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ARIZONA TAX RESEARCH ASSOCIATION

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GOVERNOR NAPOLITANO VETOES PROPERTY TAX REFORM BILL ALONG WITH BUDGET BILLS

Veto message offers support for business tax relief

Following two major tax studies that recommended changes to Arizona's property tax system, the 2005 legislative session has featured much discussion on the subject of property tax reform.

Both the House, through Representative Steve Huffman's HB 2508, and the Senate, through Senator Dean Martin's SB 1508, have passed out bills that attempt to address Arizona's high business property taxes.

Discussions between Senate and House leadership resulted in SB 1095, which passed the Legislature along with the budget bills, all of which was vetoed by Governor Janet Napolitano.

THE NEED FOR PROPERTY TAX REFORM

Most criticisms of Arizona's property tax system center on the classification system, which shifts taxes from one type of property to another based on usage. As the table on page 5 reflects, the majority of taxes are shifted from residential property (Class 3&4) to business property (Class 1) through the use of a higher assessment ratio. The assessment ratio on residential property is currently 10% while business property is taxed at 25% of full cash value.

For tax year 2004, approximately \$850 million in property taxes was shifted to business property from classifications with lower ratios. Class 1 property accounted for just 22% of total value but carried 42.3% of the property tax burden. Owner-occupied homes, on the other hand, accounted for 61% of tax base and paid just 41.9% of the tax burden.

The result of this classification system is that Arizona consistently ranks nationally among the states with the highest effective tax rates on business property. For tax year 2004, Arizona ranked 5th nationally in a comparison of tax burdens on major industrial

property in an annual property tax study from the Minnesota Taxpayer's Association. Conversely, residential property annually ranks in the bottom quartile among the states.

SB 1095 called for a phased reduction in the class one assessment ratio from 25% to 20% over a 10-year period beginning in FY 2007. The bill also calls for an increase in the "homeowner rebate" provided to class three as a way of offsetting potential tax shifts associated with the decrease in the class one assessment ratios.

While the fate of SB 1095 was wrapped up with many other issues between the Legislature and the Governor, the need for property tax reform is still recognized by many business and government leaders. In fact, the Governor's veto message referenced her support for "sensible and economically beneficial tax relief."

Both HB 2508 and SB 1508 had received bipartisan support from state legislators and

elected officials from some of Arizona's largest municipalities have also voiced support for reductions in property tax burdens on business.

SB 1095 reflects recommendations from the Legislature's Tax Reform for Arizona's Citizens (TRAC) Committee and the Governor's Citizens Finance Review Commission (CFRC).

For example, the CFRC recommended that "the state should move toward reducing overall business property tax burdens." The CFRC went on to explain that "In general, the commission believes that the state's competitiveness would be improved by reducing the overall property tax burden." SB 1095 is also consistent with the CFRC's recommendation that "The state should, where possible, phase in major changes — or phase out changes — to the tax structure over time."

ATRA Tax Practitioner Committee Bills Progressing

Two pieces of legislation, which are the result of recommendations made by the ATRA Tax Practitioner's Committee, are steadily making their way through the process.

MANAGED AUDIT AGREEMENTS

SB 1171 allows the Department of Revenue (Department) to enter into a managed audit agreement with a taxpayer, at the taxpayer's request, to audit certain business activities and types of taxes for a specified period of time. The types of taxes that may be included under the managed audit include state and local transaction privilege tax, use tax, and

luxury tax. Corporate income taxpayers become eligible for the program beginning January 2007.

Once the audit is completed, the taxpayer is required to submit the findings to the Department. At that time, the Department may review the audited records and accept or reject the taxpayer's findings and assess a deficiency or issue a refund. If a deficiency is assessed, the taxpayer is not required to pay penalties unless the audit discloses that the taxpayer committed fraud or willful tax evasion and interest does not accrue on a

UPDATE ON THE LEGISLATIVE SESSION

The First Regular Session of the 47th Legislature has introduced over 1,300 bills and resolutions, many of which affect public finance and taxation. Here is a selected list of noteworthy legislation ATRA is tracking.

