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ARIZONA TAX RESEARCH ASSOCIATION

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Legislature Adjourns Sine Die

Governor Brewer Signs Historic Sales Tax Reform Bill

The Arizona Legislature adjourned the First Session of the 51st Legislature on June 14, 2013. The 151 day session resulted in the passage of 282 bills, some of which still await action from Governor Brewer. For ATRA, clearly the most significant outcome of the session was the passage of historic reform to Arizona's complicated and cumbersome Transaction Privilege Tax (TPT).

The passage of House Bill (HB) 2111, sponsored by House Ways and Means Committee Chair Debbie Lesko, capped a year-long effort to reform Arizona's TPT system that began with the work of Governor Brewer's TPT Simplification Task Force. That Task Force worked through the summer and fall of 2012 to develop recommendations that were adopted in December 2012. Those recommendations were embodied in HB2657 that was introduced by Representative Lesko and cleared the Ways and Means Committee on an 8-0 vote on February 18, 2013. Regrettably, HB2657 then died in the House after not being scheduled for a hearing by House Appropriations Committee Chair John Kavanagh. In the last week to hear bills in the State Senate, HB2111 was amended in the Senate Finance Committee on March 20th to include a revised TPT reform bill that reflected major concessions to address city opposition in the areas of city audit authority and prime contracting tax reform.

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Legislation Doubles K-12 Debt Limits

JLBC estimates \$400 million in bonds could be sold

Every legislative session brings a combination of good news and bad news for Arizona taxpayers. Maybe top on the list of bad news was the passage of legislation to permanently increase the K-12 school debt limits by 100%. Following the collapse of the real estate market, factions in the K-12 school lobby have sought relief from the statutory debt limits imposed on K-12 schools as a part of the historic Students FIRST legislation in 1998. Their prospects for success in the 2013 session improved following Governor Brewer embracing the proposal in her Executive Budget proposal. This year's legislation was ultimately passed as a part of the special session budget package in HB2003.

ATRA argued that doubling the debt limits would drive property tax rates even higher than the significant increases experienced in the last two years. More importantly, ATRA also argued that the legislation would significantly increase inequities in an area of the K-12 school finance system that the state has already litigated and lost.

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Following two and a half months of no action on HB2111 in the Senate, the bill moved rapidly through floor action in the Senate and House on June 13th. A last minute compromise amendment with city representatives changed an expected close vote to near unanimous support in both the House and Senate.

In summary, the final version of the bill, as reflected in Senator Steve Yarbrough's floor amendment, contained the following provisions:

Single Point of Administration:

For decades, Arizona's overly complicated state and local sales tax system has burdened Arizona businesses with extraordinary and wasteful compliance costs. One of the major administrative costs of compliance for Arizona businesses is remitting multiple sales tax payments to the state and city governments. Effective January 1, 2015, the Arizona Department of Revenue (ADOR) will become the single point of administration and collection of TPT. Businesses will either remit their monthly sales tax payments on-line through ADOR or through a simplified paper form through ADOR. Arizona cities and towns opposed allowing taxpayers making paper sales tax filings to efficiently remit their payment to one source (ADOR). (Currently, businesses located in one of 73 cities that contract with ADOR for the collection of their sales taxes (called program cities) already have the ability to remit one payment to ADOR. However, businesses located in one of the 18 non-program, self-collecting cities are required to remit separately to the state and city.)

Arguing that ADOR does not have the ability to capture taxpayer specific data that non-program cities currently require, cities opposed this reform. In the end, the city compromise amendment contained a provision requiring ADOR to provide forms that capture data with the sufficient specificity to meet the needs of all taxing jurisdictions.

Single and Uniform Audit:

From the outset, the area of tax administration that was the focus of most disagreement between the business coalition and city representatives was the auditing authority of cities. Unlike most other states that conduct sales tax audits through a state agency, Arizona has also allowed cities to audit businesses in their jurisdictions resulting in chaotic patchwork for audits that exposed businesses to not only multiple audits but varying interpretations of their tax liability.

Effective January 1, 2015, ADOR will administer a standardized state audit program where all state and city auditors will be trained and certified by ADOR. Whether conducted by a state or city auditor, a business will only be subject to one audit that will cover their state, county, and city TPT liabilities. City audits, unless authorized by ADOR, will be limited to taxpayers engaged in business in only one city or town. Multijurisdictional taxpayers will be audited only by ADOR.

