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ARIZONA TAX RESEARCH ASSOCIATION

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Bill Requiring Treasurers Mail Tax Bill Passes

The Legislature passed a measure in SB1033 that requires county treasurers mail a property tax bill to all property owners, including those with mortgages. This ATRA bill, sponsored by Senator Vince Leach, passed with bipartisan support and a unanimous vote of the House.

Arizona's property tax system is considered one of the most complicated in the country, and therefore, taxpayer education is essential. County assessors are required to mail property valuation notices to all property owners by March 1st each year. State statutes require local governments to publicly educate taxpayers during the budgeting process regarding their spending priorities and how much needs to be raised in property taxes to fund those decisions. And when government plans to increase property taxes, they must hold a public hearing and publish notice under the Truth-in-Taxation law. Following the adoption of budgets and tax rates, county treasurers must notify property owners of their tax liability. The problem is, county treasurers are not currently required to mail tax bills to property owners that have a mortgage on their property.

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2019 ATRA Legislative Program Update

The 2019 Legislative session looks to finish its work in the month of May as it begins work on the Fiscal 2020 state budget. At the April 26 ATRA Legislative Policy Committee, House Chief of Staff Michael Hunter explained that each legislative session is 50% familiar and 50% new ground. There's much about each session that is mechanical and somewhat predictable and the other half is nuanced and reflective of the challenges of the day. This session is no different in that lawmakers have familiar challenges but several unique problems, particularly in the tax arena. ATRA staff has been busy advising lawmakers on sound approaches to issues such as tax conformity, the application of sales tax to remote (internet) sales, and other complicated tax questions. The following are updates on tax

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Effective Property Tax Rates Stable in AZ

Arizonans paid an average effective property tax rate (ETR) of 1.12% in 2018, which is measured by total tax levies over total full cash value. Each year ATRA completes a complex property tax model which inputs all levies and values from all jurisdictions across the state to determine ETRs. This rate is useful because it's the simplest way for taxpayers to understand what they pay, whereas jurisdictional tax rates and total tax rates do not tell taxpayers how much they paid relative to their value. It's also the only way to compare like properties in another jurisdiction or another state.

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ETRs vary considerably across different classifications as Arizona applies assessment ratios to different classes based on use. For example, business property pays on 18% of value whereas residential pays on 10%. The effective tax rate for the business classification (Class One) was 1.91% and for owner occupied residential (Class Three) was 0.87%. So while the business classification represents 21% of full cash values, it pays 35.6% of the property taxes and conversely the residential classes of three and four represent 73.4% of value, it pays 58.4% of property taxes.

Total statewide property taxes were \$7.86 billion, a 3.8% year over year increase. ATRAs property tax model captures roughly 94% of tax levies owed, due to the difficulty of tabulating each one of the hundreds of small special districts. The model does include the levies of many special districts including fire districts and all countrywide special districts.

Total property value in Arizona has consistently increased since the recession, rising from a low of \$495 billion in 2011 to \$657 billion today. However, total value has yet to reach pre-recession values. In 2008, full cash values in Arizona reached \$688 billion, an incredible 86% increase from just three years prior. While this period of inflated values is now widely understood as an unsustainable bubble in the housing market, it’s important to remember state and local budgets were crafted using these market values.

While many point to the 2008 spending watermark as their expectation for “restored funding” (including population and inflation adjustments since that time, naturally), it’s not as though the state recovered these property values at the end of the recession—that taxing capacity was a mirage. Despite years of sustained economic growth through an unprecedented 11-year economic expansion and hundreds of new properties added to the tax rolls, total value still has yet to surpass the 2008 market bubble. The pre-recession boom years were not just unrealistic at the time, they generated unrealistic expectations for future growth which impact public policy discussions today.