ATRA SUPPORTS

HB 2055 NOW: municipal sales tax refunds

(Huffman) HB 2055 attempts to create uniformity in treatment for taxpayers regarding access to refunds and interest within all cities, both "program" (DOR acts as tax collector of 76 cities) and "non-program" (twelve cities that collect their own sales tax). The legislation conforms to the state treatment, which includes the 76 program cities, for refunds by prohibiting the tax collector from conditioning any refund to a taxpayer on a requirement that the taxpayer remit the refund to its customers. Since Arizona has a transaction privilege tax (TPT) rather than a sales tax, the legal incidence for the tax is on the taxpayer-not the taxpayer's customers. The bill equalizes the non-program city interest rates on overpayments and deficiencies by conforming to the Department, and requires interest on deficiencies to be calculated from the date that the claim for refund is filed. Finally, in the case of a denial, the tax collector must issue an express written "denial" containing the grounds for the denial, plus written notification of the appeal deadlines, which alerts the taxpayer that the appeal time limits have been triggered. *Awaiting Senate Finance.*

HB 2143 schools; maximum property tax rate

(Huffman) This is the same bill that was introduced last year (HB 2160). It caps the primary property tax rate in school districts in which homeowners with 50% or more of the value in the district are at the 1% cap and the primary tax rate is 150% of the qualifying tax rate (QTR), as determined by the Property Tax Oversight Commission (PTOC). There are currently nine districts that meet the criteria and would be affected by this

legislation. The passage of this legislation would result in a cost savings to the state general fund. *The bill awaits Senate K-12.*

HB 2139 income tax; corporate sales factor

(Huffman) The corporate income tax structure for the apportionment of multi-state corporations is three-tiered, allocating a percentage to property, payroll, and sales. Arizona double weights the sales factor in the current formula. HB 2139 provides multi-state corporations with a second method for allocating income by allowing for a 100% sales factor apportionment formula, phased in over a five-year period beginning in tax year 2007, in addition to the current double-weighted sales factor. This change in corporate tax policy would take on an added importance in Arizona where business tax burdens are above average nationally and property taxes in particular are some of the highest in the country. *Awaiting a conference committee to resolve differences between House and Senate amendments.*

HB 2379/SB 1176 corporate tax credit; tuition organizations

(Yarbrough/Martin) This legislation allows for a corporate income tax credit for voluntary contributions to a school tuition organization (STO) that provides educational scholarships and tuition grants to children of low-income families. The credit is equal to the amount of the contribution if less than \$10,000, otherwise the credit is an amount approved by the Department of Revenue on a first come, first served basis. Total credits are capped at \$10 million beginning tax year 2006, increasing \$5 million per year to a maximum of \$55 million beginning tax year 2015. *Awaiting House Final Read.*

HB 2623 bond elections; ballot language

(Biggs) HB 2623 requires ballot questions for general obligation bonds to disclose that the bond debt will be paid by property taxes. The bill will also provide alternative language for municipalities that use revenues other than property taxes to service the bond debt. *Awaiting Senate Government.*

HB 2682 schools; transportation RCL; limited increase

(Gorman) This bill deals with a seriously flawed funding formula that continues to generate funding, in perpetuity, for students that are no longer there. Technically, the bill prohibits increases in a school district's transportation revenue control limit (TRCL) if the calculated amount exceeds 120% of the transportation support level (TSL). Currently, about \$54 million in local property taxes are levied statewide, effectively funding ghost students. There is also a general fund savings associated with this bill because of the state subsidies for the homeowner rebate and one-percent cap. *The bill passed the House.*

SB 1068 school district redistricting; commission; approval

(Gray) SB 1068 establishes a 13-member commission charged with reviewing all current common school districts that are not part of a unified school district. The commission is required to consider combining these common school districts into a new unified district or combining common school districts with a union high school district to create unified districts. *The bill goes next to a floor vote in the Senate.*