Trade/Service Contracting Reform:

Governor Brewer's TPT Task Force adopted an aggressive recommendation to eliminate Arizona's unique and complicated prime contracting tax. This recommendation drew considerable opposition from cities and towns and was the subject of much of the early debate on HB2657. As a result, the final version of HB2111 limited the prime contracting reform to only the "trade and service" contractors. These contractors, when

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ARIZONA TAX RESEARCH ASSOCIATION
Lyn White.....Chairman
Kevin J. McCarthy.....President
Jennifer Stielow.....Vice President
Ben Nowicki.....Research Analyst
Maria Travers.....Office Manager

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1814 W. Washington Street
Phoenix, Arizona 85007
(602) 253-9121

www.arizonatax.org
atra@arizonatax.org

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working directly on behalf of an owner for the maintenance, repair, and replacement of existing property will be exempt from the prime contracting tax. However, they will be subject to retail sales taxes on any material purchased in conjunction with those contracts. During the TPT Task Force proceedings, there appeared to be agreement that compliance with Arizona's prime contracting tax was particularly difficult for these service contractors (plumbers, HVAC, and pool repair, etc.) who operate in multiple jurisdictions on a daily basis.

Led by ATRA, the Arizona business community has struggled unsuccessfully to pass major reform of Arizona's chaotic and dysfunctional sales tax system for almost 30 years. The passage of HB2111 marks historic progress in simplifying Arizona's sales tax system and decreasing the compliance costs for Arizona business. Like previous efforts to reform the system, this effort proved to be very contentious and it would not have passed without the leadership and support of Governor Brewer. In addition, Governor Brewer's Policy Director Michael Hunter, who chaired the TPT Task Force, also deserves credit for his extraordinary skill in managing both the Task Force and legislative effort.

The champions for TPT Reform in the Legislature were led by bill sponsor Rep. Debbie Lesko, who dedicated countless hours advocating on behalf of Arizona businesses and taxpayers. Senators John McComish, Steve Yarbrough, and Steve Farley were also consistent advocates for real reform through the entire process.

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Below is the text of ATRA's message to the both the Legislature and Governor on this issue.

Background:

The state of Arizona spent the better part of the decade of the 1990's tangled in litigation on Arizona's method for capital financing of public schools. Beginning with the Supreme Court's 3-2 decision that invalidated Arizona's capital finance system in the *Roosevelt v. Bishop* case in 1994, the Arizona Legislature spent the next six years struggling to resolve that case. In fact, repeated attempts by the Legislature to address the court's decision were struck down. Finally, with the passage of Students FIRST in 1998, the court ruled that the state had satisfied its view of the "general and uniform" clause.

In addition to the creation of the School Facilities Board (SFB), along with the creation of minimum adequacy guidelines and formulaic funding for new construction, a key component of the Students FIRST legislation that exorcised the state from the *Roosevelt* case was the reduction in the influence of the inequitable property tax on school capital funding. In order to address the obvious property tax inequities that the plaintiffs attacked in *Roosevelt*, the Legislature reduced districts' access to debt financing through a reduction in the K-12 debt limits.

Basis for ATRA's Opposition:

ATRA was deeply involved in every aspect of the state's effort to resolve the school capital finance crisis created by the Supreme Court decision in 1994. Despite the fact that ATRA did not agree with the court's finding in *Roosevelt*, we had to participate in a resolution to that decision. Most of those who participated in the creation of Students FIRST did so out of necessity, not because they thought it was particularly good policy. Having said that, regardless of how we now view the Students FIRST reforms, ATRA believes that it

Governor Vetoes Bad Tax Legislation

Below is the text of ATRA's letter to Governor Brewer encouraging a veto of HB2125. The bill would have authorized Coconino Community College District to seek a permanent override of their constitutional levy limit and provide for that override to be levied as a primary property tax. ATRA appreciates the Governor's decision to veto this legislation.

Dear Governor Brewer,

In the last day of the session, the Arizona Legislature approved House Bill (HB) 2125. The Arizona Tax Research Association (ATRA) has opposed this legislation for three years and I strongly encourage you to veto this measure.