-Sean McCarthy

2018 Effective Tax Rates

Class	Type	Assessment		Percent of		Percent of Total	Effective Rate
		Ratio	Full Cash Value	Total	Total Yield		
1	Business, industrial, telecomm, utility, mines	18%	138,013,477,255	21.00%	2,630,270,421	35.62%	1.91%
2	Agricultural, vacant land, golf courses, nonprofits	15%	26,347,136,096	4.01%	347,567,592	4.71%	1.32%
3	Owner occupied residential	10%	325,896,375,478	49.59%	2,819,142,347	38.18%	0.87%
4	Rental residential; nonprofit residential	10%	158,515,317,080	24.12%	1,503,258,898	20.36%	0.95%
5	Railroads & flight property	14%	2,386,963,698	0.36%	37,855,143	0.51%	1.59%
6	Historic prop; FTZ; enviro tech; (more)	5%	5,379,965,599	0.82%	40,171,831	0.54%	0.75%
7	Comm historic property	18%/1%	59,044,881	0.01%	746,934	0.01%	1.27%
8	Rental residential historic property	10%/1%	21,588,701	0.00%	238,544	0.00%	1.10%
9	Possessory interests; leased churches	1%	559,323,190	0.09%	4,339,363	0.06%	0.78%
Total			657,179,191,978	100.00%	7,383,591,073	100.00%	1.12%

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SB1033 PROPERTY TAX STATEMENTS, *Continued from Page 1*

Currently, ten of the fifteen county treasurer's choose to mail tax statements to all of its property owners. Notably, the Maricopa County Treasurer used to mail tax statements to all its taxpayers, that is, up until a couple of years ago when Treasurer Royce Flora was elected to office and made the policy decision to stop that practice. At a minimum, taxpayers deserve the right to easily see how much government is taxing their property. ATRA congratulates Sen. Vince Leach for pushing it through to Governor Ducey's desk for his signature.

LEGISLATIVE UPDATE, *Continued from Page 1*

and fiscal policy bills ATRA has tracked so far:

GOOD BILLS

SB1033 Property tax statements; mortgaged property (Leach) See article on page one.

HB2097 personal property; reporting; exemption (Cook)

In 1996, voters approved a constitutional amendment to relieve small business owners of the administrative and financial burden of the personal property tax. Specifically, the measure exempted the first \$50,000 in full cash value from the tax. As a result of that constitutional measure, the Legislature amended the personal property tax statute in 1998 to prohibit county assessors from requiring business owners to annually report their exempt personal property. Despite that law being in effect for the last two decades, one county assessor recently began denying the exemption to taxpayers that legally did not report their exempt property.

HB2097 clarifies that a taxpayer with personal property within the constitutional exemption threshold is not required to file a report with the county assessor. This bill restores the intent of the original voter-approved measure. ***Awaits Senate 3rd Read***

HB2734 NOW: prime contracting; study committee (Cobb)

The disagreement on the level of noncompliance associated with the prime contracting tax has been a major obstacle to transitioning to a tax on materials at retail. In 2018, Rep. Regina Cobb successfully sponsored legislation that dedicated \$75,000 to study the amount of noncompliance under the prime contracting tax. That measure was supported collectively by ATRA and others in the business community, the contractors, as well as the cities. The study was completed in January of this year, and as reported in ATRA's 2019 February/March newsletter, the loss in revenue associated with noncompliance was estimated at nearly \$1 billion between 2010 and 2016.

With the release of that study, Rep. Cobb again sponsored legislation this year to establish a study committee on the taxation of prime contracting in an effort to move the discussion forward in favor of transitioning to a materials-based tax system. The study committee would be tasked with analyzing the legal framework and examining best practices from other states and policy experts on the taxation of prime contracting, specifically

including ways to decrease noncompliance. Although the bill passed unanimously out of the House, it was not assigned to a committee in the Senate. *Held in the Senate*

SB1248 property taxes; valuation; property modifications (Leach)

When significant modifications to property are made, such as new construction, destruction or demolition, the Limited Property Value (LPV) is calculated by applying a Rule B percentage to the Full Cash Value (FCV). The Rule B percentage is calculated for each class and represents the average LPV to FCV. In most cases, particularly new construction, applying Rule B will increase the LPV. However, in cases where there are significant modifications to existing property, applying Rule B to a property may actually decrease the LPV, depending on the current LPV to FCV ratio for that property. The percentage threshold for Rule B is not currently in state statute, but rather, is only referenced in a Department of Revenue (DOR) guideline. Specifically in that guideline, county assessors are recommended to apply Rule B when the modifications to property change the FCV by 10% or greater, or “at the discretion of the assessor.” Not only is the 10% threshold arguably too low, leaving the discretion up to the county assessors has also caused some assessors to inconsistently apply Rule B across the state.

