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- State policymakers should focus on flawed K12 finance formulas that drive very high and inequitable tax rates (Deseg; Transpo Delta; Small School Adjustment). This year Gov. Hobbs advocated for equity with elimination of Results Based Funding
- Bond and override campaigns should not be wrapped in misleading information
- Policymakers should make personal property taxes more equitable by reducing pre-2022 burdens

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## Government Property Lease Excise Tax (GPLET)

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- Early 80's, some cities began to aggressively use their tax exempt status for “economic development”
- The Legislature responded by creating the possessory interest tax to tax private concerns on certain government properties
- GPLET enacted in 1996 to replace tax on possessory interests that was repealed in 1995
- Officially an “excise” tax that is based on the square footage & use of a building rather than property value
- GPLET is levied on property that is owned by a city, town, county or county stadium district and leased to a private concern

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# GPLET “Reform” History



## Pre 2010



Deal length:

**Unlimited**

Rate Structure:

**Decreasing 20% every 10 years**

GPLET Tax Paid:

**Far below property tax  
Zero after 50 years**

## 2010 Reform

Deal length:

**25 years**

Rate Structure:

**20% deflator removed  
Inflation adjusted**

GPLET Tax Paid:

**Rates doubled; near property tax rates  
8 year abatement retained**

Central Business District  
(Where abatement may be offered):

**Must be contiguous & geographically compact;  
No larger than 5% of city size or 640 acres**

## 2017 Reform

Deal length:

**Up to 8 year abatement only  
OR up to 25 years paying GPLET  
then property returns to tax rolls**

Efficacy & Oversight:

**Gov Lessor responsible for  
calculating GPLET tax; Database of  
deals reported on city & DOR  
websites**

## 2018 Reform

Renewal:

**Slum & Blight designations  
updated every 10 years**



Central Business District Size:

**NOW 2.5% of city size  
or 960 acres**

Shape:

**Gerrymandering  
limited by defining  
“geographically  
compact” in law**

\*GPLET: building + land is held by Gov so property tax is not owed

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## Gift Clause Challenges

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Ariz. Const. art. 9, § 7. “Neither the state, nor any county, city, town, municipality, or other subdivision of the state shall ever give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any individual, association, or corporation....”

*Wisturber* two-pronged test:

- 1) Whether the challenged expenditure serves a public purpose
- 2) Whether “the value to be received by the public is far exceeded by the consideration being paid by the public”

\**Schires v. Carlat* “Huntington University” (2021)

\* *Englehorn v. Stanton* “The Derby” (2020)

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## Schires Supreme Court Ruling makes current GPLET Structure Legally Problematic

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**Even before the *Schires* decision, the lower court found *Derby* to be in violation of the Gift Clause**

As lower court questioned in *Derby* – “...if payments under a future GPLET agreement must more closely approximate the amount of *ad valorem taxes*, does the GPLET have any remaining usefulness to incent redevelopment? In other words...this judicial officer questions whether the death knell for the GPLET’s usefulness has rung.”

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# Problems beyond Constitutional Infirmities

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- Central planners picking winners & losers
- GPLET increases state aid payments (in Millions) to school districts – impacting all taxpayers statewide
- Higher property tax rates on other properties

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## GPLET Recommendations

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**If policymakers can't repeal GPLET entirely following the court decisions, then they should reduce the taxpayer subsidy**

- Reduce 8- year abatement period to 4 years or less
  - Project would need to pen out to ensure the *give* doesn't exceed the *get* in order to not violate the Gift Clause
- Improve Transparency
  - Require DOR to publish an Annual Report that includes the data the Department already receives from Lessors & County Treasurers

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# University Leasing

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# AG Mayes Drops Omni Case

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- Omni Deal (\$125M project)
  - No property taxes for 60 years
  - ABOR agreed to pay \$19.5M to Omni to build conference center (in exchange for 7 days use annually)
  - Omni agreed to prepay \$5.9M in rent and annual rent during 60-year lease term totaling more than \$118M
  - ABOR agreed to build a parking structure
- Supreme Court remanded to trial court and allowed two claims to be argued:
  - The lease to Omni was not for a public benefit
  - ABOR paying for construction violates the Gift Clause
- March 2023: AG Mayes drops Omni case

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# Update on 2023 Sales Tax Issues

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- 2013 TPT reforms tried to address some historic taxpayer concerns with state and city audits. The Final Report of the TPT Task Force said “A Majority of the Task Force maintains that it would be a vast improvement if all audits were the responsibility of one statewide entity, ADOR.”
  - Centralization of Audit Function by ADOR minimizes differences in interpretations & audit results
- Those 2013 Audit Reforms have, to a certain extent, been undermined by a successful end run by the cities around state law.

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# Cities end-run around Legislature via IGA

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- Cities Audit Authority expanded in IGA:
  - State & Municipal Audit Resolution Team (SMART) created in IGA as an advisory committee for resolving TPT issues, including audit. No reference to existing statutory Unified Audit Committee (UAC) to coordinate uniform audit functions
  - Any decision by DOR denying a city request to audit may be referred to SMART. Majority vote of SMART can override DOR's denial, otherwise DOR Director may act in best interests of all parties. Cities may submit Director's decision to AG for review
- Remedy:
  - Expand UAC's existing statutory authority – reinforce DOR has final say regarding TPT audits - *Not a committee created via IGA or subject to review by AG*
  - Prohibit multi-jurisdictional taxpayer audits by cities

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# The *ADP* Case

**ADP v. ADOR**, 254 Ariz. 417 (App. 2023). (Review denied by Arizona Supreme Court.)

**Background:**

- Arizona is the only state that has not amended its statutes to specify whether software is tangible personal property (TPP), or whether it is taxable for some other reason. (ATRA tried in 2018 and 2019!)
- Unlike the state, Arizona city tax codes address the taxation of software.
- Arizona TPT applies to proceeds from selling or renting TPP.
- ADOR taxes software as TPP that is either sold or rented.
- This case involved ADP's request for a refund of TPT that ADP paid on its proceeds from software that Maricopa County employees used to enter their time for payroll purposes.

## The *ADP* Case

- **Holding:** The Court of Appeals held that ADP's proceeds from its software license agreement with Maricopa County were subject to TPT as the rental of tangible personal property.
- The Court relied on a 1943 Arizona Supreme Court Case involving jukeboxes, and on a 1970 case involving coin operated laundry machines and car washing equipment.
- The Court of Appeals hinted it would have liked to decide *ADP* differently when it said it felt “compelled to follow” the jukebox case, and that it was “beyond [their] prerogative and authority to rectify” the discord between their decisions in this case (that software is TPP) and in the *Honeywell* case (that “[t]here is little doubt that computer software is intangible property”).

