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ARIZONA TAX RESEARCH ASSOCIATION

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2015 LEGISLATIVE UPDATE

Introduction

As of the second week of March, the First Regular Session of the 52nd Legislature is already nearing completion with the Legislature passing a budget transmitted to the Governor's office on March 9. This newsletter provides an update on the 2015 ATRA Legislative Program.

GOOD BILLS

SB1446/HB2590 TPT Reform; contractors (Lesko/Fann) The 2015 TPT contracting reform clean-up bill provides additional clarity regarding maintenance, repair, replacement, and alteration (MRRA) projects. More specifically, the legislation clarifies the thresholds in which an "alteration" project retains its treatment as an MRRA that is subject to tax on materials at retail rather than the prime contracting tax. The thresholds are established as follows: For residential property, the contractor will pay tax on materials at retail if the contract price for the work is 25% or less of the property's full cash value for property tax purposes. For commercial property, the contractor pays tax on materials at retail if all of the following are true: 1) the contract amount is $750,000 or less; 2) scope of the work directly relates to 40% or less of the existing square footage; and 3) scope of the work includes an expansion of existing square footage that is 10% or less of pre-existing square footage. Additionally, a provision was added to provide a 25% cushion for the performance of work that was reasonably believed to be an alteration project at the inception of the contract but exceeded the applicable thresholds for any reason would still qualify as an alteration project. The thresholds stated above only apply to "alteration" projects and do not apply to projects pertaining to maintenance, repair, and replacement since those contracts are wholly subject to tax on materials at retail.

To address concerns raised by the public works industry, this year's legislation maintains the pre-TPT reform treatment of roadway and other surface/subsurface projects that may include vertical construction. The change does not apply to state projects other than Arizona Department of Transportation projects and most special taxing districts. Additionally, the legislation includes a "safe harbor" provision and a retroactivity clause of January 1, 2015.

The legislation had widespread support among all stakeholders and as a result, easily passed both the House and Senate. SB1446 was signed by Governor Ducey as an emergency measure (Chapter 4).

HB2538 special districts; truth in taxation (Mitchell) HB2538 extends the truth-in-taxation (TNT) requirements that are currently required for the primary property tax levies of counties, community colleges, cities and towns to the operational levies of countywide special taxing districts, which include library districts, flood control, public health services, and jail districts. The TNT requirements apply only to the operational levies of the special taxing districts and are exclusive of the levies for voter-approved bonds.

The transparency requirements of TNT make taxpayers aware of tax increases in a timely manner and provide taxpayers with the opportunity to communicate with their elected officials.

HB2538 passed the House 37-23. The bill passed Senate Finance 3-2 on March 4 and awaits Senate Rules.

SB1066 Political subdivisions; financial audit reports (Pierce) Under current law, a local governmental entity is required to file its financial audit within four months after the close of the fiscal year. If extenuating circumstances exist, the entity may request a four-month extension from the Auditor General. Often however, the deadline for filing financial audits is not met, and in some cases, not for several years. As introduced, SB1066 would have prevented a local jurisdiction who failed to file its financial audit within 18 months after the close of the fiscal year from increasing its general fund budget in the subsequent year. As amended in the Senate, SB1066 extends the current four-month deadline (eight months with the four-month extension) to nine months. If a jurisdiction does not file its financial audit with the Auditor General's office on or before the adoption of the subsequent year's budget, a form as prescribed by the Auditor General must be submitted with the budget indicating that the financial audit has not been completed, with the option to provide a reason for the lack of filing. Additionally, SB1066 requires that the financial audits be posted on the entity's website within 7 days of filing, which must be retained on the website for at least 60 months.

SB1066 passed the Senate unanimously passed House County & Municipal Affairs 8-0.

HB2147 TPT; municipal tax; pole attachment (Olson) Provides a TPT exemption for leasing or renting space for utility pole attachment under the personal property rental classification. This legislation was the result of a previous court case that ruled billboards are considered tangible personal property rather than improvements to real property and any revenues from rental activities are subject to TPT under the personal property rental classification (*ADOR v. Arizona Outdoor*). The premise behind the court ruling is that billboards do not qualify as real property improvements because they are not permanently attached to the ground. However, a recent audit by the Department of Revenue of an electric co-op extended this decision to utility poles, indicating that charges for any third-party attachment to a utility pole are considered revenues from leasing personal property and therefore subject to TPT. However, utility pole attachment agreements are legally different from billboard rentals, and as a result, cannot be treated the same way. Unlike a traditional billboard lease in which an advertising company acquires an exclusive right to use the billboard for a period of time, joint pole usage agreements do not acquire the same property rights. The proposed legislation under HB2147 will reverse the improper application of the court's ruling and restore the proper treatment of joint pole usage agreements under TPT.

