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ARIZONA TAX RESEARCH ASSOCIATION

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JLBC Director Stavneak: Recession Concerns Stunt State Revenue Growth Rates



Richard Stavneak, Director of the Joint Legislative Budget Committee (JLBC), kicked off ATRA's 2022 Outlook Conference with a report on the state's fiscal picture.

On the heels of 17% revenue growth in FY 2022, state general fund revenue is estimated to grow by a moderate 6% in FY 2023 and only 2% for FY 2024 due to ongoing recession concerns. Stavneak noted that this moderate growth path, in addition to previous legislative commitments, results in available ongoing revenue of \$140M and \$2.5B in one-time fund balance for FY 2024.

Stavneak reviewed commitments by the Legislature that will affect future budgets, including the Prop 123 cliff in FY 2026 in which the K-12 state land trust distributions will cease. Unless voters approve an extension, the state general fund will be required to backfill \$300M to maintain K12 base funding.

Stavneak further explained that revenue growth through the first four months of the year grew by 12.1%, generating \$1B in unanticipated revenue for FY 2023.

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Economist Glenn Farley Provides Economic Outlook

Glenn Farley, Director of Policy & Research at the Common Sense Institute Arizona, presented Outlook attendees with a report on the national and local economies and their impact on Arizona's finances.

Farley emphasized that, in general, there was a strong correlation between a state's pandemic-era policy response and subsequent economic recovery. Farley described how Arizona's economy recovered fairly quickly and with less volatility compared to other states. While Arizona and the U.S. followed similar job loss patterns, Arizona experienced fewer job losses in the manufacturing and construction sectors.

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The baseline spending projections reflects changes to statutory funding formulas, such as for AHCCCS and K12 spending, and no discretionary additions. The enacted FY 2023 budget’s 3-year spending plan assumes spending classified as “one-time” does not continue, but includes future year spending increases that were agreed to in the budget. Stavneak warned that if the state continues the “oxymoron of ongoing one-times” of school building repairs and state employee health insurance subsidies, the cost would be \$287M.

Stavneak warned that the entire \$2.5B in one-time surplus should not be allocated, not only because of future economic uncertainty but also due to the higher than budgeted Empowerment Scholarship Account enrollment that will likely absorb substantial ongoing spending capacity.

Pat Derdenger and Heidi Thomas Named 2022 ATRA Outstanding Members

On behalf of the ATRA Board of Directors, President Kevin McCarthy presented Pat Derdenger and Heidi Thomas each with the 2022 Outstanding Member Award at the ATRA Outlook Luncheon.

This year marks the 20th year Pat Derdenger of Lewis Roca Rothgerber Christie LLP has served on the ATRA Board of Directors. With a long career representing taxpayers in administrative disputes or in the court room, Pat has built an outstanding reputation as an expert in Arizona state and local tax law and administration. His expertise and leadership has proven to be a great asset to ATRA’s Tax Policy Committee as well as the ATRA Board.



Heidi Thomas of Early Warning Services LLC has been a fixture on ATRA’s Tax Policy Committee for many years and began service on the ATRA Board of Directors in 2019. A recognized expert in Arizona transaction privilege tax, Heidi is always the reliable go-to expert for all things sales taxes for the ATRA Tax Policy Committee. Heidi has dedicated countless hours over the last several years assisting ATRA in its pursuit to convince policymakers that Arizona businesses deserve a clear and understandable law in the area of digital goods and services. After decades of work in state and local sales taxes in Arizona, Heidi’s expertise is truly second to none and a huge asset to ATRA.



In presenting the awards, McCarthy expressed that having subject-matter experts like Pat and Heidi is the key reason for ATRA’s continued success.