# The *ADP* Case

- Arizona's Supreme Court declined review.

## What's Next?

- ADOR is likely to argue that proceeds from the following services, and more, are subject to TPT: **video streaming services** such as Netflix, **music streaming services** such as Spotify, **online database and research services** such as Westlaw and LexisNexis (and many others used in other industries), **cloud storage services** such as Dropbox, **videophone services** such as Zoom, and **audiobook services** such as Audible.

## Any Hope for Taxpayers and Consumers?

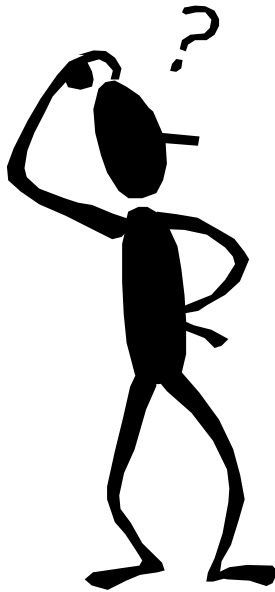
- I think *ADP* is distinguishable from many other situations involving services delivered over the internet.

CAVANAGH



# The *ADP* Case

## Questions?



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QASIMYAR, MESQUITE POWER, SAN DIEGO GAS &  
ELECTRIC

# Notable Property Tax Litigation

Pat Derdenger

Lewis Roca

ATRA 2023 ANNUAL MEETING

NOVEMBER 17<sup>TH</sup>, 2023

## **QASIMYAR V. MARICOPA COUNTY (APP. 2021): CHANGE IN CLASSIFICATION FROM CLASS 4 (RENTAL RESIDENTIAL) TO CLASS 3 (OWNER OCCUPIED) TRIGGERS “RULE B”**

- Rule A: Limited value increases by 5% per year. ARS 42-13301.
- Rule B: Used where there is: omitted property, **change in use**, new construction, parcel split, parcel subdivided or parcel consolidation.
  - Limited value is established at a percentage of full cash value that is comparable to that of other properties of the same or similar use or classification. ARS 42-13302.
- Rule B ratios for Maricopa County, Class 3 owner occupied:
  - 2020—71%      2021—69%      2022—68%      2023—55%      2024—48%
- *Qasimyar* involved single family rental residential property (Class 4) that changed to owner occupied residential (Class 3).
- Court held this was a change in use and classification that triggered Rule B.
- Maricopa County argued that there was no change in use because the property remained a single family residence whether it was rented or owner-occupied.
- 2022 Legislation (Ch. 300) changed result in *Qasimyar* by adding to 42-13302.A.2: “a change in the occupant or classification of a single-family residence is not a change in use, in and of itself.” But no retroactive effective date; effective September 24, 2022.
- Refunds for prior periods for Maricopa County (*Qasimyar* was a class action) where the Rule B limited value was lower than the Rule A limited value. Maricopa County announced that it will send out Notices of Proposed Correction reflecting the use of Rule B for LPV.
  - **Maricopa County estimates that over 34,000 properties will have a decrease in LPV while over 44,000 will see an increase in LPV.**

## **MESQUITE POWER V. ARIZONA DEP'T OF REVENUE (APP. 2022): ARE INTANGIBLES NOW TAXABLE?**

- Involved the property tax valuation of a natural gas-powered electric generation facility.
- There is a statutory formula for valuing electric generation facilities (statutory value). ARS 42-14156:
  - Cost (cost of construction or acquiring property in arm's length transaction) minus DOR's valuation factors (depreciation), with a floor of 10% of the "Cost."
- CAVEAT: the statutory value cannot exceed the property's market value. ARS 42-11001(6).
- Mesquite Power had in place a Power Purchase Agreement (PPA) with Southwest Public Power Resources Group for a guaranteed output of the power generated by the plant.
- Mesquite argued that the PPA was an intangible and could not be valued and taxed and should be subtracted from the statutory value
- Tax Court agreed.
- Court of Appeals overruled Tax court.
  - "We conclude that the Purchase agreement enhances the value of Mesquite's taxable property because it contributes to the plant's cash flows and current usage. Thus, it must be considered in determining the property's value."
- Ariz. Supreme Court has accepted review.

## **SAN DIEGO GAS & ELECTRIC COMPANY V. ARIZONA DEP'T OF REVENUE: A CASE FOR THE ELECTRIC UTILITY FOLKS**

- Like in the Mesquite Power case, there is a statutory formula for valuing electric utility transmission and distribution systems. ARS 42-14154.
  - “Original plant in service cost.”
  - Minus the related provision for “accumulated provision for depreciation.” This term is undefined.
  - The valuation statute requires that all terms be interpreted according to the FERC Uniform System of Accounts for electric utilities in effect on January 1, 1989.
- SDG&E owns a transmission line from Palo Verde to San Diego.
- It took the position that it could include in the “accumulated provision for depreciation” the cost of removal of the transmission line.
- FERC expressly includes the “cost of removal” as a part of accumulated depreciation.
- DOR argued that under the definition of “depreciation” (straight line depreciation over the useful life of the property), “the related accumulated provision for depreciation” does not include the unreported, prospective “cost of removal.”
- SDG&E further argued that the costs of removal reduced the “original plant in service cost” to a negative number.
  - And further argued that it could use the excess accumulated depreciation to offset the value of unrelated property.
- Court of Appeals held that “accumulated provision for depreciation” includes the “cost of removal” BUT it could not reduce the full cash value to a negative number or offset the value of unrelated property.

# **Gobbling Up National SALT Trends**

**2023 ATRA Outlook Conference  
November 17, 2023  
Scottsdale, AZ**

**Stephanie Do, Senior Tax  
Counsel, COST**





# About COST

The Council On State Taxation (COST) is the premier state tax organization representing taxpayers. COST is a nonprofit trade association consisting of over 500 multistate corporations engaged in interstate and international business.

**COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.**

COST was formed in 1969 by a handful of companies under the aegis of the Council of State Chambers of Commerce, an organization with which COST is still associated. That auspicious formation of COST was precipitated by the need of corporate taxpayers to be represented by a united voice on state tax issues - to counterbalance a number of organizations of state tax authorities. Over fifty years later, COST is more successful than ever as a result of the hard work of its nationally respected professional staff and the significant contributions of its Board of Directors and member companies.



