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ARIZONA TAX RESEARCH ASSOCIATION

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Panel Discusses *Wayfair* in Arizona

The 2018 ATRA Outlook conference included a segment on the recent *Wayfair v. South Dakota* decision that provides states the opportunity to tax remote sellers. James Busby, attorney at the Cavanagh Law Firm and ATRA Board Member, began the discussion with a legal analysis of the case law that led to *Wayfair*.

In situations when state legislation impacts interstate commerce in ways not addressed by Congress, the Court considers a state law to be lawful if it does not discriminate against or impose undue burdens on interstate commerce. In the 1977 *Complete Auto Transit* case, the Court outlined a four-prong test to determine the legality of state taxes on transactions involving interstate commerce: 1) the tax must apply to an activity with substantial nexus with the taxing state; 2) the tax is fairly apportioned; 3) the tax does not discriminate against interstate commerce; and 4) the tax is fairly related to the

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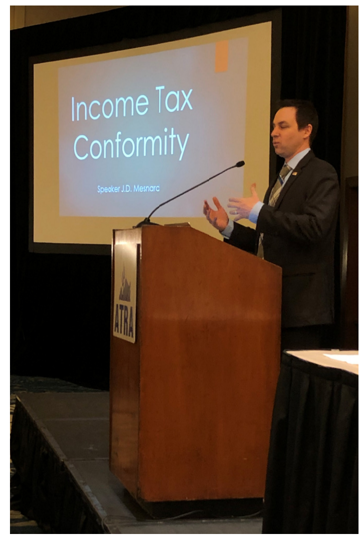
Left to right: James Busby, Christie Comanita, and Bill Molina

Mesnard Warns of Inaction on Conformity



Speaker of the House J.D. Mesnard used the ATRA Outlook Conference to make a strong pitch that time is running out for Arizona to react to the federal income tax changes in the Tax Cut and Jobs Act (TCJA) passed in December 2017.

Arizona is one of many states that uses the definition of federal income as the starting point for Arizona corporate and personal income taxes. Speaker Mesnard explained that the base broadening associated with the TCJA will result in higher state income taxes for most Arizona filers. He explained the state's inability to come to an agreement in the 2018 session on a resolution to the federal conformity problem now creates a very narrow window for a response.

Noting that federal conformity is usually assumed in Arizona and almost always non-controversial, the Speaker warned that will not be the case when personal income taxes

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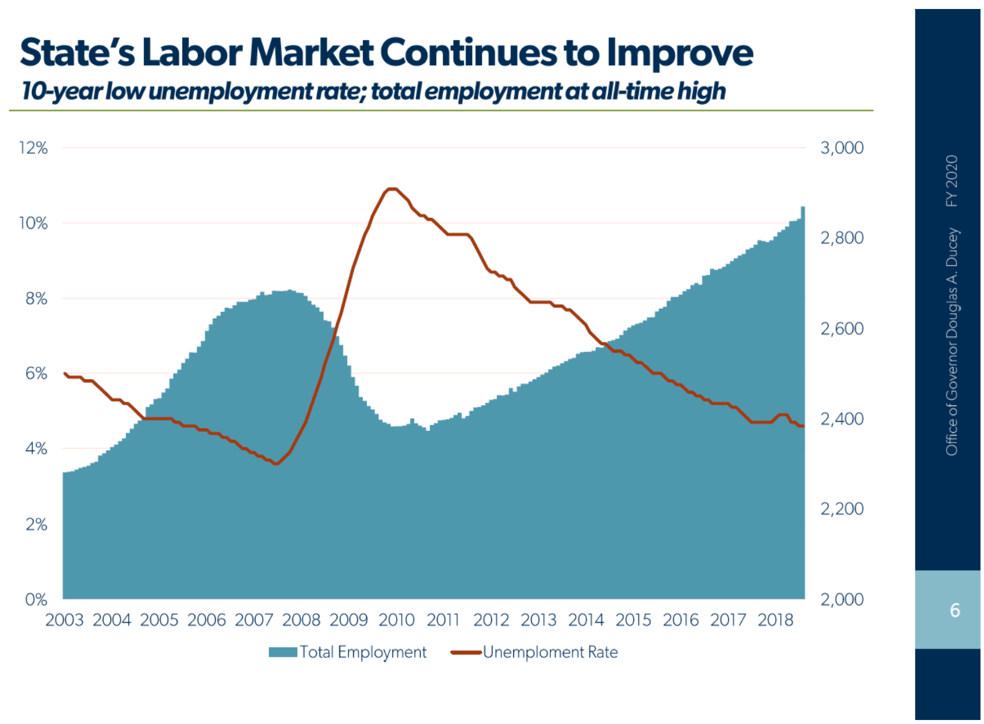
State Budget Director Cautions Big Spenders