SB 1207 community colleges; elections; political influence

(Gray) This bill requires the Attorney General to publish guidelines regarding activities permitted by statutes prohibiting the use of public resources to influence the outcome of an election. It also allows the Attorney General or county attorney to serve an order requiring compliance and to assess a penalty of up to \$500 on individuals found to be in violation. *Passed the Senate.*

SB 1506/HB 2625 parental educational choice grant program

(Verschoor/Biggs) This legislation establishes a parental choice grant program allowing pupils to apply for dollars that must be used toward tuition and fees to attend private schools. The grant

See **LEGISLATIVE UPDATE**, page 3

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LEGISLATIVE UPDATE

Continued from page 2

amounts are \$3,500 for grades K-8 and \$4,500 for 9-12. With the exception of kindergartners, students must have attended a district or charter school for 90% of the previous school year. The program is phased in with two to three grades a year until the final phase in 2010-2011. *SB 1506 passed the Senate. HB 2625 awaits final vote in the House.*

SCR 1034 secondary taxes; supermajority voter approval (Burns) If approved by voters at the next general election, SCR 1034 would require 2/3 voter approval for any county, city, town, community collect district or school district seeking a property tax levy to pay for expenditures in excess of budget or levy limits, bonded indebtedness, and any other tax that requires voter approval. *Awaiting Senate COW.*

ATRA OPPOSES

HB 2306 schools; budget reductions; exemption (Nelson) HB 2306 is special legislation allowing Agua Fria Union High School District to pay the Department of Education 35% of an illegal levy and to keep the remainder. An Auditor General report found that for FY 2002 and FY 2003, Agua Fria Union levied excess utilities property taxes to purchase and maintain a chiller system. The cost of the chiller was approximately \$800,000 and operating expenses wrongly classified as utilities was about \$600,000. The Department has reclassified the expenses and disallowed the amounts in excess of the budget limits. Similar illegal levies took place in FY 2004 and FY 2005. *The bill passed House K-12 Committee.*

SB 1415 school districts; excess utilities options (Waring) SB 1415 creates a new utilities funding formula based on utility costs per square foot over a seven-year period. Allows energy savings contracts, including capital, to be funded through excess utilities. *The bill failed in the Senate K-12 Committee.*

HB 2419 joint technological districts; funding (Anderson) A recent report by the Auditor General confirmed numerous criticisms ATRA has voiced on the funding of joint technological education districts (JTEDs). One issue examined by the Auditor General was the substantial amount of JTED dollars being used to supplant existing programs. This bill would adopt a schedule for JTEDs and member districts to phase out their current supplanting. HB 2419, does nothing else to address many other problems brought forward by ATRA and the Auditor General. *The bill awaits a floor vote in the House.*

HB 2697 NOW: school districts; overrides; retroactive applicability (Lopes) This special legislation would retroactively eliminate the two-year statutory phase down period for one school district (Window Rock Unified) that neglected to fulfill its legal obligation to obtain voter approval to renew its M&O override.

HB 2079 NOW: higher education; funding reform (Knaperek) HB 2079 allows community college districts in six counties (Graham, Maricopa, Mohave, Navajo, Pima, and Pinal) to offer four-year baccalaureate degrees in law enforcement, fire services, health professions, teacher education, and any workforce-related discipline that matches an existing two-year program. Caps the tax rate for Eastern Arizona College (Graham) at \$1.50 and requires the district board to decide by June 30, 2011, whether to continue as a community college or transfer its authority to the Arizona Board of Regents. The bill does not resolve many of the most problematic components of community college funding. *The bill passed the House.*

HB 2491 school tax credit; classroom instruction (Gould) Currently the public school tax credit revenue can be used only for extracurricular activities and character education. The bill would allow these dollars to also be spent on classroom instruction. Such a change would worsen sizeable funding inequities between school districts by making it a revenue source for the core mission of public schools. *Passed the House.*

TAX PRACTITIONERS

Continued from page 1

deficiency or refund if paid within 45 days of the date of the assessment or refund determination.

Under the program, the taxpayer maintains the same appeal rights as if the department conducted the audit. A managed audit does not preclude the Department from auditing issues not covered under the managed audit agreement, subject to the statute of limitations.