# COST Advocacy Team



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*Of Counsel*



**COST SEASONAL INTERN**

*Turkey Tester*





# Agenda

- National Revenue Forecast
- State and Local Business Tax Burden Study & COST/STRI Publications
- Indirect Taxes
  - Indirect Tax Trends
  - Digital Taxation
  - The Best and Worst of State Sales Tax Systems
- Property Taxes
  - Property Tax Trends
  - Intangible Assets



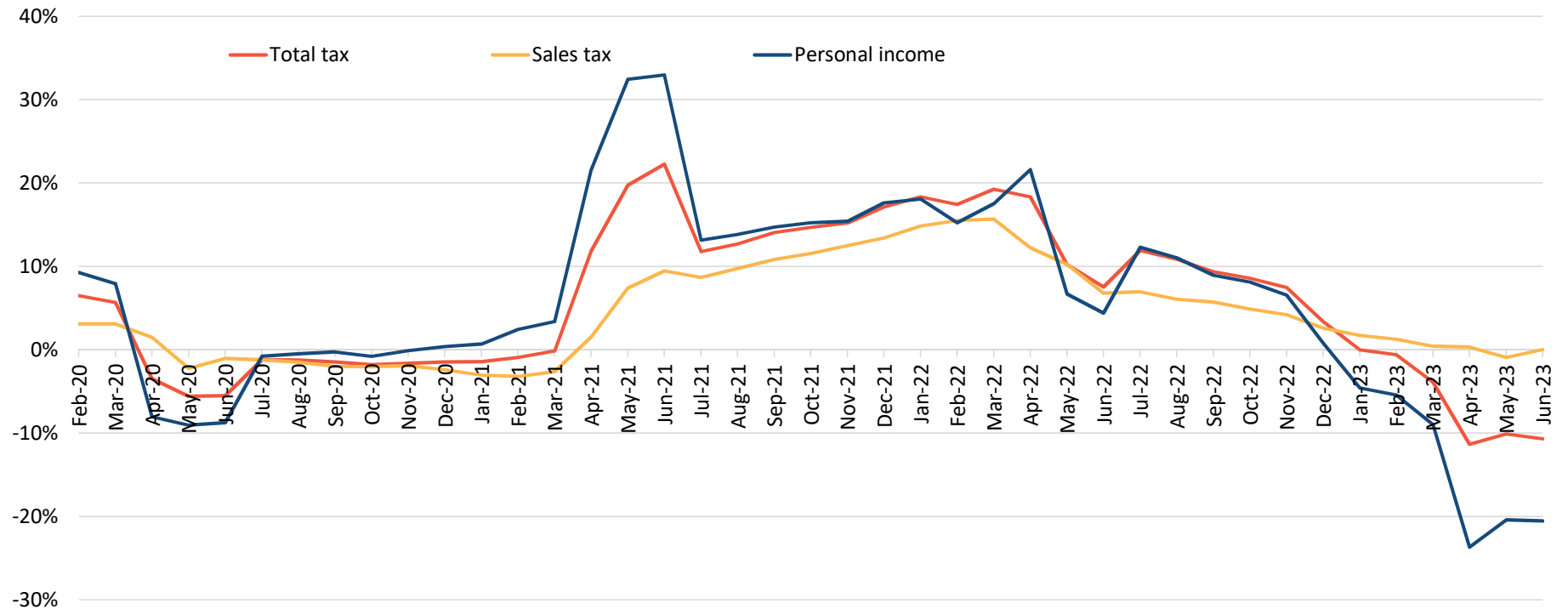
# National Revenue Forecast



# Trends in State Tax Revenues Since the Pandemic

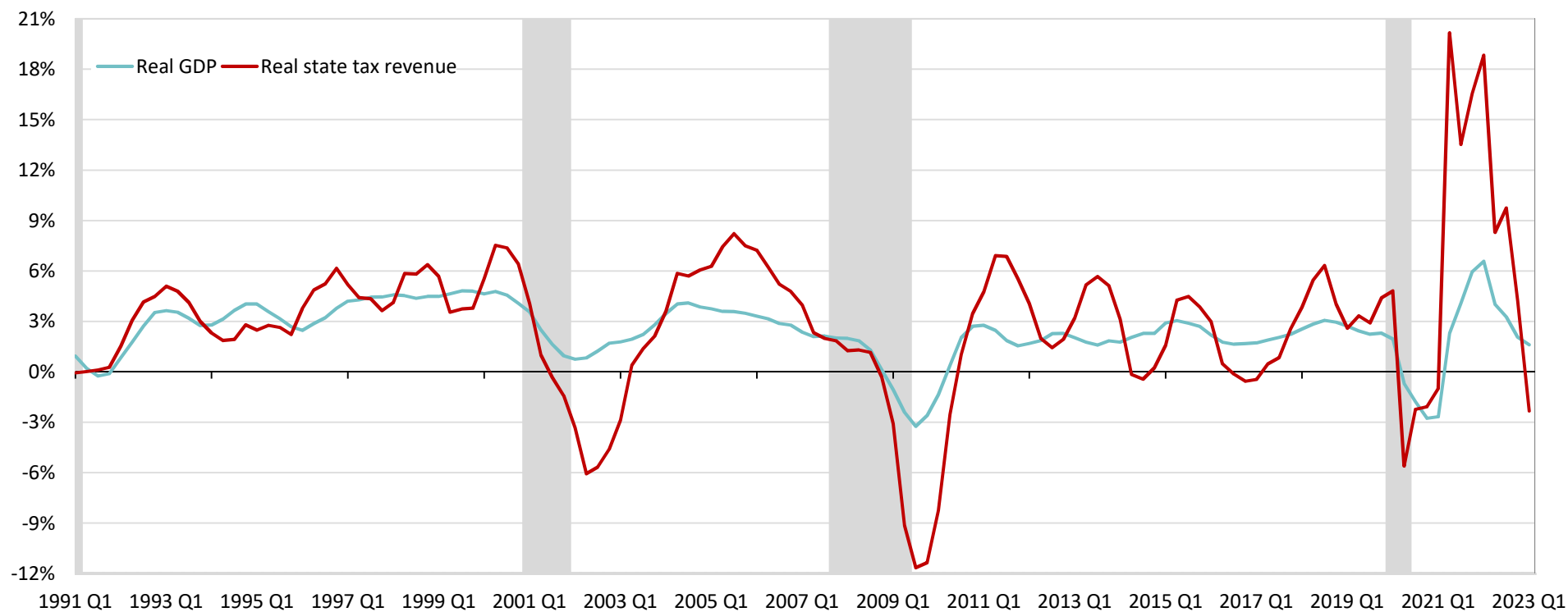
## Percent change in inflation-adjusted state tax revenues