<p>ARIZONA TAX RESEARCH ASSOCIATION Michelle Bolton.....Chairman Kevin J. McCarthy.....President Jennifer Stielow.....Vice President Kathleen Farnsworth.....Office Manager</p>	<p>Published by the Arizona Tax Research Association, a nonprofit organization whose purpose is to promote efficient and effective use of tax dollars through sound fiscal policies. Permission to reprint is granted to all publications giving appropriate credit to the Arizona Tax Research</p>	<p>1814 W. Washington Street Phoenix, Arizona 85007 (602) 253-9121 www.arizonatax.org</p>
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Regarding ongoing inflation concerns, Farley noted that as of August 2022, the monthly household “inflation tax” in the Phoenix area was over \$840. The current annual inflation rate in Phoenix of 13% is greater than the U.S. at over 8%. Since 2020, the average Phoenix area household would have had to spend \$9,800 more to fund the same consumption, with 60% of the increase in housing, food and gasoline costs. According to historical data, Farley warned that it is improbable that the current economic cycle does not end in recession.

Farley cautioned that the nation’s real estate market is in correction. Specifically in Arizona, home prices began declining in June and are down approximately 4% through September.

On the tax front, Arizona’s 2.5% single-rate income tax will be the lowest in the country among states with an income tax, which makes us particularly attractive relative to California’s 13.3% top marginal rate. Furthermore, Farley emphasized that past commercial property tax reforms will also drive investment in upcoming years.

Looking ahead, Farley advised that, in addition to limiting the growth in ongoing budgets, state and local policymakers can further reduce taxes, particularly taxes on investment and business expansion. He noted that the expanded tax base resulting from the remote seller’s (Wayfair) tax and recent income tax reforms provides policymakers with the ability to finance continued tax cuts elsewhere. Farley closed his presentation by urging policymakers to invest meaningfully in the states’ water, power, and transportation infrastructure out of concern that rapid post-2020 growth will likely stress these resources relative to historic estimates.



Michelle Bolton Re-Elected ATRA Chairwoman

At the 2022 ATRA Annual Meeting, Michelle Bolton, Director of State Government Affairs for Intel, was re-elected Chairwoman of the ATRA Board of Directors. The other officers elected were **Bill Molina**, University of Phoenix, first vice-chair; **Byron Williams**, Southwest Gas, second vice-chair; **Jeff Mirasola**, Lumen, third vice-chair; and **Dave Minard**, Individual, Secretary/Treasurer.

The following were elected to seats on the ATRA Board of Directors for terms expiring in 2027: **Richard Bark**, Freeport McMoRan; **David Minard**, Individual; **Dave Howell**, Wells Fargo; **Jeff Sandquist**, Veridus; **Pat Derdenger**, Lewis & Roca; **Steve Trussell**, Arizona Rock Products Association; **Terry Ryan**, Apple Inc.; **Kyle Cardita**, On Semiconductor; **Russell Smoldon**, B3 Strategies; **Courtney LeVinus**, Arizona Multihousing Association; and **Mark Gaspers**, The Boeing Company.



ATRA Briefs Major Tax Issues for 2023

ATRA President Kevin McCarthy kicked off the segment by noting that the last two years of major reforms to Arizona's tax system was part of a consistent 30-year effort to improve Arizona's tax code. Those reforms have successfully improved Arizona's economic competitiveness over the last three decades.

Property Tax Reforms

McCarthy provided a historical perspective on Arizona's high business property tax burdens that result from Arizona's classification system. Rather than attempt to fix the problem, city representatives and economic development groups pushed for targeted tax breaks. Taxpayer efforts to finally reform the system broke in 2005 when lawmakers began reducing the business (class 1) assessment ratio from 25%, which is now scheduled to be reduced to 15% by tax year 2027.

ATRA Vice President Jennifer Stielow reviewed how the reductions in the business assessment ratio has improved the effective tax rates (ETR) on businesses by nearly a full percentage point since 2005, from 2.66% to 1.73% in tax year 2021.

As the ETR's on businesses has improved, so too has Arizona's competitiveness. Stielow explained that based on an annual property tax study published by the *Minnesota Center for Fiscal Excellence*, Arizona's business tax burden has improved significantly from top 8th to 28th as a result of the reductions in the assessment ratio.

McCarthy noted that in addition to real property reforms, the enactment of a series of measures to reduce the business personal property tax have significantly decreased that burden.

