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ARIZONA TAX RESEARCH ASSOCIATION

NEWSLETTER VOLUME 83 NUMBER 3 MARCH/APRIL 2023

ADOR Confirms Cities Interpretation of MRRA Inaccurate

ATRA's legislative effort this year to simplify residential MRRA (maintenance, repair, replacement, alteration) contracts under the prime contracting tax was met by the same inaccurate information floated by the League of Arizona Cities and Towns as last year. Based on a request from the bill sponsor, the Department of Revenue responded with an explanation of how the law actually works, entirely debunking the misinformation peddled by the League.

Rep. Michael Carbone took the reins this year in the latest attempt to simplify MRRA under HB2807. Same as last year's version, HB2807 specifies that residential contracts to add or expand square footage beyond the roof would be subject to the prime contracting tax (like all new construction is currently taxed) and contracts simply to remodel a home would be taxable under MRRA (materials subject to tax at retail).

Arizona is one of few states that subjects contracts to tax under prime contracting in lieu of paying taxes on materials at retail. Under the prime contracting tax system, contractors purchase materials *tax-free* at retail with the use of exemption certificates and pay tax on 65% of the gross proceeds of the contract

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Sales Tax Revenues Continue Strong Growth Trend

Remote Sales Higher than Anticipated

According to a recent revenue report from the Joint Legislative Budget Committee (JLBC), sales tax collections posted "robust growth" based on January sales activity. The $629.2 million in sales tax collections for the month of February was 11.9% higher than the prior year and $43.5 million above the Baseline forecast. Much of the sales tax growth was driven by tourism-related activity from restaurants and bars (+16.5%), lodging (+31.1%), personal property rentals (23.4%), and amusements (+27.8%). Year to date, sales tax revenue is up 8.9%, $73 million above forecast.

Of the five major sales tax categories, construction contracting remains the strongest driver with 28.4% growth. According to JLBC, contracting revenue has generated double-digit growth in nearly every month over the last year, with most of the growth associated with industrial and commercial construction activities. Revenues generated from contracting activity accounts for approximately 10% of total sales tax revenues. Retail

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when the projected is finally completed. MRRA was a product of a failed legislative effort recommended by Governor Brewer's 2012 TPT Simplification Tax Force to outright eliminate the prime contracting tax. Final negotiations left most new construction in contracting and moved contracts for maintenance, repair, replacement and most alterations (MRRA) to tax at retail.

Regardless of contract price, materials used in all contracts that involve MRRA activities are taxed at retail. On the other hand, residential contracts that include "alteration" activities, which is defined to mean "a direct physical change to existing property," are subject to the prime contracting tax if the contract price exceeds 25% of the home's full cash value. The confusion is caused by different interpretations of what constitutes "a direct physical change" to property. This area of taxation is so complicated that the guidance provided by the Department of Revenue is over 20 pages long and includes over 30 scenarios (TPN 18-1). Not only are taxpayers confused, but based on testimony by the League, it was unveiled that the cities and towns are as well.

Testimony by the League representative in the House Ways and Means Committee is demonstrative. In determining how a residential contract would be taxed, the League representative testified that a contract to remodel just one room, like a kitchen, would be taxed under MRRA because it is just "one system" whereas a remodel of an entire home would be considered prime contracting since it entails the remodel of "more than one system." DOR responded that this statement "apparently introduces a new interpretation of alteration that is unsupported by the law." DOR further clarified that a kitchen remodel that includes only the replacement of items would indeed be considered MRRA because it would fall under the "replacement" definition that is not subject to the alteration threshold—regardless of the cost of the project. Furthermore, the "alteration" definition specifically states that alteration does not include maintenance, repair or replacement. The League representative also inaccurately testified that all revenues generated for materials incorporated into MRRA contracts go to the places where the materials are sold and not to the location of the project. DOR strongly disagreed since current law requires TPT licensed contractors that purchase MRRA materials tax-exempt to report taxes on those materials ***based on the location of the project.*** In fact, DOR stated that approximately $196 million of taxable materials used in MRRA projects have been reported to the cities where the work is being performed *(DOR's response to League testimony may be read in full here).*

The inaccurate testimony provided by the League is of great concern. Arizona's cities exercise separate audit authority that has historically created significant problems for business taxpayers. Those problems are amplified when city auditors take positions in conflict with DOR.