Year-over-year percent change, 12-month moving averages



Source: "From Boom to Bust: State Tax Revenue Returns to Slow Growth Norm," Lucy Dadayan, Tax Policy Center, Sept. 7, 2023

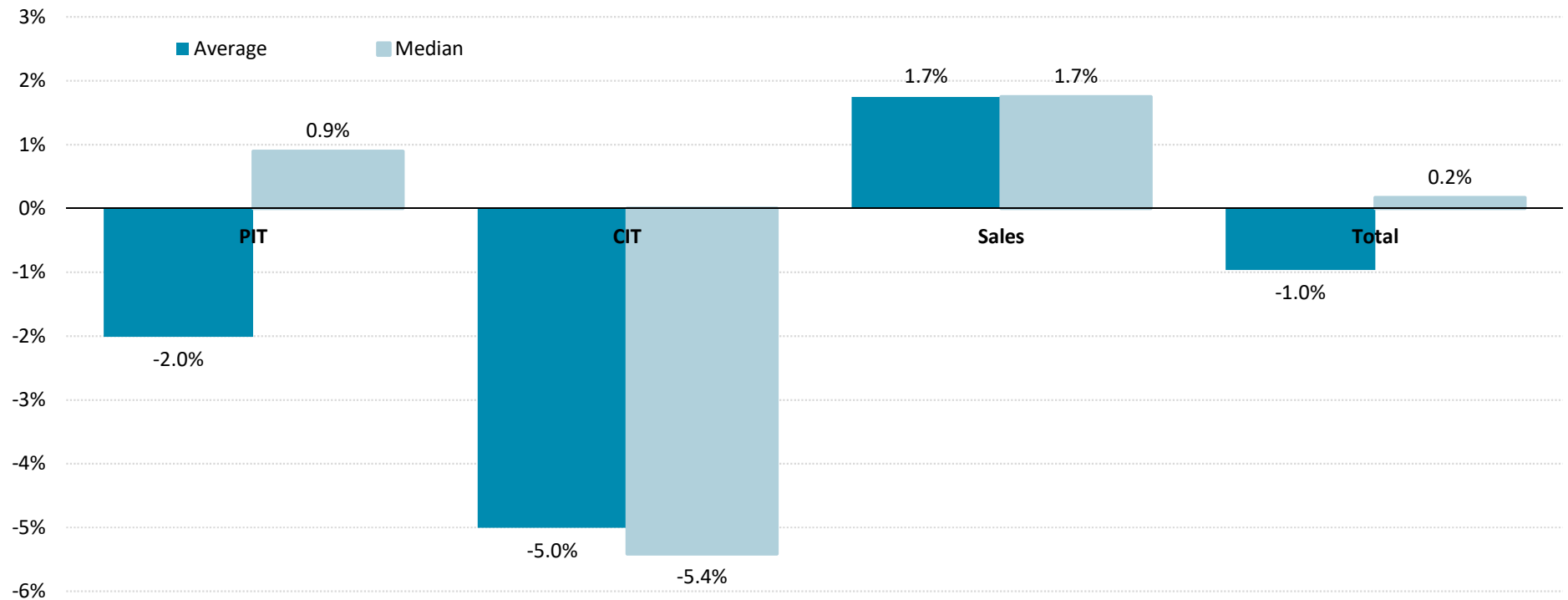
# State Tax Revenues: More Volatile Than the Economy



Source: “From Boom to Bust: State Tax Revenue Returns to Slow Growth Norm,” Lucy Dadayan, Tax Policy Center, Sept. 7, 2023

# States' Most Recent Revenue Forecasts for FY 2024

State revenue forecast for FY 2024 (year-over-year nominal percent change)



Source: "From Boom to Bust: State Tax Revenue Returns to Slow Growth Norm," Lucy Dadayan, Tax Policy Center, Sept. 7, 2023



# State and Local Business Tax Burden Study & COST/STRI Publications





# **COST Scorecards**

**Goal is to work with the state tax policy makers (legislative and executive branches) to improve tax administration.**

- The Best and Worst of State Tax Administration, Update to be issued around November/December 2023
- The Best (and Worst) of International Property Tax Systems, June 2019
- The Best and Worst of State Sales Tax Systems, December 2022 – expanded to address B-2-B tax on digital products
- The Best and Worst of State Unclaimed Property Laws, October 2013