As you know, Arizona has one of the most complicated property tax and public finance systems in the country. Arizona's property tax system is governed by a combination of constitutional and statutory provisions. Arguably the most important constitutional provision is the 1% cap on the taxes of residential property taxpayers. This provision is not only an important protection for residential taxpayers, it also has serious state general fund implications because statutes make the state liable for homeowner taxes that exceed the cap.

Arizona's property tax system, while complicated, does account for the perverse incentive that would exist if voter approved bonds, overrides, and special districts fell within the protections of the 1% residential cap. In fact, the **only** purpose for the constitutional distinction between those voter approved tax levies and levies for operational purposes is to ensure that the homeowner/voter would not be afforded 1% cap protection on voter approved bonds, overrides, and special districts.

I believe imposing the costs of a voter approved override on a primary property tax that is subject to the 1% cap is unconstitutional. In addition, HB2125 obviously sets a very dangerous precedent that will most certainly lead to future legislation by other local governments seeking similar treatment.

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would be a major mistake to pretend that the *Roosevelt* case never occurred or that the state can simply "walk away" from Students FIRST reforms.

ATRA appreciates the fact that recent budget deficits forced state policymakers to shift funding from SFB to higher priorities. However, in addition to the school districts' concerns about the loss of capital funding through SFB, the state also must be cognizant of the capital finance lawsuit by the charter schools. Clearly, doubling the statutory debt limits, which increases the inequity between districts and charters schools, will improve the charter schools position in their litigation with the state.

Finally, ATRA believes that Arizona policymakers need to reevaluate Arizona's K-12 capital finance system. In doing so, policymakers should avoid changes that guarantee a new round of litigation like the state experienced in the 1990's.

College Expenditure Limits Lack Accountability

Through a lack of regulation, Arizona's community college districts (CCDs) were able to inflate their expenditure limits by more than \$100 million in Fiscal Year (FY) 2012. The large discrepancy can be attributed to the community colleges' ability to report its own student count estimates to the Economic Estimates Commission (EEC), the outfit in charge of calculating expenditure limits for counties, cities, and community colleges. Audits conducted by the State revealed that most community colleges exaggerated their reported student counts in FY 2012, amounting to millions of dollars in additional capacity.

In 1980, voters approved limits to the amount certain jurisdictions could spend for operating purposes in an effort to protect taxpayers from exorbitant budgets proposed by taxing entities throughout the state. These spending limits were enacted to apply to counties, cities, and community college districts and are calculated by multiplying a population growth factor by the jurisdiction's base year expenditures, which uses the latter of 1980 or the year of incorporation. For cities and counties, population data used to determine their expenditure limits are furnished by the Arizona Department of Administration. Community colleges, on the other hand, have the liberty to submit their own population estimates, using full-time student equivalents (FTSE) as the population metric.

Prior to 2000, the community colleges operated under the oversight of the State Board for Community Colleges (Board). One of the statutory requirements of the Board was to submit the FTSE estimates for each college to the EEC to compute expenditure limits. The Board, however, was dissolved in 2000, allowing the colleges to submit their own FTSE estimates, removing any accountability or oversight in the calculation of expenditure limits for colleges. This practice has created hundreds of millions in excess capacity, which amounted to \$102 million in FY 2012.

Audits showed that community colleges overstated their FTSE counts by 18,089 (12.8%) in FY 2012. Nine of twelve community college districts were found to have bloated FTSE estimates and eight of those nine were in excess of more than 10%. The two provisional community college districts, Santa Cruz and Gila, had the most excessive FTSE estimates above their audited figures at 179% and 71%, respectively. These percentages produced corresponding overages in their expenditure limits. In other words, Santa Cruz Provisional used an expenditure limit nearly three times what it should have been and Gila used a limit nearly twice the amount of the adjusted limit.

The largest district, Maricopa CCD, had a 12% discrepancy between submitted and audited FTSE. More than half of the excess capacity in college expenditure limits was attributable to Maricopa CCD, which produced an additional \$52 million in FY 2012. The second largest district, Pima CCD, adjusted its limit upward nearly \$22 million as a result of overstating its FTSE by 21%. Both Mohave and Yavapai had surplus capacity in excess of \$7 million with deceptive student counts of 26% and 18%, respectively. Navajo CCD gained \$2.8 million in expenditure limit capacity with an excess student count of 21%. The 11% FTSE discrepancy gave Pinal CCD additional capacity of \$4.7 million and a 3% difference in student count equated to \$862,338 for Graham CCD. Cochise, Coconino, and Yuma/La Paz CCDs were the only colleges that did not report excessive FTSE estimates.