Income Tax Cuts

McCarthy provided an overview of the reductions in Arizona's Personal Income Tax (PIT) dating back to 1990 when the top marginal rate was 8% and kicked in at just \$7,374 of income. He noted that the aggressive tax cuts that began during the Symington administration greatly improved Arizona's ranking, both regionally and nationally.

McCarthy informed that the move to a 2.5% flat tax rate has promoted discussions regarding the complete elimination of the PIT. He warned that might be feasible if PIT revenues begin to drop markedly, however, ATRA research suggests that isn't likely. The aggressive rate cuts over the years only resulted in dramatic revenue growth and the PIT continues to be a major reliable state revenue source. Adjusted for inflation, Arizona's PIT produced 185% more revenue (\$5B) in 2019 than in 1991 (\$1.2B).

As the PIT was being reduced over the years, the Legislature was mindful that reductions in the corporate tax rate needed to be addressed as well. Since 1990, the Legislature has reduced the corporate income tax rate from a high of 9.3% to the current rate of 4.9%. Reducing the corporate income tax rate over time improved Arizona's national ranking from 7th highest to near the bottom at 43rd.





School Finance Principles

Kevin McCarthy advised that many of the current problems in Arizona's property tax system are typically the result of inequities in the school finance system, which can then lead to policy and legal challenges. He noted that with the huge increases in state funding to schools, school overrides (based on a percentage) have ratcheted up as state funding has increased. Specifically, the \$3.6B (40%) increase in state funding since FY 2017 has driven override levies up 31%, further undermining the goal of equitable funding.

ATRA was part of last year's unsuccessful legislative effort to reform Arizona's school finance system. The major reforms included in that effort consisted of a new state funding formula to allow districts that do not levy a secondary tax to receive more money by switching to charter funding. Another reform included reducing or eliminating the inequitable funding streams outside of the school budget limits, such as the transportation funding formulas, desegregation, and adjacent ways. McCarthy closed by reinforcing the importance of making progress incrementally and emphasized that taxpayers and policymakers should not agree to additional funding without reforms.

Outstanding TPT (Sales) Tax Issues

Stielow provided an update on the major sales tax issues facing taxpayers, beginning with a brief background on the ongoing struggles Arizona taxpayers have trying to comply with an independent municipal sales tax code outside of state statute. ATRA and taxpayers have had some success in simplifying this chaotic system beginning with major sales tax reform in 2013. That reform preempted cities on local collection and audit; however, much work needs to be done to address the complications taxpayers face having to comply with two tax bases.

The TPT prime contracting/MRRA (maintenance, repair, replacement, alteration) statutes continue to be an area under Arizona's sales tax code that needs further simplification. ATRA's 2022 legislative proposal that would have taxed materials used in a residential remodel at retail rather than prime contracting failed to pass due to opposition from the cities. ATRA will make another attempt to reform this complicated area in the tax code during the 2023 legislative session.

Stielow noted that lack of clarity in the taxation of Digital Goods & Services (DGS) continues to be an area that desperately needs to be resolved. Absent a law that explicitly makes DGS taxable, she explained that the Arizona Department of Revenue (ADOR) relies instead on the definition of tangible personal property (TPP) to tax DGS under the Rental of TPP. ATRA attempted to clarify the taxation of DGS during the 2018 and 2019 sessions but both attempts were unsuccessful. ADOR recently issued a narrow draft ruling stating that remotely accessed webhosting and servers are taxable under the Rental of TPP. ATRA provided comments to ADOR in opposition to the draft ruling and requested the department refrain from issuing the ruling until the Legislature acts. That ruling has yet to be finalized.

Lastly, Stielow discussed that one of the major reforms under TPT Simplification that may need to be clarified, either administratively or through legislation, is the 2013 reform that required ADOR to oversee all state and local audit functions. Unfortunately, there have been continued attempts by the cities to weaken ADOR's statutory authority over the audit function. This is a significant area of concern for taxpayers and ATRA intends to pursue action to return ADOR's audit authority to the status taxpayers thought was achieved with TPT Simplification.

Senior EY Tax Manager Talks National SALT Trends

David Sawyer, Senior Manager at Ernst & Young LLP National Tax Department, provided conference attendees with an update on major tax issues in states around the nation and at the federal level.