USE TAX PERCENTAGE BASED REPORTING

SB 1185 allows the Department to authorize a taxpayer that holds a use tax direct payment permit to use a percentage-based reporting method for determining use tax payments. All taxpayers become eligible for the program after taxable periods beginning June 30, 2007.

Taxpayers are currently required to file returns with the Department based upon actual purchases that are subject to use tax. Depending on the type of business, as well as the level of business activity, remitting use tax payments according to actual purchases can be costly from a taxpayer resources standpoint.

Under this program, the Department works with the taxpayer to determine the percentage and standards to be applied based on an analysis of the taxpayer's historical data and may issue a letter of authorization, valid for up to four years.

Flexibility is provided by allowing the Department the right to revoke a letter of authorization at any time if there is a change in law or administrative rule, a change in the taxpayer's business operations, or if a taxpayer commits fraud, malfeasance, or misrepresents material facts.

Approximately 25 states have implemented a managed audit program and/or a use tax percentage-based reporting method. Both programs are good public policy in that they help facilitate taxpayer compliance as well as free up government resources.

Jennifer Schuldt

TABLE 1: STATEWIDE EFFECTIVE PROPERTY TAX RATES FOR 2004

Class	Description	Assess Ratio	Total Taxable Full Cash Value	Percent of Total	Total Yield	Percent of Total	Effective Rate
1	Commercial, Industrial, Utilities, & Mines	25%	73,111,625,884	22.09%	2,011,786,107	42.24%	2.75%
2	Agricultural & Vacant Land	16%	24,123,289,973	7.29%	364,602,009	7.66%	1.51%
3	Owner-occupied Residential	10%	200,760,981,270	60.65%	1,996,683,233	41.92%	0.99%
4	Rental Residential (10%)	10%	28,800,738,542	8.70%	342,680,500	7.20%	1.19%
5	Railroad, Private Car, Airline Flight	21%	1,229,755,583	0.37%	29,123,492	0.61%	2.37%
6	Res.historic, Ent./Foreign Trade Zones	5%	2,931,535,674	0.89%	17,214,436	0.36%	0.59%
7	Commercial Historic	*	22,307,814	0.01%	441,598	0.01%	1.98%
8	Rental Residential Historic	*	2,788,200	0.00%	42,010	0.00%	1.51%
9	Possessory Interests	1%	19,474,248	0.01%	15,057	0.00%	0.08%
Total			331,002,497,188	100.00%	4,762,588,443	100.00%	1.44%

* The ratio applied is based upon class 1 property for Class 7 and Class 4 property for Class 8, subtracting for up to 10 years all but 1% of the full cash value of modifications to restore and rehabilitate historic property.

Arizona's Classification System: Tax Year 2004

Arizona's property tax system "classifies" property according to its usage. Each class of property is assigned an assessment ratio, pursuant to state law, ranging from 1% to 25%. The assessment ratios are applied to both the primary and secondary values of a property and determine a property's net assessed value. All classifications use the same tax rates (with exception of the homeowner's rebate).

Class 1	(25%)	Mines and mining claim property, and standing timber. Local telecommunications service, gas, water and electric utility company property, pipeline company property, producing oil, and gas property. Commercial and industrial real property not included in other classes. Commercial and industrial personal property exceeding \$56,298 of full cash value (A.R.S. § 42-12001).
Class 2R*	(16%)	Agricultural real property and vacant land (A.R.S. § 42-12002).
Class 2P**	(16%)	Agricultural personal property exceeding \$56,298 of full cash value (A.R.S. § 42-12002).
Class 3	(10%)	Residential property not used for profit (A.R.S. § 42-12003).
Class 4	(10%)	Leased or rented residential property (A.R.S. § 42-12004).
Class 5	(21%)	Railroad operating property, private car company property, and airline flight property (A.R.S. § 42-12005).
Class 6	(5%)	Noncommercial historic property, foreign trade zone property, qualifying military reuse zone property, qualifying enterprise zone property, qualifying environmental technology property, and qualifying environmental remediation property (A.R.S. § 42-12006).
Class 7		Ratio applied to Class 1 property, subtracting for up to 10 years, all but 1% of the full cash value of modifications to restore and rehabilitate historic property (A.R.S. § 42-12007 and 42-12101).
Class 8		Ratio applied to Class 4 property, subtracting for up to 10 years, all but 1% of the full cash value of modifications to restore and rehabilitate historic property (A.R.S. § 42-12008 and 42-12101).
Class 9	(1%)	Possessory Interests (A.R.S. § 42-12011).