As introduced, SB1248 set the threshold at 20% or greater and specified that tenant improvements would not trigger Rule B. The County Assessors opposed the bill in the Senate because, although they agreed that Rule B was being applied inconsistently, they thought 20% was too high and they didn’t agree with the exclusion of tenant improvements. As a result, the bill was amended to remove the reference to tenant improvements and to reduce the Rule B percentage to 15%. Having the percentage threshold in statute rather than in DOR guideline ensures that all assessors will apply Rule B in a consistent manner among all taxpayers. *Awaits House Rules*

SB1334 Independent functional utility; deduction (Mesnard)

The TPT retail classification provides an exemption for the purchase of machinery and equipment used in manufacturing. The installation of that exempt M&E is also exempt under the prime contracting tax if it has “independent functional utility” (IFU) and is attached to real property for stabilization purposes. The current law replaced the “permanent attachment” test that dated back to 1996, which was enacted to overturn an Arizona Court of Appeals decision that changed a longstanding DOR policy regarding the tax treatment of the installation of exempt M&E that did not become permanently attached to real property. However in 2012, DOR advanced a draft ruling that was in direct conflict with the permanent attachment law, and as a result, the Legislature enacted the IFU test in 2013. However, in 2017, DOR issued a private letter ruling that incorrectly denied the installation exemption because the exempt M&E was bolted down to a concrete pad strictly for stabilization purposes. Fortunately, after much discussion, DOR acknowledged their position did not correctly reflect the law and agreed to revise the 2017 ruling. With DOR’s commitment to revise the ruling, ATRA requested the bill be held. *Struck in House Approps.*

SB1161 S/E: school facilities; revisions (Leach)

Though Arizona law presently requires school districts report to the School Facilities Board (SFB) their vacant and unused space, the report has widely been considered incomplete. Many districts do not complete the report and almost none of it is deemed by the district to be suitable for charter school use. Naturally, districts are hesitant to encourage competition in their vacant or unused facilities. As struck in the Senate, SB1161 rewrites the section

of law in this area entirely, making it both the duty of SFB as well as the Department of Administration. They will annually publish a publicly available list of vacant and underutilized space suitable for use by a school. Buildings used for special education, magnet schools, career and technical education, preschool, or facilities less than five years old would not be considered partially used buildings, except these exceptions cannot exceed 25% of a districts total school building space. Buildings considered “partially used” must be at least 4,500 unused square feet. Vacant buildings are those that have been vacant and unused for two years or more.

Nonvoter approved lease agreements (as lessee or lessor) may last up to 20 years from 15 years, while retaining the exemption against constructing new district school facilities, which must be voter approved unless all payments come from unrestricted capital monies. District governing boards may now sell a district building without voter approval if it has been vacant or partially unused for at least three years. At the end of a lease with a charter school, a district has the option to increase rent but must provide a public rationale.

With explosive growth in charter schools and open enrollment, Arizona’s public school system is likely over-built and shows no sign of abating. ATRA supports SB1161 because it encourages districts to share space with other districts and charters, which should save taxpayers money in reduced capital costs and allows schools to spend more on operations. ***SB1161 awaits a House floor vote.***

SB1460 TPT; digital goods and services (Ugenti-Rita)

Following a 2017 legislative study committee which found the state lacks statutory authority to tax digital goods and services, the Legislature attempted a legislative fix in 2018 to provide the state the legal authority to tax digital goods and exempt digital services. When that effort failed, the coalition of businesses and business groups helped construct a new effort for 2019 in SB1460. The bill puts into place nationally accepted definitions for software, digital goods, and digital services in a new classification of transaction privilege tax (TPT). The bill makes electronically delivered licensed prewritten software and all digital goods subject to TPT. Licensed software is software where the user has the right to electronic transfer; in essence the user has a right to a full copy as opposed to remote access. For digital goods, such as ebooks, movies, television shows and audio files, they are taxable if transferred electronically or accessed remotely. Though this makes streaming audio and video taxable, there are exemptions for scheduled programming, such as live linear broadcast, which has never been subject to TPT.