Matt Gress, Director of the Governor's Office of Strategic Planning and Budgeting Office (OSPB), kicked off ATRA's 78th Annual Outlook Conference with a presentation on the state's fiscal health. General Fund revenues outpaced projected revenues for the second year and he stressed that while the state's balance sheet is stronger than it has been in recent years, fiscal restraint is necessary in order to preserve that stability in future years.

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

Speaking to the economic health of our state, Arizona leads western states in population growth and net migration, while the growth in California and Colorado are trending down. Arizona's labor market is at an all-time high with job growth increasing by 2.9%. The construction industry is experiencing much of that growth at 10.8%, followed by manufacturing at 5.1% growth. In fact, Arizona's manufacturing growth rate ranks 3rd fastest nationally. Sales taxes are the leading major revenue source supporting the state general fund, representing 45.2% of total revenues. Individual income taxes account for 41.3% of total revenues, followed by corporate income taxes at just 2.4%, and 11.1% in all other tax categories. However, he warned that the current growth rate is not sustainable, and due to future economic uncertainties, the forecast is continually being revised.



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Gress emphasized the need to balance fiscal prudence and program needs, while at the same time avoiding past fiscal mistakes. The FY 2019 was structurally balanced and the executive intends to maintain that balance while managing his top priorities, which include K-12 and public safety. At full implementation, the K-12 initiatives enacted for FY 2016 through FY 2023 will boost K-12 funding by $2.2 billion. That includes additional funding above inflation for Prop 123, teacher raises, additional assistance, and the extension to Prop 301. The Governor is also focused on public safety initiatives aimed at decreasing the relapse of former inmates by providing substance abuse treatment, educational services, employment centers, and re-entry centers. The Border Strike Force Bureau, which the Governor created a few years ago, will continue to focus on securing the Arizona-Mexico border by seizing illegal drugs and stopping criminals.

Stielow & McCarthy Provide Overview of Major Tax Issues for 2019

ATRA staff presented an overview of the major tax issues facing taxpayers in 2019. In the area of property taxes, staff focused on the 25% growth in K-12 secondary levies over the last five years, as growth in budgets has resulted in significant increases in override levies. Fire district levies also continue to grow as many districts grapple with PSPRS unfunded liabilities, among other issues, with one-third of the districts now at the $3.25 tax rate cap. Another major problem area discussed was government's use of its tax exempt status, which has recently expanded to the non-profit world, to shield private development from the property tax rolls. ATRA staff also outlined the principles that should guide Arizona's response to the recent *Wayfair* decision. Additionally, ATRA will renew its effort for clarity on Arizona's tax treatment of digital goods and services. ATRA urged lawmakers to rapidly enact Federal Conformity and adjust marginal rates or standard deductions to offset the personal income tax increase that will occur in Arizona as a result of federal base broadening.

Doug Lindholm Provides State of State Taxes

Doug Lindholm, the President and Executive Director of the Council on State Taxation (COST), provided the Annual Meeting luncheon speech, focusing on the many challenges facing state tax policymakers. Lindholm focused on the impacts of Federal Tax Reform on state taxes and the aftermath of the *Wayfair* Supreme Court decision.