*Note: Real Property (R).

**Note: Personal Property (P).

Statewide effective property tax rates reflect inequitable distribution of tax burden

Arizona's statewide average effective tax rate (ETR) for tax year 2004 is 1.44%. Table 1 on page 4 shows the ETRs on each of Arizona's nine classes of property.

Unlike most states, Arizona classifies property based on its use in order to shift the tax burden from one class of property to another (see descriptions of the classifications on page 4). As a result, properties with higher assessment ratios carry a disproportionate share of Arizona's property tax burden.

The ETR is calculated by dividing the total tax yield for each property class by the full cash value. For purposes of the calculation, exempt property is removed from the full cash value.

With a 25% assessment ratio, commercial and industrial properties, utilities, and mines (Class 1), have the highest ETR in 2004 at 2.75%. Accounting for 22.09% of the state's property value, class 1 properties pay 42.24% of the taxes. Railroads and airline flight property (Class 5) have the second highest ETR at 2.37%.

The largest class of property, owner-occupied homes (Class 3), has an ETR of 0.99%. Accounting for 60.65% of the state's

property value, Class 3 properties pay 41.92% of the taxes. Taxes on owner-occupied residential properties are reduced as a result of the lower assessment ratio of 10%, as well as the 35% homeowner rebate provided by the state on school primary taxes. Additionally, total primary taxes for owner-occupied homes are capped at 1% of value.

Over the years, policymakers have created tax incentives for some taxpayers in an effort to circumvent high commercial property taxes. For example, Class 6, which includes properties located in foreign trade and enterprise zones, are assessed at only 5% as opposed to 25%. Included in the same class are historic residential properties that are also assessed at 5%, instead of the 10% that is assessed on other residential properties.

Class 6 properties carry 0.89% of the state's total value and pay 0.36% of total taxes. The ETR is 0.59%.

Rental residential properties that are restored as historic (Class 8) are also given a break in their property taxes. In this case, the portion of the property value that represents the cost to restore and rehabilitate the property is deflated by a 1% assessment ratio.

Possessory interests (Class 9) are also assessed at 1% and shoulder the lowest burden, with an ETR of 0.08%.

Assessment ratios explain most of the differences in ETRs across classes, but it is not the only determinant. ETRs will vary among different taxing jurisdictions depending on the level of tax rates.

The shift in property tax burdens that exists currently in Arizona's system can be demonstrated from another point of view. Table 2 (below) shows what the effective tax rates would have been in 2004 had they been based on taxable full cash value without assessment ratios. The analysis maintains other features in the tax system like the minimum qualifying tax rate (MQTR), the homeowner's rebate, and the one-percent cap.

The column on the far right of Table 2 shows the difference in yield between what was levied on each class and what would have been the case in a system without assessment ratios. The current system shifts over \$848 million in property taxes to commercial and industrial taxpayers and saves homeowners from nearly \$753 million in taxes that fall on other classes.

