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ARIZONA TAX RESEARCH ASSOCIATION

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Adjacent Ways Reform Bearing Fruit

After shining a light on the Adjacent Ways expenditures by K-12 school districts, property tax levies dropped considerably from north of $60 million to just $23 million statewide in FY 2018.

The special assessment for Adjacent Ways was designed as an additional property tax levy for school districts to pay for capital projects in the public right-of-way, adjacent to their property which occur on occasion as the result of road expansions and other public improvements. Because there was no limit to the tax, there were several documented abuses of the fund.

In addition to being a source of abusive taxation, the fund is inequitable as it is easier for wealthier districts to access because the amount of levy would not require noticeable changes to tax rates. Districts with less taxable property could not afford these levies with the high rates they would incur.

In the late 1990's, the enabling section of law was clarified to limit the spending to its

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2018 ATRA Legislative Program Update

As the 2018 Legislative session heads towards the 80th day of session, much work remains with many important bills awaiting action as well as the FY 2019 state budget. ATRA has successfully advocated for passage of two ATRA bills in HB2115 (K-12, bond ballot language) and HB2185 (K-12 primary tax rate calculation) while two others near the finish line in HB2126 (GPLET CBDs, slum and blight) and SB1385 (TPT audits, administrative hearings).

GOOD BILLS

HB2479/SB1392 TPT; digital goods and services (Ugenti-Rita, D. Farnsworth)

Following a 2017 legislative study committee which found the

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Higley Unified Redux

ATRAs Complaint Resurfaces in Scottsdale Unified

Some three years after being found to have directed improper expenditures at Higley Unified, Superintendent Denise Birdwell is being terminated for cause by the Scottsdale Unified School District (SUSD) for related accusations which ATRA believes might also be illegal.

Listed among the accusations against Birdwell by the SUSD Board are the receipt of checks from Brian Robichaux, who at the time worked for architecture firm Hunt and Caraway (HCA), in undisclosed amounts in 2015 and $30,000 at least in 2016.

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original intent. However, due to a lack of oversight, abuses continued. Famously, Higley Unified expended over $6 million from their Adjacent Ways account on lease payments for two middle schools in 2014.

In 2016 ATRA led an effort in SB1117 to add oversight to the tax. A reform was crafted to require the state's School Facilities Board (SFB) validate accordance with the law for all expenditures in excess of $50,000 from the fund. In addition, the Adjacent Ways fund was added to the list of funds audited in district's annual financial audit.

SB1117 ensures a legal project exists before an expenditure occurs. Oversight from SFB has curtailed abuses of the Adjacent Ways levy with several proposed projects being denied by the SFB, although the vast majority have been approved as legal. This oversight has brought transparency to taxpayers and limited the desire of local governing boards to levy this tax and add monies to this fund.

Adjacent Ways expenditures peaked in 2009 when they reached $132 million, suggesting spending was closely related to the school construction boom. The significant reduction in the number of new district school sites over the past decade has certainly played a role in the decreased use of the fund.

One troubling trend discovered was architects packing as many costs into the Adjacent Ways fund as possible for new construction projects to maximize its usage while shielding the bond or capital fund. The curious result was a design where all roadways were labeled as fire lanes so those costs could be supplanted. Thus the total cost of construction as advertised in bond elections could be lower. In some examples, the Adjacent Ways fund was paying for roughly 10% of the projects total costs.

On a related note, tracking tax levies for these K-12 subaccounts statewide will be much easier going forward thanks to former Representative Justin Olson's 2016 law (HB2481), which among other reforms, will allow the Department of Revenue to annually break down the primary rate by account. Before that law change, ATRA would have to collect data county by county.

-Sean McCarthy

BIRDWELL, *Continued from Page 1*

HCA was the same firm used in the Higley scandal. The board also alleges the district issued two blanket purchase orders which comingled funds from the Adjacent Ways fund, which suggests illegal expenditures were made.

In July 2015, ATRA reported on roughly $8 million in illegal expenditures at the Higley Unified School District. The district had entered into a lease agreement for two middle schools where the district would pay up front fees plus $3.2 million per year (growing to $4.15 million in FY2017). Records show the district made those payments from their Adjacent Ways account at the direction of Superintendent Birdwell.

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The consultant selected by Higley to organize the financial agreement for the two leased middle schools was EFDS (Education Facilities Development Services). Their response to the Higley proposal encouraged the district to use a lease purchase model, writing their data "…suggests that a lease rate, with the incorporation of Adjacent Ways would be within your budget."

The two middle schools at Higley were procured using an alternative delivery model where the district selects vendors based on qualifications using a committee. The district selected EFDS without any knowledge of the final costs to lease the schools. In fact, it wasn't until months after the project was approved before the lease terms were agreed on.