He began by noting that the expected “Red Wave” across the country actually turned into more of a “Blue Ripple.” Although voters in Massachusetts’s passed an Arizona-style Prop 208 income tax increase, a similar proposal in California was rejected.

Sawyer discussed the current trend across the nation to impose new taxes on digital goods and services (DGS). He referenced three types of tax proposals on “Big Tech” that include digital advertising services, social media advertising, and data mining services. Focusing specifically on a court challenge to Maryland’s digital advertising gross revenues tax under *Comcast et al. v. Comptroller*, the state court recently ruled that the new tax violated the Internet Tax Freedom Act (ITFA), Commerce Clause, and the First Amendment. The federal case under *US Chamber of Commerce v. Comptroller* seeking injunctive and declaratory relief on similar grounds is still pending.

Like Arizona, taxation of digital commerce continues to be one of the most contentious sales tax issues debated across the states. Sawyer outlined four significant issues that have dominated the discussions surrounding taxation of DGS, including whether states have jurisdictional nexus over remote sellers, how to define and whether to tax DGS, and how to source sales of digital products. He noted one area that has generally been ignored or underreported is the extent to which the sales tax base includes business-to-consumer transactions as well as business-to-business transactions.

Sawyer continued with a discussion on the consequences and ramifications of *Wayfair*, specifically referencing litigation by an Arizona internet seller under *Halstead Bead, Inc. v. Lewis, U.S. Dist. Ct. for Eastern Dist. of Louisiana*. Louisiana’s sales tax system is highly burdensome on taxpayers since it forces remote sellers to file and remit sales taxes separately to numerous parishes (i.e. municipalities). To avoid tax compliance issues, Halstead purposely halts sales into the state before reaching the \$100k/200-transaction threshold that requires remote sellers to remit sales taxes to Louisiana. Following the electorate’s failure to pass a constitutional amendment to streamline local sales tax collections, Halstead filed suit in federal court arguing Louisiana’s tax system is unconstitutional under both the Dormant and Due Process Clauses. The Court dismissed the case earlier this year citing the federal Tax Injunction Act, meaning the litigation should have been filed in state rather than federal court. *Halstead Bead* intends to file an appeal.

Sawyer closed his presentation addressing the complexities surrounding taxation of traveling and teleworking employees. The “mobile workforce” is an area in which the states have widely varied and inconsistent requirements for filing personal income tax returns and withholding for temporary work periods. He emphasized



SALT Trends, *Continued from page 6*

that in nearly half the states, nonresident employees incur a liability from the first day in the state and employers incur a related withholding obligation. He cited litigation under *New Hampshire v. Massachusetts* in which New Hampshire, which does not tax personal income, challenged the Massachusetts temporary emergency regulation imposing taxation on nonresidents during the pandemic. New Hampshire filed in the U.S. Supreme Court on behalf of its residents requesting the Court to find the regulation an unconstitutional “extraterritorial assertion of taxing power.” In June 2021, the Court denied New Hampshire’s motion without explanation. New Hampshire responded to the Court’s denial by passing a law in June 2022 prohibiting a state from imposing its income tax on New Hampshire residents working remotely and performing work from within New Hampshire.



Marcus Dell'Artino, Partner at First Strategic, and Chad Campbell, Co-Founder of Lumen Strategies, provide counter perspectives on the 2022 election results.



Senate President-Elect Warren Petersen (left) and Sen.-Elect David Farnsworth



Russell Smoldon (B3 Strategies) has a sidebar with former Rep. Steve Huffman (center) and Sen.-Elect Ken Bennett (right)



Rep. Quang Nguyen leads the ATRA Conference crowd to the Pledge of Allegiance



Jon Gabriel, Ricochet.com Editor-in-Chief & Contributor to The Republic, presents during ATRA's 2022 Awards Luncheon



(Left to right): James Busby (The Cavanagh Law Firm), Susan Bittick (Ryan, LLC) and ATRA President Kevin McCarthy



(Left) Bas Aja (AZ Cattle Feeders Assoc.) and Richard Bark (Freeport McMoRan)