HB2147 passed the House 57-0 and passed Senate Finance on 2/25 with a 4-1 vote. HB2147 awaits Senate COW.

HB2442 community college expenditure limits; recalculation (Olson) Currently, community college districts submit an estimated student count to the Economics Estimates Commission (EEC) for the purposes of calculating the budget year expenditure limit. For a time there was oversight on this estimated student count via the State Board of Community Colleges which was disbanded in 2000 due to budget cuts. Historically the estimated student count has been over-estimated to build significant budget capacity. They are the only jurisdictions with such leeway in their constitutional expenditure limitation.

The underlying bill required the EEC to recalculate the expenditure limit and the Auditor General would audit the expenditure limits based on actual student count. As a concession to the community college districts, the

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sponsor removed this section. As amended, HB2442 provides oversight of estimated student counts by having the student count estimates presented and approved by the Joint Legislative Budget Committee prior to the EEC setting the expenditure limits for the upcoming fiscal year.

HB2442 was held in House COW. A Strike Everything amendment to create a study committee on this issue was added to HB2414 in Senate Education and passed on March 12; it awaits Senate Rules.

HB2613 political activity; public resources; limitation (Petersen) HB2613 limits the ability of local governments to run "district-focused" advertisements from the call of an election through the election day when the jurisdiction is seeking a tax-related issue. While explicit support of tax measures is well understood to be illegal, the ability of a district to expend any amount of funds towards the support of the measure implicitly is undefined.

The limitation applies to counties, cities, school districts, community college districts, and special districts. The prohibition does not include "routine communications" which is defined as "germane to the functions of the [jurisdiction] and that maintain the frequency, scope and distribution consistent with past practices or are necessary for public safety." The bill provides a simple test local governments and the county attorney's office can use to assess what advertising is legal during an election and what would qualify as improper use of public funds. It also serves to quickly dismiss unfounded accusations of electioneering on the part of local governments.

HB2613 passed the House 36-23 and awaits a committee hearing in the Senate.

SB1371 schools; desegregation; OCR; funding; phase-out (Lesko) Addressing the single largest loophole in Arizona school finance, SB1371 provides a five-year phase out of Office of Civil Rights (OCR) monies and a 10-year phase out of Desegregation monies for the 19 school districts currently using the authority. Designed as a short term remedy for school districts which had been accused of violating the civil rights of students, Deseg/OCR districts have spent $4 billion of property tax dollars since 1986 and will continue in perpetuity.

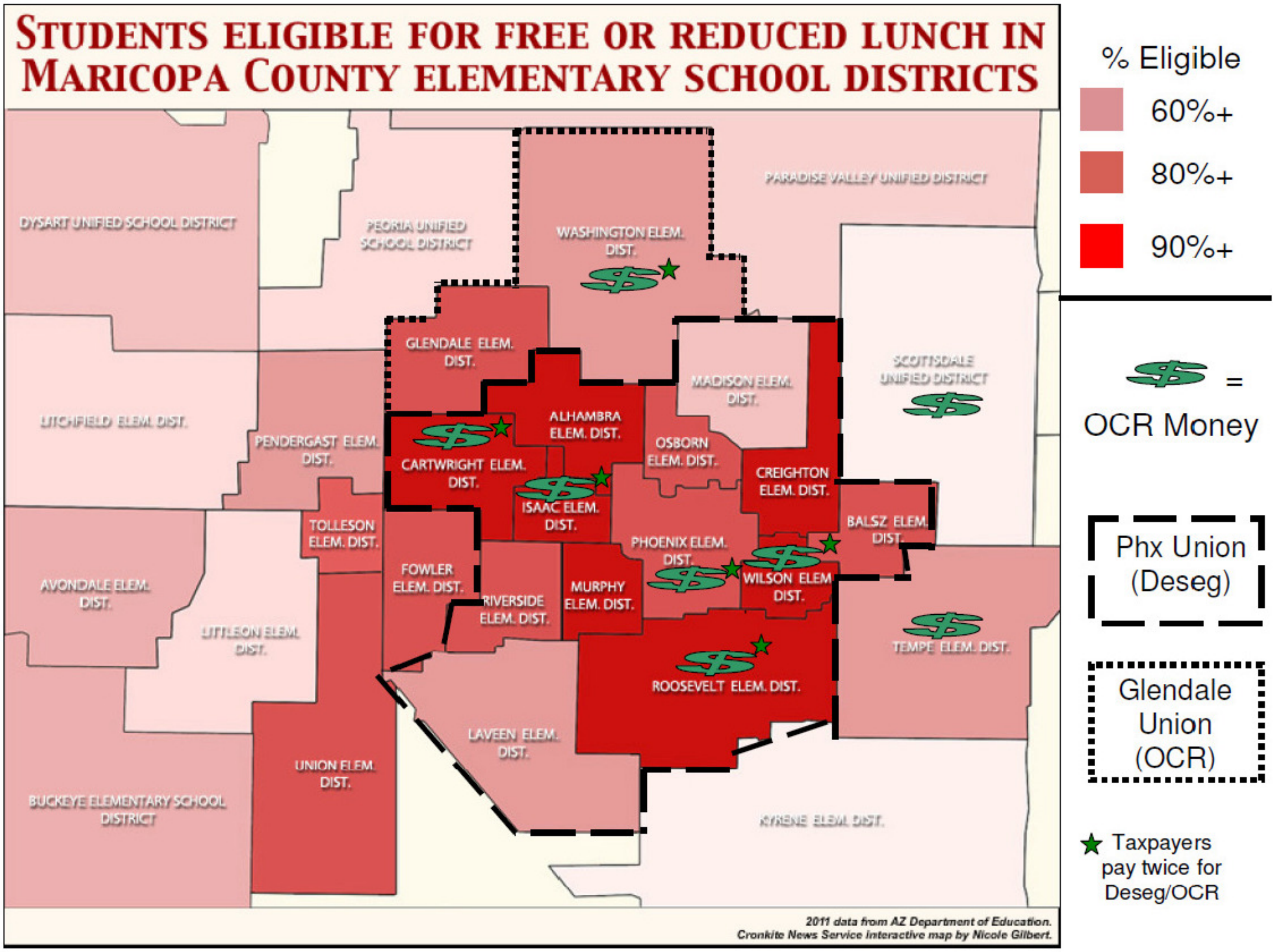
The money was capped in 2009 and exists as a $211 million budget bonus for the districts which accessed the authority. Only two districts ever received federal court orders to desegregate: Phoenix Union and Tucson Unified. Phoenix Union was declared unitary in 2005 but still levies their full amount annually at $56 million; money no neighboring district has access to. Tucson Unified was declared unitary but is back under court order after an appeal until it re-applies for unitary status. They continue to levy an extra $64 million annually despite their significant reduction in enrollment over the last several decades.