The procurement timeline was suspiciously tight, which suggests the awarding companies had been determined in advance. The RFP was posted on June 20, 2012. Phase 1 selection was just 19 days later, when the superintendent-led "evaluation committee" reviewed four generic submissions describing the firms experience and qualifications. The following day they whittled the candidates from four to two. The next day the two selected groups presented their phase two proposal which supposedly required specific financial details and EFDS (Education Facilities Development Services) was selected as the winner with Core as the construction contractor and Hunt and Caraway as the design/architect firm. The following day was July 12, when the board approved the Lease Purchase.

The Higley matter was referred to the Arizona Attorney General's office in early 2016, where an investigation has continued and likely expanded given the issues at SUSD. The Legislature responded with SB1117 in 2016, discussed in the accompanying article in this newsletter.

-Sean McCarthy

LEGISLATIVE UPDATE, *Continued from Page 1*

state lacks statutory authority to tax digital goods and services, HB2479 and SB1392 were crafted to provide the state the legal authority to tax digital goods and exempt digital services. The bill puts into place nationally accepted definitions for software, digital goods and digital services. Software delivered by any means and digital goods transferred electronically are made subject to retail and use transaction privilege tax (TPT). Licensed software and digital goods are taxable if they are sold, rented or licensed for any period of time. Further, digital goods such as ebooks, movies, television shows and audio files are taxable if the user has the capacity to download content, meaning the user has the right to offline viewing or listening.

After moving through committees on each side and voting out of the House 39-19, the bill awaits a final vote in the Senate. Regrettably, The League of Cities and Towns produced a fiscal analysis which suggested the bill would result in a cut to state revenues of $118 million and $47 million to cities. The League admits their data includes digital goods like Netflix and Spotify, which the bill makes taxable. Curiously, the entire tax base for the rental of personal property, which is how the state has begun to tax certain digital products, is only $197 million, meaning the estimated $118 million hit is absurd. Moreover, the growth in this tax base has been just $40 million since the depths of the recession in 2010. Certainly not all of that growth could have been from digital services. Instead of asking for amendments to satisfy their concerns, the League has simply asked the Senate to kill the bill, leaving the state without tax laws in this area and taxpayers hung out to dry. *HB2479/SB1392 awaits final read in the Senate.*

HB2115 bonds; ballot language; procedures (Mitchell)

In 2015, the Legislature passed a bill to standardize the "ballot question" for all General Obligation (G.O.) bond election ballots. This reform was placed in Title 35, which provides election guidance for all G.O. bond questions. Prior to the standardization, there was considerable leeway in the crafting of the "ballot question" (the statement which occurs just before a voter indicates a "Yes/No" mark). While most elections since the change have occurred in accordance with the 2015 law, there remains some confusion due to a lack of harmony between Title 35 and school district laws in Title 15. Finally, the opportunity was taken to remove unnecessary language in Title 15. *HB2115 overwhelmingly passed the House and Senate and was signed by the Governor. Chapter 11.*

HB2126 government property; abatement; slum; blight (Leach)

Following the successful passage of HB2113 in 2017 which provided several reforms to the Government Property Lease Excise Tax (GPLET), it was resolved by stakeholders to readdress concerns about the justification for the use of abatement in the 2018 session. The crux of the 2018 issue was municipal slum and blight declarations which justify the tax abatement offered in GPLET. Following stakeholder meetings, it was agreed these declarations must be renewed every 10 years. Also, the size of central business districts were limited to the existing land area in 2017 or 2.5% of a city's area or 960 acres. Previously it was 5% or 640 acres. Also, a definition of geographically compact, a current legal demand of central business districts, was provided to prevent substantial gerrymandering going forward. *The bill passed the House unanimously and awaits a vote on the Senate floor.*

HB2185 school districts; tax levy; calculation (Norgaard)

In 2016, the Legislature passed bipartisan legislation to reform the calculation of the primary property tax rate for K-12 schools in HB2481. The bill improved transparency in the setting of tax rates so taxpayers would have greater ability to predict their tax liability while stabilizing rates. The inaugural implementation in FY2018 revealed a few technical issues which required legislative changes. A stakeholder group including ATRA, the County School Superintendents, and K-12 school district representatives crafted technical changes to ensure the implementation is effective and does not create unintended consequences. The bill also removed several sections of law in Title 15 deemed unnecessary with the reforms. *HB2185 passed unanimously and was signed by the Governor. Chapter 68.*

HB2280 universities; lease-back financing (Leach)

HB2280 limits the ability of public universities to use their tax-exempt status for economic development. Some public universities have been aggressively using their land, which is state land not subject to property tax, for the purposes of commercial development and harvesting the property tax that would otherwise be owed to the underlying jurisdictions for the benefit of the university and the developer. By keeping the deed in the hands of the university instead of the developer, who signs a long-term lease, the Improvement on a Possessory Right (IPR) tax is avoided. The developer or the lease-hold interests who pays for the rights to use the building pays an in-lieu fee which is far lower than the property tax. This abatement of tax is not imagined in state law and represents a problem for state policymakers. HB2280 clarified that universities may use their land for development but prospectively may not abate property taxes. It further created reforms in designated research parks to ensure they prospectively met their legislative intent of housing research associated with the university. *The bill passed House Ways and Means but lacked the votes on the House floor.*