On federal tax reform, Lindholm warned of the many pending issues in the corporate income tax arena which require state law changes in light of TCJA. On *Wayfair,* Lindholm encouraged the adoption of the Streamlined Sales and Use Tax Agreement, which many states appear to be shrugging off as an unnecessary goal.

K-12 Finance Discussion: New Money Must Go Towards Reform

Lisa Graham Keegan and Sean McCarthy led a discussion on school finance issues at the 2018 ATRA Outlook Conference. Key among the themes was the notion that major K-12 reform doesn't occur often and when it does, it is because elected officials provided strong leadership through contentious negotiations.

McCarthy focused his presentation on finding pathways to reform. The recent past has included new money for K-12 without reform to the finance system, to the tune of $1.3 billion committed to the formula in the last several years on top of population and inflation adjustments. If this trend continues, reformers should not wonder why change remains elusive: almost every key revision of the school finance formula involves new money into the system as a down payment on reform. Policymakers should not commit significant new funds to K-12 without driving the system towards their goals: one that is more fair and equitable. Furthermore the business community should not accept any tax increase unless it does little harm to the economy and tax system and is accompanied with significant reform.

Reform goals for taxpayers include phasing out the parts of the formula that drive inequities, namely the hold harmless formulas that fund government instead of funding students. The same student should be worth roughly the same no matter the public school they attend. With an even playing field, students can no longer be used as political bait and the phrase "our students don't learn because our funding is low" cannot be used without parents wising up and choosing another school. This doesn't mean Arizona needs perfect dollar equity: the courts have ruled that as an opt-out, charters may be funded differently. However it should not include the unjustifiable differences that exist today, particularly between districts.

Lisa Graham Keegan focused her talk on the strategies that have led to academic gains in Arizona schools and how to continue that progress. Entitled "Accelerating Arizona's Progress," Keegan emphasized that future changes and resources should be added with an eye towards incentivizing what has led to academic improvement. This means finding ways to replicate successful programs and encourage matriculation to successful schools. Essentially: pay for the things you want.

Both speakers talked about the pension problem. The state's public retirement system costs roughly 24% of salary split between the employee and employer. This causes hiring

problems for schools whose teachers are not interested in the cost of a defined benefit retirement. An opt-out could relieve stress in teacher hiring.

Finally, both speakers indicated that restricted spending, or state funding that comes with mandates on how it must be spent should be avoided. Public schools should be free to experiment with different models and do what works for them. Instead, policymakers should focus on transparency: let the public decide if a school's spending seems reasonable and also make them aware of the school's academic outcomes.

James Busby Named 2018 ATRA Outstanding Member

This year's ATRA Outstanding Member is James Busby from the Cavanagh Law Firm. James received the award during the Annual Luncheon following the ATRA Outlook Conference. In presenting the award, ATRA President Kevin McCarthy noted that a large reason for ATRA's success over the last 78 years is that ATRA's Board of Directors consists of subject matter experts in the area of public finance and policy development. That blend of expertise in taxation and policy development has been a powerful combination that has served ATRA well for decades. McCarthy praised Busby's expertise in state and local taxation and his willingness to use that expertise in support of ATRA's mission.

ATRA Officers Re-Elected for 2018

At the 78th Annual Meeting following the Outlook Conference, Steve Barela, the Director of Tax at Arizona Public Service, was re-elected Chairman of the Arizona Tax Research Association's Board of Directors. This will be Mr. Barela's third term as Chairman. The other officers re-elected were **Richard Bark**, Freeport McMoRan, first vice-chair; **Michelle Bolton**, Cox Communications, second vice-chair; **Bill Molina**, University of Phoenix, third vice-chair; **Dave Minard**, Individual, Secretary/Treasurer.

The following members were elected to seats on the ATRA Board of Directors for terms expiring in 2023: **James Busby,** The Cavanagh Law Firm; **Rodney Ross**, Pinnacle West Corp; **William Dvorak**, AT&T; **Thomas Marin**, Ernst & Young; **Frank Crociata**, Gallagher & Kennedy; **Hugh Donahue**, Freeport McMoRan; **Scott Leedom**, Southwest Gas Corp; **Jason Baran**, Salt River Project; **Michael Galloway**, Ryan, Rapp & Underwood; **James Barash,** RSM; **Phillip Bashaw**, Arizona Farm Bureau. For terms expiring in 2022: **Courtney LeVinus**, Arizona Multi- Housing Association.