In addition to the current complications, residential contractors struggle with the reality they could face a city auditor with an entirely different interpretation of MRRA. For the second year in a row, this common sense reform likely will not pass. Despite industry and taxpayer support, some lawmakers continue to view simplifying tax compliance burdens solely through the lens of fiscal impacts.

-Jennifer Stielow

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sales, on the other hand, generates the majority of tax revenues collected and continues to display healthy revenue growth for state and local government operations. The continued healthy growth in sales tax revenues can, in part, be attributed to recent legislation that authorized the collection of sales taxes from remote sellers.

Sales Tax Growth Rates Compared to Prior Year		
	February	YTD
Retail/Remote Seller	7.1%	6.3%
Contracting	28.4%	21.1%
Use Tax	19.6%	11.3%
Restaurant & Bar	16.5%	12.9%
Utilities	2.5%	(7.7)%

Source: JLBC Monthly Fiscal Highlights, March 2023.

Wayfair legislation – Remote Sellers and Marketplace Facilitators

Wayfair legislation enacted during the 2019 session authorized the collection of sales taxes from remote (out-of-state) sellers and marketplace facilitators, effective October 1, 2019. Prior to 2019, online sellers with a physical presence in this state were required to remit sales taxes but sellers with only an economic nexus (no physical presence) were not. That all changed as a result of the Wayfair legislation that required sellers with sales above a certain threshold (currently $100k) to remit sales taxes to this state and its municipalities. At the time of the legislation, JLBC estimated that remote sales would generate between $117.5 million to $301.8 million in state and local sales tax revenues. However, FY 2022 actual data reported by DOR shows that the tax collections associated with remote sales easily beat that estimate with total tax collections reaching $838 million. In FY 2023, annualized revenues from remote sales is tracking at nearly $1 billion, which would bring the total amount collected from remote sales to approximately $2.8 billion since 2019 (See tables on page 5).

-Jennifer Stielow

State Student Funding Formula Clears Senate

SB1495, a bill to create a new state student funding formula, cleared the Senate on a 16-12 vote. For decades, ATRA has advocated for a school finance system that advances equity and parental choice as a priority. As the state continues to face litigation over equity concerns, there is no better time than now for revisions to be made.

SB1495 would allow any school district with no secondary property tax (no bonds or overrides) to switch to a new state funding formula similar to the current charter funding system. Upon the approval of district voters, eligible districts would opt into the new state funding system (an average of $1,200 more per pupil) and agree to forgo bond and override funding as well as expenditures typically funded by primary levies such as desegregation spending, adjacent ways, excess transportation costs and small school spending. SB1495 would give those lesser-funded districts a step up without taking money from already well-funded districts.

Disappointingly, the bill was opposed by every voting Democrat on the Senate floor. Rather than view the bill as a real opportunity to elevate Arizona's poorest public school districts to the same funding level as charter schools, the Democrats shockingly criticized the potential fiscal impact of helping those poor school districts.

-Jack Moody

College Property Taxes Per FTSE Climbing

Property tax levies make up a significant portion of community college budgets. Unlike some state aid and tuition, property taxes are not connected to changes in FTSE. This means that because of property tax stability, most Community College Districts (CCDs) are able to maintain spending and budget growth despite significant decreases in student enrollment.

Pinal, and Yavapai had the highest levy/FTSE in FY22. The two districts both saw decreases in FTSE and increases in their primary levies. Graham and Cochise had the lowest levy/FTSE rates, though both did receive additional state funding in the form of equalization aid.

Pinal and Pima saw the greatest increases in levy/FTSE between FY12 and FY22. In that span, Pima's FTSE was nearly halved while its levy nearly doubled. Similarly, Pinal's levy increased by nearly 70% while its FTSE decreased by nearly 40% in the same time span.