It is common for CCDs to adopt general fund budgets in excess of their expenditure limits without being in violation of the limit because not all expenditures are subject to the limit. For example, districts are able to exclude certain general fund expenditures of tuition and fee revenue in order to stay within the constitutional limit. Additionally, districts exclude expenditures of revenue received in connection with workforce

Action on Other ATRA Bills

Some Pass – Some Die

HB2347 tax levy; bond costs

Sponsored by House Ways & Means Chair Rep. Debbie Lesko, HB2347 limits the annual secondary property tax levy for General Obligation (G.O.) bonds to the amount necessary to pay the annual debt service, including a reasonable amount for delinquency. The bill was amended in the House to allow the levy to be adjusted for errors in the levy in the prior year, if applicable, among other technical changes. ATRA pursued this legislation to prevent the future abuse of certain jurisdictions that, in the past, neglected to adjust secondary property tax rates when property values were on the rise, causing taxes to increase well beyond what was necessary to satisfy the annual debt service requirements on voter-approved G.O. bonds. This bill was signed by Governor Brewer (Chapter 188).

SB1470 dedicated property tax /HB2544 city parcel tax; prohibition

Last year, the Town of Paradise Valley proposed legislation that would have allowed a city or town to levy a new parcel tax on property for the payment of fire services. ATRA strongly opposed the creation of a new property tax on homes and businesses that didn't include any of the limitations or protections that are built into Arizona's existing property tax system. Thankfully that bill failed; however, the Town proceeded with the parcel tax anyway. The Town's action to move forward with the parcel tax prompted ATRA to propose legislation under HB2544, which was sponsored by Rep. Justin Olson. As introduced, HB2544 prohibited a city or town from imposing a tax based on the size or value of property outside of our existing property tax structure. Meanwhile, the Town of Paradise Valley proposed a strike-everything amendment in the Senate under SB1470. Sponsored by Senator Adam Driggs, SB1470 would have authorized a city or town to levy a property tax that would be designated specifically for fire, police and emergency medical services. Since both bills addressed the same issue, ATRA and representatives for the Town of Paradise Valley agreed to combine the measures into one bill, and once amended on the House floor, SB1470 encompassed both measures. SB1470 cleared the House on a vote of 44-17 but ultimately died in the Senate when leadership refused to Final Read the bill.

Expenditure Limits, *Continued from Page 5*

development. After accounting for all exclusions, Maricopa CCD's applicable expenditures were under the limit by \$1, so had Maricopa used a more realistic FTSE count, it would have been in violation of its expenditure limit. Pima, Mohave, and Yavapai also met their expenditure limits in FY 2012. Expenditure limit audits have not yet been submitted for Gila, Graham, and Pinal.

	FY 12 FTSE (from CCD)	Audited FY 12 FTSE	FY 12 EEC Expenditure Limit	Recalculated Expenditure Limit	Difference
Cochise	9,200	9,210	\$70,584,273	\$70,662,068	-\$77,795
Coconino	2,350	2,355	\$15,833,517	\$15,867,446	-\$33,929
Gila	1,350	790	\$7,961,284	\$4,658,896	\$3,302,388
Graham	3,550	3,433	\$26,176,636	\$25,314,298	\$862,338
Maricopa	92,850	83,024	\$492,299,679	\$440,207,960	\$52,091,719
Mohave	4,338	3,450	\$36,395,014	\$28,945,298	\$7,449,716
Navajo	2,500	2,070	\$16,251,916	\$13,456,791	\$2,795,125
Pima	26,600	22,028	\$125,892,320	\$104,255,569	\$21,636,751
Pinal	5,800	5,246	\$48,815,447	\$44,153,400	\$4,662,047
Santa Cruz	720	258	\$4,246,018	\$1,521,513	\$2,724,505
Yavapai	4,692	3,974	\$47,208,739	\$39,985,161	\$7,223,578
Yuma	5,613	5,636	\$48,954,882	\$49,156,228	-\$201,346
Total	159,563	141,474	\$940,619,725	\$838,184,627	\$102,435,098