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services the state provides. In the 1992 *Quill* case, the Court held that for purposes of the "substantial nexus" prong of the *Complete Auto* test, physical presence was required for Commerce Clause purposes.

In *Wayfair*, the Court overruled Quill's physical presence requirement and determined that South Dakota's economic nexus statute satisfied the substantial nexus prong of the four-part *Complete Auto* test. Specifically, South Dakota's "safe harbor" provision limited the imposition of the tax collection obligation only on vendors with at least $100,000 in sales to customers in the state or at least 200 transactions annually. In addition to the "safe harbor" provision, the South Dakota law also prohibited the retroactive obligation on affected businesses to remit taxes. Additionally, South Dakota had adopted the Streamlined Sales and Use Tax Agreement (SSUTA), which requires member states adopt the SSUTA uniform tax base. The Court remanded the *Wayfair* case to the South Dakota Supreme Court to ensure that the state's law does not violate another prong of the *Complete Auto* test.

Busby emphasized that Arizona's lack of a uniform tax base puts it far from being in a position to begin requiring remote sellers collect and remit sales taxes. Not only does the state tax base lack uniformity with the city tax base, but the tax base between cities also varies widely due to over 50 tax base options adopted by the various 91 municipalities. Busby further clarified that if Arizona wants to collect its share of taxes from remote sellers, the Legislature will need to implement significant tax code changes in order to sustain legal challenges, which should include the codification of the municipal tax base into state statute. Busby closed by recommending that if municipalities want to benefit from the *Wayfair* decision, they should abandon their separate tax codes in favor of a single, statewide tax code.

Christie Comanita, Director of Research and State Compliance for the Streamlined Sales Tax Governing Board, provided her perspective on Arizona's hurdles to meeting the *Wayfair* checklist. The checklist includes criteria specified in the Court's decision that, if enacted by other states, would likely avoid discriminating against or putting an undue burden on remote sellers. That criteria included standardization of taxes to reduce administrative and compliance costs, including a single, state level administration, uniform definitions of products and services, simplified tax rate structures, access to sales tax administration software paid for by the state, among other criteria.

Comanita noted that the Court's Opinion in *Wayfair* stated concerns that states with complex tax systems would begin requiring remote sellers to collect and remit sales taxes in their states without simplifying their tax codes. Following the Court's decision, the Streamlined Governing Board issued a Press Release applauding the *Wayfair* decision that removed the physical presence requirement and recognized that South Dakota and similarly situated states had removed the "undue burdens" and allowed those states to require remote sellers to collect and remit state and local sales taxes. Ms. Comanita emphasized that the Streamlined Governing Board is committed to working with the business community to ensure that "implementation of this decision is fair, efficient and transparent for all taxpayers and administrable for sellers, purchasers and the states."

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will be noticeably increased. He noted if policymakers fail to act prior to the 2019 session, it will create considerable uncertainty as Arizonans looking to file their returns in January will have no direction from the State on how to do so and may end up being required to file amended returns.

Speaker Mesnard pointed out that of the 18 states that practice static conformity (action to conform has to be taken every year), Arizona and California are the only states where the Legislature has not responded to TCJA. Mesnard made clear his preference would be to conform to the new federal tax code and take further action to avoid a large tax increase through changes to either the standard deduction or marginal rates or a combination of options.

Chairman Steve Barela hosts the Annual Luncheon

Rep-elect Gail Griffin, Richard Bark

Doug Lindholm, Christie Comanita, James Busby & Senator-elect Vince Leach

Rep-elect John Kavanagh, Michael Preston Green

Rep-elect Warren Petersen, Kevin McCarthy

Commissioner Justin Olson, Bill Molina