Once again, the primary opponent to the legislation is the League of Arizona Cities and Towns, whose position is that Arizona should use the rental of personal property classification to tax all digital goods and all digital services. The only compromise offered by the League was to exempt web hosting and a narrow exemption for one business offering. After passing the Senate Finance Committee on a party line vote, the bill was held on the Senate Floor. With Senators Paul Boyer, Kate Brophy-McGee, and Frank Pratt in opposition, the bill did not receive a vote in the Senate.

After opponents mocked the notion that the state would be sued for attempting to tax digital goods and services without statutory authority, lawsuits have begun to mount. As of April 2019, at least four lawsuits have been filed against the state, from a variety of industries and including a class action lawsuit representing Software as a Service companies. If any of them are successful, the state will likely lose the ability to tax any remotely accessed product such as audio and video streaming, if not all digital goods and electronically delivered software. ***SB1460 passed Sen Finance and never received a vote in the full Senate.***

HB2445 TPT; residential rentals; notice (Griffin)

HB2445 requires cities and towns notice by first class mail any new or increased rate of tax at least sixty days before the effective date of the rate change. The notice is required to be sent to each residential transaction privilege tax (TPT) licensee and to the address of each residential rental property. ATRA supported the effort because taxpayers deserve a fair warning that their taxes will rise and residential property owners must have time to legally adjust rents for tenants. *Chapter 53*

FAVORABLY AMENDED BILLS**HB2367 limited audit review; electronic portal (Toma)**

As introduced, HB2367 would have allowed DOR to conduct limited scope audits using third party (undefined) data and, if the taxpayer did not respond within 15 days, DOR would be allowed to automatically assess tax, interest or penalties based on that information. ATRA was originally opposed to the measure since “third party data” was undefined and the automatic tax assessment did not provide enough taxpayer protections. After working with DOR throughout the session, the final enacted version allows DOR to contact taxpayers for reporting discrepancies yet provides the appropriate protections for taxpayers.

As amended, HB2367 allows DOR to conduct a limited scope review of a filed individual income tax return if it discovers a discrepancy between amounts reported on the return and information reported by employers. DOR may request records from the taxpayer in support of the filed return and propose a tentative amount of tax, interest, and penalties based on the additional information. The taxpayer has at least 30 days to respond to the notice on a form prescribed by the department. A limited scope review may be conducted only once per tax year per taxpayer and is not considered an initial audit contact under the following circumstances: the taxpayer provides documentation or an explanation to resolve the discrepancy; the taxpayer files an amended return to correct the discrepancy; DOR adjusts the return at the taxpayer’s request based on an agreed upon amount, or DOR requests the taxpayer file an amended return to resolve the discrepancy. Additionally, beginning January 1, 2019, DOR may issue deficiency assessments through an electronic portal to individual income taxpayer’s if the taxpayer agrees in writing to allow DOR to use the portal to issue the notice for specified periods. *Awaits Governor’s Signature*

BAD BILLS**HB2702 TPT; marketplace facilitators; nexus (Toma)**

When the Supreme Court eliminated the physical presence test in *Wayfair v. South Dakota*, allowing states to apply an economic nexus standard and thus impose their sales taxes on remote sellers, ATRA welcomed the decision. ATRA called on policymakers to immediately begin the necessary work to address this complex issue. ATRA recommended a study committee in 2019 to address the many issues involved from policy to implementation. Other states with complex sales tax systems like Colorado, Alabama, and Louisiana have created task forces to study this issue. Several national groups have warned these states against hastily crafted economic nexus laws which create undue burdens on remote sellers, lest they result in litigation. HB2702 was a rushed effort which created an economic nexus and marketplace facilitators nexus law without sufficient reforms to make the law less vulnerable to such litigation. In particular, the bill did not create a uniform base of tax between the state and localities, only referring to a uniform retail base by reference, the definition of which would effectively be controlled by the cities themselves. This would have the effect of creating distinct tax bases between goods sold

online versus those in traditional stores, creating more chaos for taxpayers and possible equal protection violations.