The rest of the districts involved only received a letter from the OCR alleging a civil rights violation. Dozens of districts have received OCR letters in the past but only 17 took advantage of the levy before the Legislature put a soft cap on the program in 2003.

These "short-term" remedies have endured for decades and exploded 2,100% over time, supplanting general fund budgets and giving recipient districts on average $760 more in per pupil funding. The levy is not "equalized" by the state, meaning the property tax is paid on top of the normal amount taxpayers pay for K-12 education. In some districts, both the elementary and high school districts have access, meaning taxpayers get hit twice for this punitive program.

Deseg/OCR levies are not subject to the scrutiny of voter approval and are not in any way tied to pupils, poverty, or demographics (see the map graphic on the next page). It is hardly fair that schools down the street from one another should have vastly different financial opportunities. It is an equity issue for schools who compete for teachers as well as well as a taxpayer fairness issue.

SB1371 passed Senate Finance (3-2), Senate Rules and awaits Senate COW.



HB2109 ballot; form; secondary property taxes (Petersen) There presently is considerable confusion as to how official ballot language should appear for general obligation (G.O.) bonds. In Title 35 (indebtedness) and Title 15 (school bonds), state law directs for bond elections: "where the principal and interest will be paid by a levy of property taxes, the ballot shall contain the phrase 'the issuance of these bonds will result in a property tax increase sufficient to pay the annual debt service on these bonds.'"

As clear as this might appear, G.O. bond election authors have interpreted this law to be met by including this phrase in the "full text insert" only, which accompanies the ballot in a separate, small booklet. This is because Title 16 gives the county elections officer the authority to write the question for the "official ballot." What a voter sees when they are voting is a question that simply asks if the voter will authorize a jurisdiction to sell a certain amount of bonds without any mention of the payment mechanism.

As it stands, legislators need to address the discrepancy between state law and the language as it appears on the ballot. The legislative intent is to make transparent to voters that a G.O. bond affects property taxes. This is an important distinction as there are other types of bonds which are not paid via secondary property taxes and the voters deserve to have that information made plainly clear.

HB2109 simply adds seven words to the end of these types of bond ballots: *"…to be repaid with secondary property taxes."* This meets the intent of state law, gives clarity to elections officers, and adds transparency for voters.

HB2109 passed the House (36-24), passed Senate Finance 3-2 on March 4, and awaits Senate COW.

Bad Bills

HB2253 Property tax assessments; one-year cycle (Mitchell) HB2253 is a proposal that is being aggressively advocated by the Maricopa County Assessor. Dubbed the "Single-year tax roll," the bill would reverse a major property tax reform passed in 1994 that properly aligned the property tax valuation and appeals calendar with the state and local government budgeting calendar. As proposed, the bill reduces the current calendar from 18 months to 7 months.