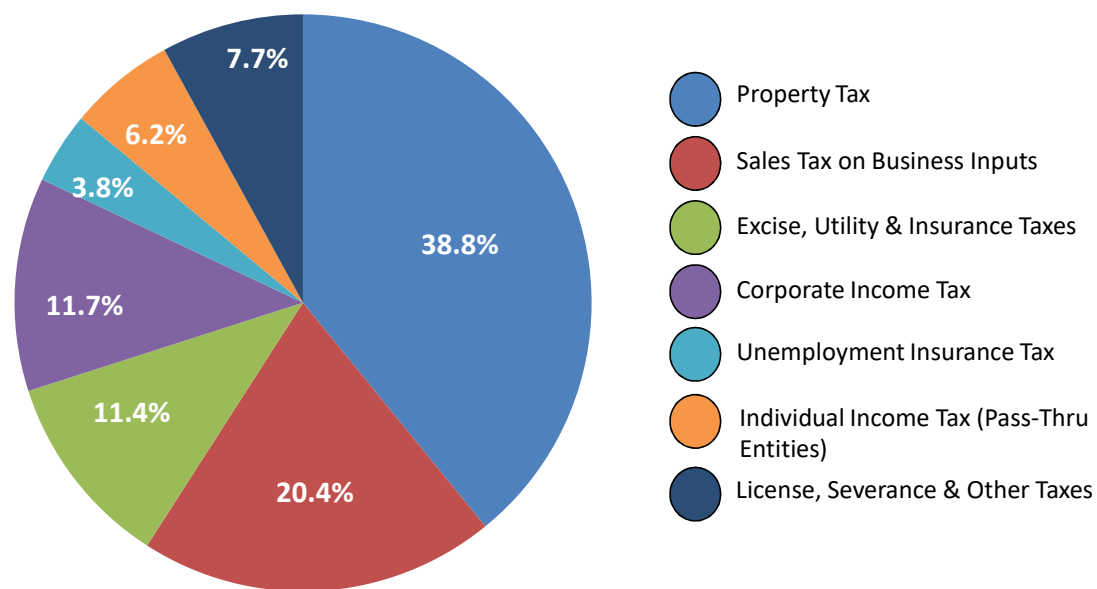
## Recent COST/STRI Studies

- **Minnesota's New Approach to Taxing Foreign Income Is Unfair and Unwise** (August 2023)
- **State Digital Services Taxes: A Bad Idea Under Any Theory** (April 2023)
- **5 State Tax Policy Changes That Would Modernize Laws & Ease Administration & Compliance** (April 2023)
- **FY21 State and Local Business Tax Burden Study** (December 2022)
- **COST Scorecard on Sales Tax Administration** (December 28, 2022)
- **Down the Rabbit Hole: Sales Taxation of Digital Business Inputs** (July 2022)
- **Resisting the Siren Song of Gross Receipts Taxes: From the Middle Ages to Maryland's Tax on Digital Advertising** (July 2022)
- **Locally Administered Sales and Accommodations Taxes: Do They Comport with Wayfair?** (July 2022)
- **A Global Perspective on U.S. State Sales Tax Systems as a Revenue Source: Inefficient, Ineffective, and Obsolete** (November 2021)
- **Convergence and Divergence of Global and U.S. Tax Policies** (August 2021)
- **State Adoption of European DSTs: Misguided and Unnecessary** (May 2021)
- **Eureka Not: California CIT Reform is Ill-conceived, Punitive and Mistimed** (May 2021)
- **Forthcoming Studies:** E-Invoicing: Worldwide Combined Reporting; Digital Business Inputs Part 2





# US FY 2021 State and Local Business Tax Burden Study



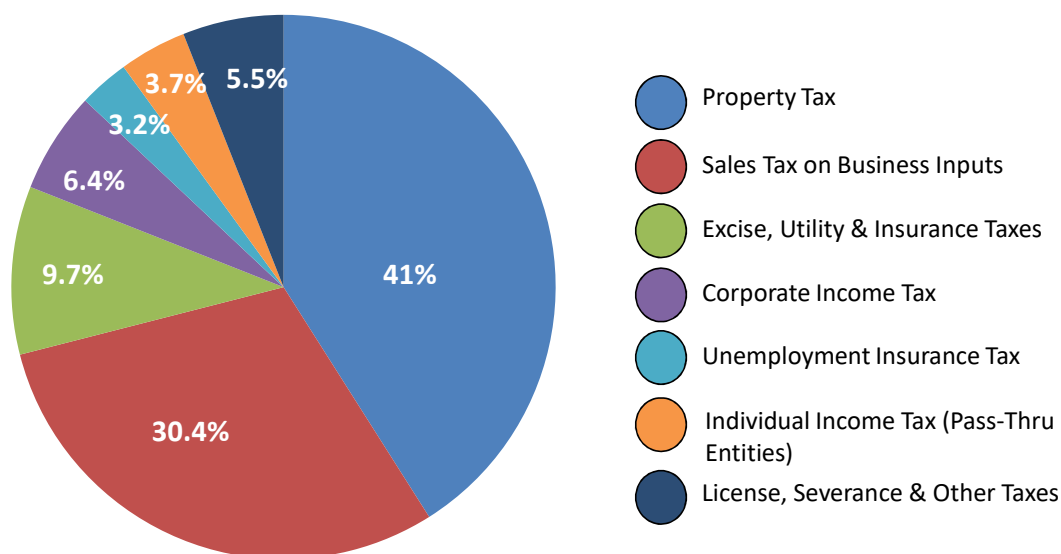
Source: *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2021*, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (December 2022)

## How Much Do Businesses Pay?

- Businesses paid more than \$951 Billion in U.S. state and local taxes in FY21, an increase of 13.6% from FY20
- State business taxes increased by 17% and local business taxes grew by 10.2%
- Corporate income tax revenue increased by 53.3% in FY21
- In FY21, business tax revenue accounted for 43.6% of all state and local tax revenue
- Remarkably, the business share of SALT nationally has been within approximately 1% of 44% since FY03



# Arizona: FY 2021 State and Local Business Tax Burden



## How Much Do Businesses Pay?

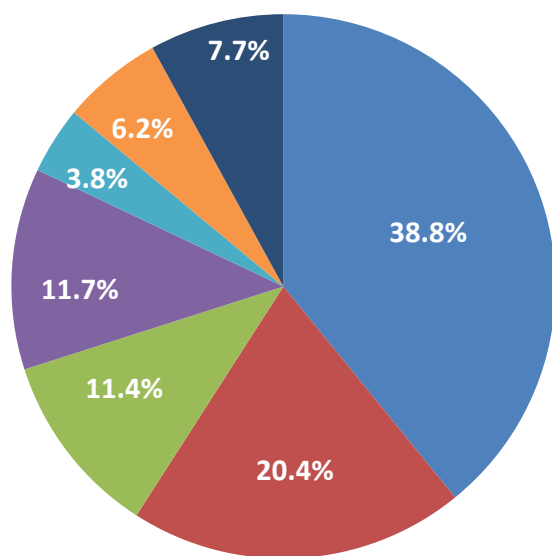
- Businesses paid \$14.2 Billion in Arizona state and local taxes in FY21, an increase of 13.6% from FY20
- Corporate income tax revenue increased by 80% in FY21 from FY20
- State business taxes increased by 12.9% and local business taxes grew by 12.5%
- In FY21, business tax revenue accounted for 41% of all state and local tax revenue

Source: COST, STRI, EY FY21 State and Local Business Tax Burden Study (December 2022)

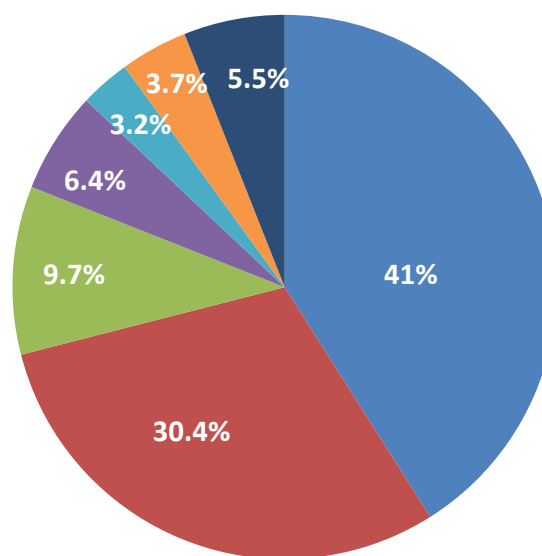


# US Versus Arizona Comparison

## United States



## Arizona



- Property Tax
- Sales Tax on Business Inputs
- Excise, Utility & Insurance Taxes
- Corporate Income Tax
- Unemployment Insurance Tax
- Individual Income Tax (Pass-Thru Entities)
- License, Severance & Other Taxes

Source: COST, STRI, EY FY21 State and Local Business Tax Burden Study (December 2022)