Several business community groups opposed HB2702 and asked lawmakers to go back to the drawing board, resulting in the scrapping of HB2702. A group of local tax lawyers and several national experts warned lawmakers their approach was insufficient to meet the demands of the *Wayfair* case and would likely result in litigation. Finally, lawmakers must acknowledge the significant revenue increase created by the expanded nexus laws, which are tax increases for business who presently pay use taxes and will pay higher retail TPT with these changes. A renewed effort began late in the session to create an economic nexus law, which as of this writing is shaping up to be a much better approach. ***HB2702 passed House Ways and Means and was held in House Rules.***

HB2304 school districts; overrides; ballot question (Udall)

A bill that has been introduced several times in the past, HB2304 sought to water down the “ballot question” for K-12 district overrides from “Budget Increase Yes/No” to “Local Support Yes/No”. In ATRA’s opinion, the school lobby already maintains a favorable advantage in override questions because they do not mention the word “tax” when the operative function of a school override is an additional property tax. In addition, when districts are simply extending their current override, the question is a cozy “Override Continuation Yes/No”.

ATRA opposed this effort because it is an inappropriate ballot question for K-12 budget overrides. As the place where the voter marks their vote, it’s important that it remain legitimate. To opt for a most obscure “local support” not only clouds the meaning of the question, it delegitimizes the point of voter approval. The truth is property taxpayers “locally support” school districts whether they approve overrides or not, through two property taxes in the State Equalization Tax Rate and the Qualifying Tax Rate, making this option most inappropriate as it suggests that a ‘No’ vote means the voter intends to provide no “local support”. ATRA argued in committee that if any change should be made, it should be the addition of a mention that it is a property tax question, as in “Additional Property Tax for Budget Increase, Yes/No.” ***HB2304 failed in House Education.***

HB2563/SB1080 TPT use tax; education (Udall/Allen)

Companion bills in the House and Senate along with accompanying ballot referrals would ask voters to raise the current 0.6% sales tax for education to 1% and revise the formula. The existing formula sends roughly \$623 million total to K-12 education, \$83 million to Universities and \$25 million to community colleges, although it is rather complex and has several buckets. As amended on the floor on both sides, the bill would eliminate most of the buckets and simply give 75% of the money to K-12 with far fewer restrictions, 20% to Universities and roughly 5% to community and tribal colleges. K-12 would receive just shy of \$300 million in new funds, Universities would receive \$140 million and \$32 million for community colleges.

ATRA opposed this sales tax increase primarily because it lacks reforms to the school finance system. Further, the bill watered down the existing Classroom Site Fund by removing the performance pay provision, suggesting all teacher pay be based on a traditional pay scale. Finally, the dilution of the Prop 301 formula, by adding so much the higher education buckets, added only a fractional amount of money for K-12, eliminating the ability to derive reforms from the funding increase. ***HB2563 was held in House Rules. SB1080 was held on the Senate floor.***

(Continued on next page)

MONITORED BILLS**SB1101 schools; calculated opportunity index (Carter)**

SB1101 added a wrinkle to the existing public school finance formula which adds funding for districts and charters with schools that have more than the statewide average for poverty, measured by qualification for federal free or reduce lunch (FRL). A weight of .059 is added for this index, which is measured as the differential between each schools FRL rate and the statewide average, so funding is increased based on concentration of poverty. Recipients of the funding submit a report to the Legislature demonstrating the academic gains of pupils in these schools, using assessments aligned to state standards. As amended in the Senate, the bill reduced any monies levied in relation to Desegregation or compliance with the Office of Civil Rights on a fifty cent to each dollar ratio, although there were discussions of amending it back to a dollar for dollar reduction in the House, an amendment ATRA supported. Cost to the State General Fund was an estimated \$36 million with a \$2.7 million local property tax impact in non-state aid districts. *SB1101 was held in House Appropriations.*

SB1256 school districts; procurement practices; auditors (Gray)

SB1256 removed two provisions from law introduced in the 2018 budget, one that required low-bid procurement for all district school procurement and one that required districts rotate auditors every three years and that the audit firm also not be a financial consultant to the district. The bill also added a pilot program where one medium sized district and two small districts with ongoing alternative delivery procurements will receive technical assistance and consulting from the School Facilities Board. *Chapter 85*