TABLE 2: ARIZONA'S TAX SHIFT

Current tax levies without assessment ratios show how the system shifts \$848 million to business taxpayers

Class	Total Taxable Full Cash Value	Percent of Total	Total Yield	Percent of Total	Effective Rate	Difference In Yield
1 Commercial, Industrial, Utilities, & Mines	73,111,625,884	22.09%	1,163,454,989	24.43%	1.59%	(848,276,179)
2 Agricultural & Vacant Land	24,123,289,973	7.29%	308,672,893	6.48%	1.28%	(55,868,175)
3 Owner-occupied Residential	200,760,981,270	60.65%	2,749,328,456	57.73%	1.37%	752,870,724
4 Rental Residential (10%)	28,800,738,542	8.70%	467,698,905	9.82%	1.62%	125,039,886
5 Railroad, Private Car, Airline Flight	1,229,755,583	0.37%	25,038,558	0.53%	2.04%	(4,084,883)
6 Res.historic, Ent./Foreign Trade Zones	2,931,535,674	0.89%	47,348,774	0.99%	1.62%	30,134,338
7 Commercial Historic	22,307,814	0.01%	406,249	0.01%	1.82%	(35,349)
8 Rental Residential Historic	2,788,200	0.00%	58,681	0.00%	2.10%	16,671
9 Possessory Interests	19,474,248	0.01%	218,010	0.00%	1.12%	202,966
Total	331,002,497,188	100.00%	4,762,225,516	100.00%	1.44%	(0)

DESEG/OCR FUNDING REFORM NOW UP TO STATE SENATE

The Arizona House of Representatives has again passed legislation to reform school district desegregation (deseg) funding. HB 2498, introduced by House Ways & Means Chairman Steve Huffman, deals with one of the most significant drivers of property tax growth, especially in Maricopa and Pima counties.

State law allows school districts to levy unlimited property taxes in excess of their budget limits, for an unlimited amount of time and without voter approval, if the district has either a court order to desegregate or an agreement with the U.S. Department of Education's Office for Civil Rights (OCR). This exemption from budget and property tax limits may continue long after the court order has been lifted or the OCR agreement is no longer monitored.

Currently, 19 school districts utilize the state deseg/OCR law to levy taxes over their budget limit. Specifically, only two districts are under court orders to desegregate: Tucson Unified and Phoenix Union. The remaining 17 districts are currently, or at least were at some point, under scrutiny by the OCR to remediate some claimed violation of civil rights. In other words, if a school district is accused of violating some student's civil rights, they are rewarded with unlimited access to property taxes in perpetuity.

Deseg/OCR levies are unlimited budget overrides requiring no voter approval. For decades, these levies have driven a wedge into school district and taxpayer equity, widening the gap every year in a public school system that is required by the Arizona Constitution to be "general and uniform." Disparities in tax burdens resulting from these desegregation levies can be severe, with some property owners paying tremendously higher tax rates than similarly valued property in an adjacent district. Some districts have used this taxation authority to compensate for the loss of revenue when overrides are rejected by voters, essentially saying to taxpayers, *You don't get to say no.*

A 1990 special study by the auditor general found that "expenditures budgeted outside of the revenue control limits for desegregation programs are growing" and that "some costs categorized as desegregation expenditures do not appear to be related to desegregation orders and agreements." During FY 1991, the year in which the auditor general's report was released, 10 districts budgeted \$47.3 million under this provision. For FY 2005, 19 districts budgeted \$193.5 million, a 309% climb.

Despite the Auditor General's recommendations that the Legislature take a more active role in strengthening

accountability for desegregation programs, lawmakers had accomplished very little until 2002 when the Legislature capped deseg/OCR levies for a two-year period. For FY 2005, the Legislature adopted a so-called "soft cap" that allows districts to increase their deseg/OCR budgets by 2% plus district enrollment growth.

According to JLBC, the deseg/OCR property taxes would increase by an estimated \$5.2 million in FY 2006 if the current "soft cap" is continued. Approximately \$1 million of that would come from the state general fund to cover homeowner rebate costs. On the other hand, if a "hard cap" is put in place, property taxpayers and the state will not face an increase beyond their current exposure. If the Legislature does nothing, the deseg/OCR levies will increase by unknown amounts and the number of participating districts will grow.

HB 2498 puts into place reasonable reforms to deal with the authority these school districts have to levy unlimited property taxes. The bill will cap deseg/OCR property tax levies at their current level. Any justifiable increases for new or existing deseg/OCR expenditures will be subject to state appropriation, as is the case with most other special categories of K-12 funding.

Michael Hunter