# Indirect Taxes





# Indirect Tax Trends

## Historical Trends

**Broad based services proposals-often coupled with repealing/phasing out income taxes**

These proposals often garnered opposition from widely diverse service industries

**Representational/affiliate nexus/use tax reporting**

Pre-*Wayfair*, states were focused on getting online retailers to collect

**Digital goods defined to include e-books, videos and music**

**Sales tax prepayments allowed states to have use of revenues more quickly**

## Current Trends

**“Digital goods” broadly defined to capture additional internet-based services**

**Proposals to impose new, discrete taxes on specific services/transactions**

E.g. digital advertising, data sharing, financial trades/stock market transactions

**Expansion of gross receipts taxes and fees**

**Shift in collection responsibility from the seller to the marketplace facilitating the transaction**

Expanded to include all aspects of the sharing economy

Expand obligation to collecting other fees related to retail sales, e.g., battery, e-waste



# Digital Taxation

**States continue to seek ways to expand scope of sales and use taxes by extending tax to cover digital goods and services or by enacting new taxes specifically focused on digital services:**

- Expand the sales and use tax scope to include digital goods and services (e.g., software/SaaS, digital equivalents)
- Maryland Digital Advertising Services Tax
  - Aimed at large social media and technology companies but has affected significant number of businesses and industries
  - Similar/identical legislation introduced in other states
- Target other aspects of the “digital economy” (e.g., social media advertising, sale of personal information and data, operating as a social media company, data mining services)





## ***ADP, LLC v. Arizona Department of Revenue***

- Jan. 2023: The Arizona Court of Appeals determined that a contract granting access through the internet to ADP's eTime software constituted a lease of tangible personal property subject to the Transaction Privilege Tax under the definition in A.R.S. § 42-5071(A).
- Sept. 2023: The Arizona Supreme Court declined to review the case.





## ***ADP, LLC v. Arizona Department of Revenue***

### **COST Amicus Brief**

- No statutory authority to include ADP's SaaS in the TPT tax base as the lease or rental of tangible personal property.
  - Arizona has not amended its traditional statutory definitions of "tangible personal property" to reflect digital products.
- Arizona is an outlier among states that tax digital products.







# MTC Digital Products Project

## Multistate Tax Commission (MTC) Sales Tax on Digital Products Project

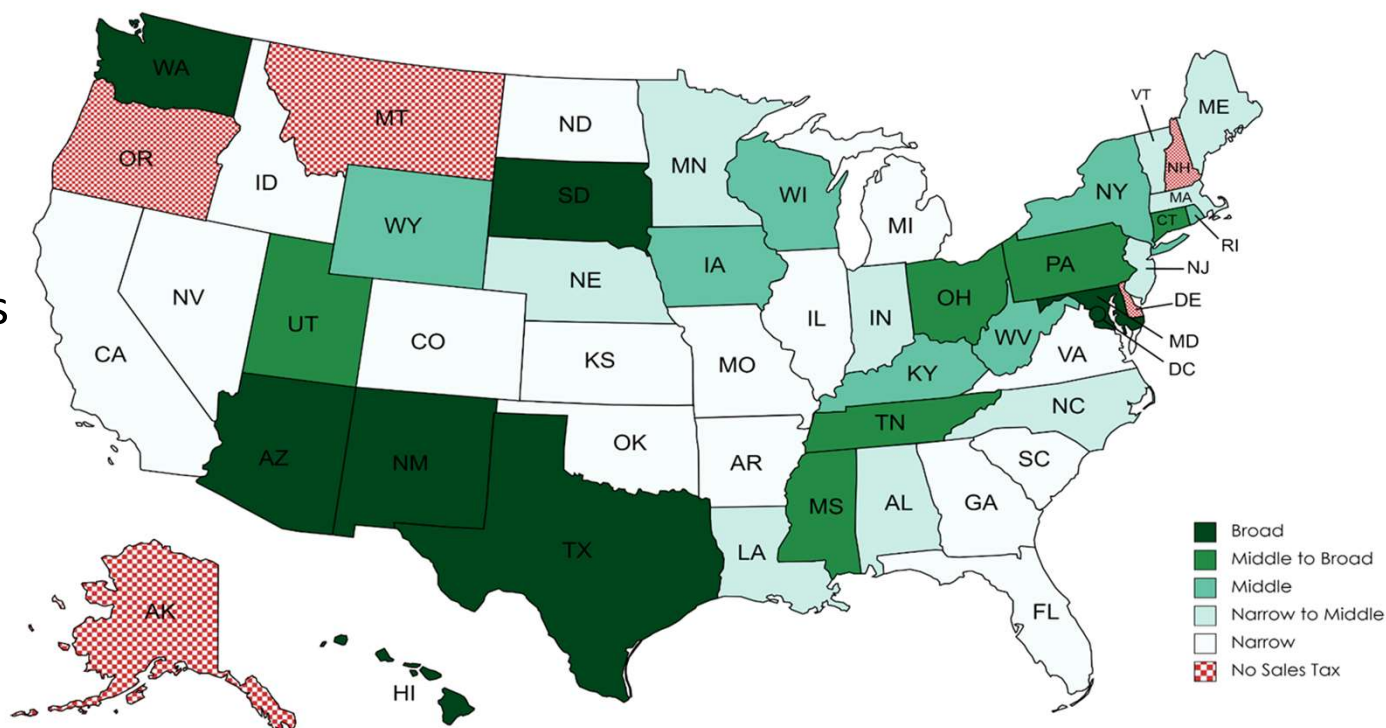
- April 2021 – Washington State proposes a project to the MTC Uniformity Committee to consider a simpler and more adaptable approach to taxing digital products.
- September 2022 – First work group meeting of state representatives led by Gil Brewer from Washington State. Work group meets the first Thursday of each month at 11:00 am EST.
  - Project page on MTC website has meeting info and other resources:  
<https://www.mtc.gov/Uniformity/Project-Teams/Sales-Tax-on-Digital-Products>
- Fall 2022 – present – Work group members decide the first topic they want to study is definitions for digital products and what items exist in the marketplace. MTC staff compile a 46-jurisdiction survey of state taxation of digital products.