Arizona's CCDs have all experienced major growth in their levy per FTSE figures over this ten-year period. For districts like Pima, a major drop in enrollment is to blame for their high levy/FTSE figure. In almost every case, levies continue to grow while enrollment falls across the board.

District	FY12 Levy/FTSE	FY17 Levy/FTSE	FY22 Levy/FTSE	5yr Change	10yr Change
Cochise	$1,899	$3,274	$4,053	72%	113%
Coconino	$2,803	$3,763	$5,513	34%	97%
Graham	$1,427	$1,932	$3,724	35%	161%
Maricopa	$4,693	$6,205	$10,296	32%	119%
Mohave	$5,478	$9,929	$13,658	81%	149%
Navajo	$6,140	$7,861	$11,604	28%	89%
Pima	$4,092	$7,263	$10,747	78%	163%
Pinal	$6,617	$13,147	$17,490	99%	164%
Yavapai	$9,742	$12,358	$15,248	27%	57%
Yuma/La Paz	$4,227	$5,591	$6,717	32%	59%
Total/Average	**$4,541**	**$6,503**	**$10,032**	**43%**	**121%**

* Table excludes provisional districts

-Jack Moody

State Retail & Remote Sales Tax Collections				
Fiscal Year	**Retail**	**% Chg**	**Remote**	**% Chg**
FY 2019	$3,583,229,740	-	-	
FY 2020*	$3,735,621,348	4.3%	$174,299,637	-
FY 2021	$4,312,419,552	15.4%	$416,668,791	139.1%
FY 2022	$4,859,333,467	12.7%	$516,897,387	24.1%
FY 2023 (8 mos.)	$3,326,113,923		$407,670,090	
FY 2023 annualized	$4,989,170,885		$611,505,135	

Counties Retail & Remote Sales Tax Collections				
Fiscal Year	**Retail**	**% Chg**	**Remote**	**% Chg**
FY 2019	$525,183,429	-	-	-
FY 2020*	$508,969,122	-3.1%	$25,392,134	-
FY 2021	$592,438,911	16.4%	$60,373,721	137.8%
FY 2022	$674,814,306	13.9%	$73,905,121	22.4%
FY 2023 (8 mos.)	$469,235,774		$54,993,309	
FY 2023 annualized	$703,853,661		$82,489,964	

Cities & Towns Retail & Remote Sales Tax Collections				
Fiscal Year	**Retail**	**% Chg**	**Remote**	**% Chg**
FY 2019	$1,351,785,692	-	-	-
FY 2020*	$1,436,537,767	6.3%	$58,052,074	-
FY 2021	$1,664,198,648	15.8%	$149,797,140	158.0%
FY 2022	$1,892,176,680	13.7%	$186,202,901	24.3%
FY 2023 (8 mos.)	$1,283,835,683		$148,271,419	
FY 2023 annualized	$1,925,753,525		$222,407,129	

Education Retail & Remote Sales Tax Collections				
Fiscal Year	**Retail**	**% Chg**	**Remote**	**% Chg**
FY 2019	$429,987,569	-	-	-
FY 2020*	$448,274,562	4.3%	$20,915,837	-
FY 2021	$517,490,346	15.4%	$49,720,906	137.7%
FY 2022	$583,120,016	12.7%	$61,182,451	23.1%
FY 2023 (8 mos.)	$399,133,671		$48,920,411	
FY 2023 annualized	$598,700,506		$73,380,616	

State & Local Retail & Remote Sales Tax Collections				
Combined	**Retail**	**% Chg**	**Remote**	**% Chg**
FY 2019	$5,890,186,431	-	-	-
FY 2020*	$6,129,402,799	4.1%	$278,659,682	-
FY 2021	$7,086,547,457	15.6%	$676,560,558	142.8%
FY 2022	$8,009,444,470	13.0%	$838,187,860	23.9%
FY 2023 (8 mos.)	$5,478,319,051		$659,855,229	
FY 2023 annualized	$8,217,478,576		$989,782,843	

*FY 2020: Remote online sales collections November 2019 through June 2020.