The current valuation and appeals calendar begins with valuation notices mailed by March 1st and concludes with the roll certified on December 20th of the same year. Those values are turned over to local governments for budgeting purposes beginning in January the following year. County assessors are required to complete and publish the important constitutional levy limits by February 10th. State government, along with counties, cities and towns, college districts, and school districts, are required to comply with various Truth- in-Taxation (TNT) laws prior to their budgets being finally adopted. TNT laws call for the use of the final equalized values of the jurisdiction for their calculations.

The proposed valuation and appeals calendar begins with valuation notices mailed on February 1st with the roll certified on August 15th. The bill proposes no changes to the state and local budgeting and tax calendar. As a result, of the valuation and appeals calendar would run simultaneous with the current budgeting and tax calendar. Unlike the current calendar where assessors have 11 months before they are required to publish the constitutional levy limits, the assessors' proposal would have just 10 days to produce those calculations. The use of preliminary values, before any valuation appeals or errors to the roll are made, versus the use of the "final equalized values" in the current calendar creates significant problems in both state and local government finance.

The significant reduction in the time allotted to taxpayers to pursue an appeal of their property valuation reduces their chance of receiving a fair administrative hearing. Moreover, the proposed calendar would make considerably worse Arizona's "pay-to-play" law where taxpayers are forced to pay taxes on the disputed value before they can pursue the case in tax court. Under the present appeals calendar, most tax cases can be settled before a taxpayer is required to pay taxes on the disputed value. Under the proposed calendar, a significantly higher number of tax cases will fall victim to the pay-to-play law.

HB2406 Fire District Tax ; Overrides (Stevens) HB2406 extends the current period of a temporary tax override for fire districts (FD) from five years to eight years. In addition the override would not be limited by the existing 5% levy limit. ATRA worked with the FDs a few years ago to draft legislation that would allow FDs to seek voter approval for the existing temporary five-year override that was limited to districts that experienced at least a 20% decline in property values over two consecutive years to exceed the $3.25 tax rate cap but remain subject to a 5% levy limit. Allowing FDs to utilize the override provision without regard to a reduced tax base and extending the override to 8 years, **without any limit to the annual levy,** is not the answer to the FDs problems.

Over the last 10 fiscal years, FD operating levies climbed $110 million or 86%. During the real estate boom between 2004 and 2009, many FDs rode soaring property values to record increases in levies by leaving the tax rate the same. In those five short years, FD levies more than doubled statewide. Following the peak in 2009 and through 2014, although property values fell 33%, FD levies dropped only 7.9% as a result of the FDs increasing their tax rates. In fact, the median tax rate of all the FDs increased 39%, from $2.00 in 2009 to a median rate of $2.79 in 2014. As a result, the number of FDs that have reached the statutory $3.25 rate cap has risen dramatically over the last couple of years.

Arizona has 156 FDs and the skyrocketing property tax rates for many of them demonstrates that they should be looking aggressively at options other than to simply continue increasing property tax rates. Clearly, the cost structures for some of these districts, particularly those that participate in the Public Safety Personnel Retirement System (PSPRS), are no longer sustainable with a small property tax base. Even city governments, with a variety of revenue sources, are struggling to cover PSPRS costs.

HB2406 was discussed and held in the House Ways & Means Committee. A rural FD study committee was amended to HB2162.

HB2562 school property; proceeds; limitations; removal (Norgaard) HB2562 removes all restrictions on the use of proceeds from the lease or sale of school property. Currently, state statute has a variety of limitations on the sale of school property and a few limitations on proceeds from leases. A school district cannot sell property and use the money for M&O. They can always put the proceeds of the sale of property towards paying off existing debt. Beyond that, there is a 50/50 test that is applied to what school districts may do. The Constitution allows split districts to acquire debt up to 15% of their assessed valuation or 30% for unified districts. If a district has LESS than 7%/14% of the districts current assessed value in debt, then they can lease property for more than one year for M&O: up to 10% of the revenue control limit (RCL) without voter approval, 15% with voter approval. They can use 100% towards capital outlay/school plant. If a district has MORE than 7%/14% of the districts current assessed value in debt, then they can lease property and use 25% of the money towards M&O (still not exceeding a 15% of the RCL) or lease and use 100% towards capital outlay and they can sell property and use up to 62% towards capital outlay.

The reason for the 50/50 test is to discourage highly indebted districts from selling property and not using at least some of the proceeds to pay off debt.

The basis for the present law takes into account *Students First* and litigation from the 1990s whereby the state now has nexus to adequacy standards in school district facilities. Using the sale of property towards M&O general fund budgets creates equity issues among districts and a chaotic financial setup using one-time funds for ongoing expenditures. The unintended consequences and potential abuses are endless.

HB2562 passed unanimously in the House and awaits Senate Education.