# MTC Work Group Classification of the Breadth of State Digital Sales Tax Bases

The MTC has analyzed state approaches to digital products and generally divided state sales tax bases into three categories:

- (1) Narrow
- (2) Middle
- (3) Broad



MTC Chart



# Digital Products – COST Response

## The COST Response

- Include a robust discussion of digital business input exemptions (B-to-B purchases)
- Encourage taking a position in MTC's White Paper that B-to-B purchases of digital products should be excluded from the sales tax base to avoid tax pyramiding

## Anti-Pyramiding - History

- From the beginning, most state sales taxes were generally designed to apply to one stage – the retail sales stage – to avoid sales tax pyramiding (e.g., production, distribution and retail stages).
- In the first few decades of sales tax system development, most states enacted sale for resale exemptions and some level of exemption for ingredient and component parts, materials and machinery used in the manufacturing sector.
- Unfortunately – with purchases made by service industries, wholesalers, retailers, and eventually digital businesses, there was no similar history of “suspending” sales tax for B-to-B purchases.

## Anti-Pyramiding - Policy

- States should not discriminate against digital products by providing manufacturing exemptions for tangible property production but not for similarly situated digital goods production.
- Only a small minority of states currently exempt digital business inputs from their sales tax base.

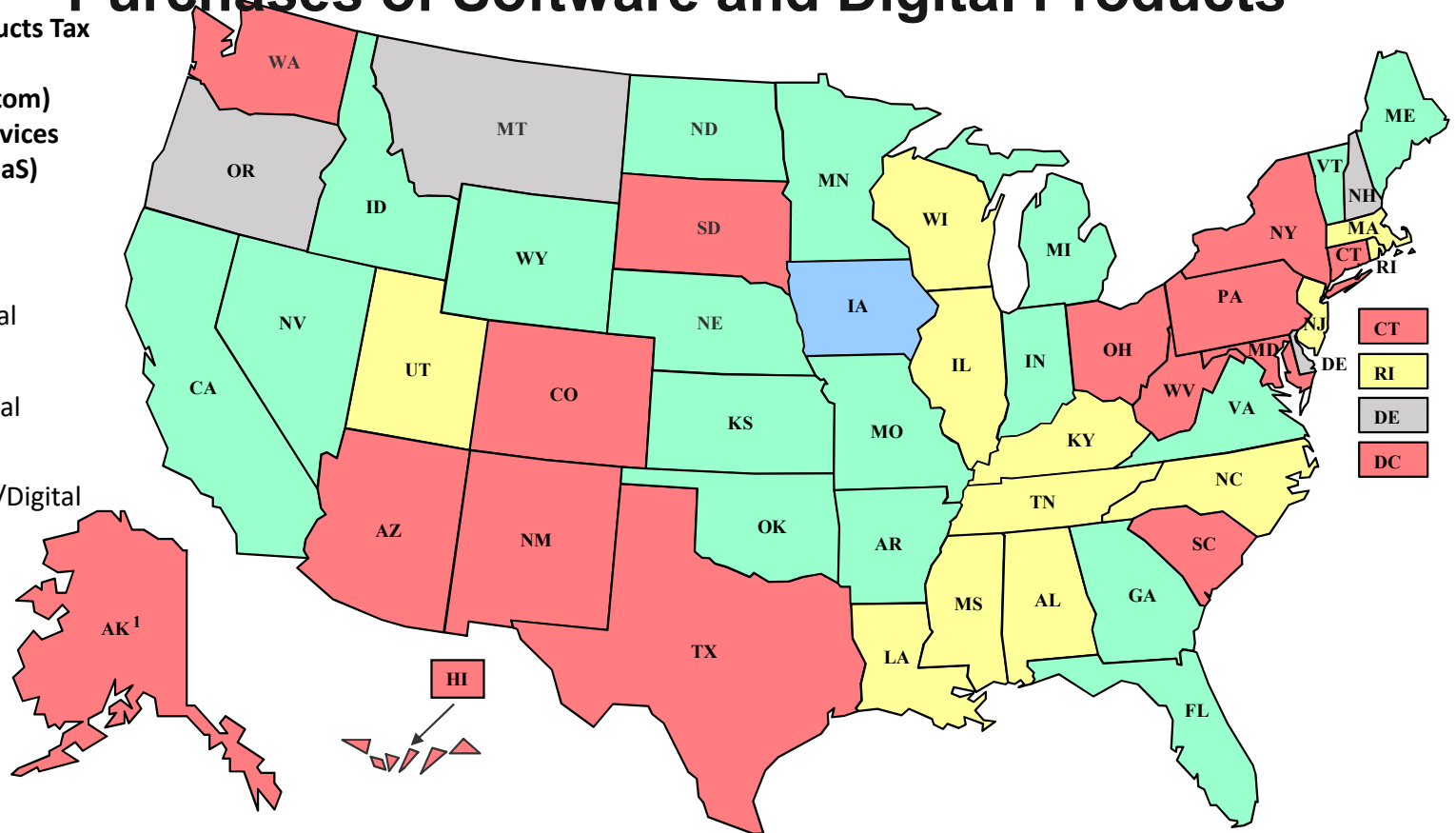
See: Karl A. Frieden, Frederick J. Nicely, and Priya D. Nair, “Down the Rabbit Hole: Sales Taxation of Digital Business Inputs,” *Tax Notes State*, July 18, 2022.

# Only One State has a Full Exemption for Business Purchases of Software and Digital Products

## Three Software/Digital Products Tax Types

- Software (canned or custom)
- Data Processing/Info Services
- Software as a Service (SaaS)

- Full Business Exemption
- Taxes One Software/Digital Products Category
- Taxes Two Software/Digital Products Categories
- Taxes All Three Software/Digital Product Categories
- No sales tax

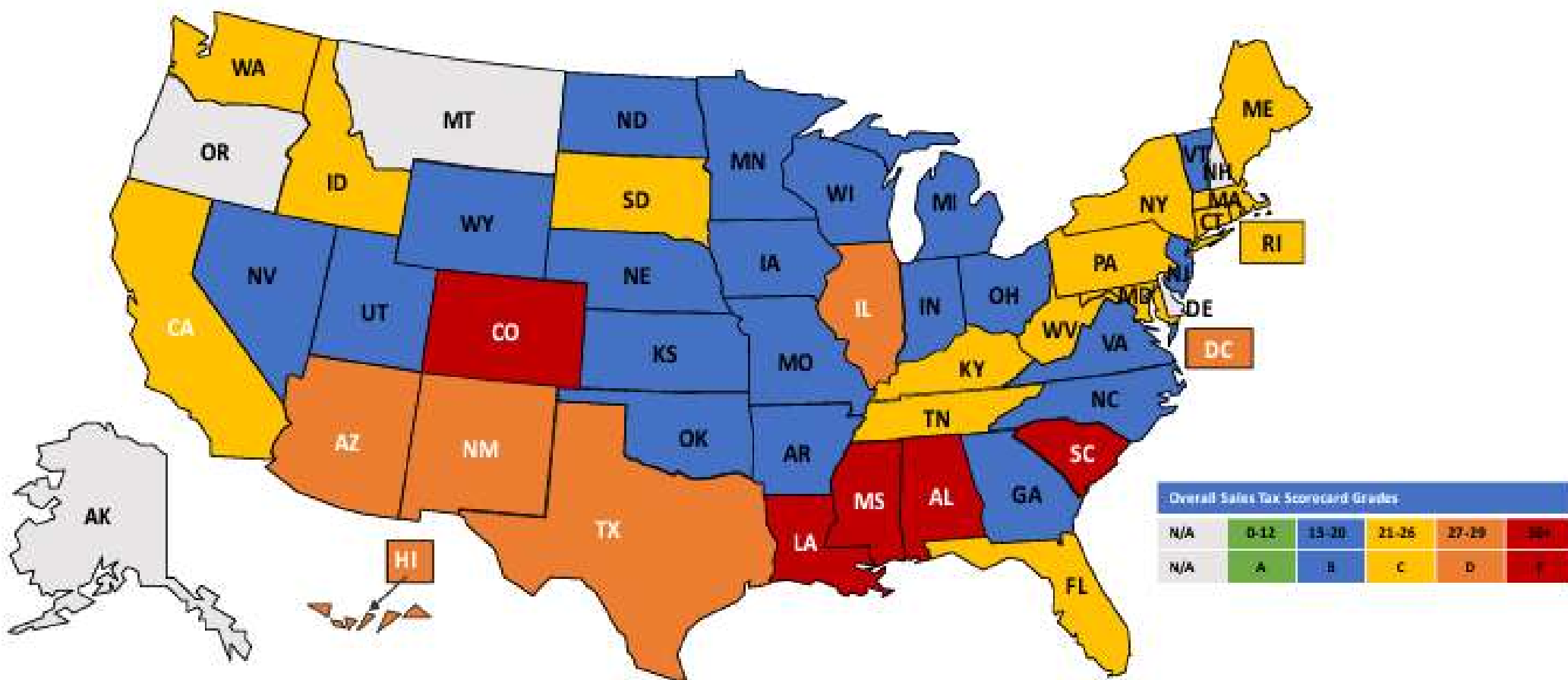


**Disclaimer:** This information should be used for general guidance and not relied upon for compliance.

**Source:** Council On State Taxation (COST)

<sup>1</sup>Data is based on local municipalities since Alaska does not have a state-wide sales tax

## 2022 COST Sales Tax Scorecard: Overall Grades



Source: : Karl A. Frieden, Frederick J. Nicely, and Priya D. Nair, "The Best and Worst of State Sales Tax Systems, Dec. 2022.



## Arizona's Grade Detailed

- Business Inputs Exemption: 6 out of 8
- Software Digital Products: 6 out of 7
- Simplification & Uniformity: 5 out of 6
- Central Administration: 3 out of 5
- Sales Tax Process: 4 out of 6
- Reasonable Payments/Credits: 4 out of 6
- Fair Audits/Refunds: 2 out of 5

THANKSGIVING DAY TIMELINE

SERVING TIME:

DISH

	START TIME	COOKING TEMP	COOKING TIME

THANKSGIVING DAY TIMELINE

SERVING TIME: 5:00pm

DISH

	START TIME	COOKING TEMP	COOKING TIME
Green beans			
remove pies, turkey, ham from fridge			
remove premade casseroles from fridge			
sweet potato casserole in oven			
warm ham in toaster oven			
corn casserole in oven			
rice casserole in oven			
turkey in toaster oven w ham			
make stuffing/dressing			
gravy			
oven			
cherry sauce			





## How Can Arizona Improve

- Provide broad business inputs exemptions
- Taxation of digital products should be by statutes that reflect digital products, not traditional “tangible personal property”
- Join the Streamlined Sales and Use Tax Agreement (SSUTA)
- Follow best practices for marketplace facilitator laws
- Centralize audits with no contingency fee audit practices
- Follow fair sales tax processes, such as accepting MTC and SSUTA exemption certificates





# Property Tax Trends

- **Business Personal Property Trends**

- Audits which were postponed or delayed due to COVID are now on the forefront
- Tax rates are increasing across all jurisdictions
- Assessors and Tax Collectors are delayed in updates to values or settlements due to lack of staffing
- Obsolescence or value adjustments granted during COVID are not being approved

- **Real Property Trends**

- Capital markets and interest rate increases over the past 12 months
- Cash flow
- Rent increases
- Increase in insurance costs in coastal states (e.g., Florida, Louisiana)

- **Residential Property Trends**

- Increased property valuations
- Legislative property tax relief





# Intangible Assets In Assessments

## Increased controversy on valuations involving intangibles

- ***Olympic & Georgia Partners, LLC v. Cnty. of Los Angeles*, review granted (July 12, 2023):** Whether the subsidy that the city paid to hotel owner is included in hotel's valuation
- ***Kingfisher Wind, LLC v. Wehmuller*, reh'g denied (Dec. 2, 2022):** Whether Production Tax Credits (PTCs) are "property" subject to ad valorem taxation in Oklahoma
- ***Petrogas v. Xczar, Whatcom County Assessor*, review denied (July 12, 2023):** Whether overpayment related to a purchase price and assigned to goodwill is exempt intangibles.





# Intangible Assets In Assessments

- **Exemption from real property taxation**

- The value of intangibles used in a business *shall not* enhance or be reflected in the value of the business's taxable property
- Tangible real property should be valued assuming the presence of intangibles necessary to put the tangible property to beneficial and productive use (i.e., value property at its highest and best use by assuming the presence of intangibles, but do not include the value of the intangibles)
- When the unit being valued includes both taxable property and non-taxable intangibles, the value of the non-taxable intangibles must be removed to arrive at the value of the taxable property only

- **Exemption from personal property taxation**

- The value of intangibles assets should not be reported on the personal property tax returns



## ***Mesquite Power, LLC v. Arizona Dep't of Revenue***

- Primary Issue: Whether the existence of an intangible power purchase agreement (PPA) enhances the value of the real and tangible personal property subject to property tax assessment.
- Department argued that though the PPA has little to no independent value, the PPA's presence enhances the value of the real and tangible property of the plant.
- Taxpayer argued the PPA has independent value that must be excluded when valuing the real and tangible personal property.
- Court found that because the PPA influences the purchase price a willing buyer would pay for the property, the proper valuation of the property should reflect the effect of the PPA. Though severable, the PPA is not easily disentangled from the plant. Thus, the court held that the PPA enhances the value of the Taxpayer's taxable property because it contributes to the plant's cash flows and current usage.
- Review denied (June 2, 2023)



**Thank you!**

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