HB2282 schools; transportation funding; calculation (Norgaard)

HB2282 proposes to cap the local property tax which pays for the difference between the state formula for K-12 district transportation and the hold harmless formula amount, known as the "Transpo Delta," at current levels. This local tax is in addition to normal K-12 taxes. The K-12 finance formula equalizes the cost of general fund budgets so property taxpayers and the state general fund share the burden. School districts are funded formulaically based on actual route miles driven for school and extracurricular activities. However, school districts may add an additional local property tax in order to spend at their historic high transportation budget. This currently costs taxpayers $79 million per year and has grown substantially in the last several years as school districts contract in size. It is a significant source of inequitable spending as older districts which have contracted more in size spend more per pupil than growing or younger districts as well as charter schools. *The bill was heard in House Education but did not receive a vote.*

SB1385 TPT appeals; confidentiality (Farnsworth D)

A recommendation from ATRA's Tax Policy Committee, SB1385 improves the efficiencies in the TPT appeals process. For years, taxpayers have been subjected to lengthy delays since they are currently required to appeal to the Office of Administrative Hearings (OAH) prior to appealing to the State Board of Tax Appeals (BOTA) or Tax Court. Particularly as it pertains to appeals that require a legal interpretation that may only be resolved in Tax Court, requiring taxpayers to exhaust the administrative appeals process can be very costly for both the taxpayer and DOR.

To remedy this situation, SB1385 allows TPT taxpayers that are issued a proposed deficiency assessment or the denial of a refund claim to skip OAH and appeal directly to BOTA or Tax Court. Upon the request of DOR, the bill was amended to include a "meet and confer" step prior to the taxpayer appealing beyond OAH to discuss any additional information that may assist DOR in resolving issues earlier in the process. If DOR does not schedule this meeting with the taxpayer within 45 days of the request, the taxpayer may then proceed to the next level.

Another important provision in the bill provides flexibility for DOR to exchange confidential information with taxpayers. Specifically, SB1385 provides a definition for the existing statutory term of "principal officer" in which DOR may disclose confidential information to include a chief executive officer, president, secretary, treasurer, vice president of tax, chief financial officer, chief operating officer or chief tax officer or any other corporate officer who has the authority to bind the taxpayer on matters related to state taxes. *Awaiting Senate COW.*

BAD BILLS

HB2456 Rio Nuevo TIF extension (Finchem)

In 1999, Tucson voters were asked to support the proposed Rio Nuevo Tax Increment Financing (TIF) District intended to fund a ten-year project at a cost of $320 million. Following a twenty-year extension granted by the Legislature in 2006, supporters of the District are asking for at least ten more. Through FY 2017 alone, over $152 million in state sales tax revenue has been redirected to Rio Nuevo. In fact, during the Great Recession when the state lost 40% of its revenue that resulted in spending cuts to K-12 and other important areas, Rio Nuevo still pulled down over $75 million.

Under current statute, the District had until January 1, 2009 to issue debt and the TIF sunset date is scheduled to be the earlier of July 1, 2025 or when the current outstanding debt of approximately $60 million is paid off. HB2456 extends the date in which the District may issue new debt to January 1, 2025 and extends the TIF sunset date to the later of July 1, 2035 or whenever all of the debt is paid off, which means the TIF could exist well beyond 2035.

The Rio Nuevo board has made arguments that the entity should be allowed to exist beyond 2025 and that can be accomplished without a continuation of the sales TIF. As it does now, the district could continue to abate taxes under the Government Property Lease Excise Tax (GPLET). A conservative estimate of how much more will be extracted from the state general fund and shifted to Rio Nuevo shows total revenues through the existing sunset date will reach $275 million. With a ten-year extension to the existing sunset date, revenues will reach a grand total of at least $460 million.

ATRA has long opposed sales TIF schemes that siphon revenue from the state general fund that are redirected to benefit local projects. More importantly, taxpayers in other communities around the state of Arizona, who are faced with funding their own projects, should not be asked to indirectly participate in the funding of these local projects. At a minimum, if the state desires to assist in the funding of local projects, it should do so through the appropriations process where projects compete for funding with all other requests for public funding. *HB2456 passed both houses and awaits action by the Governor.*

Class 6 Targeted Property Tax Relief

Two bills were introduced this session to provide targeted tax relief for specific classes of property. Under both proposals, property would be reclassified under class 6, which is assessed at only 5%.

SB1268 Senior Valuation Freeze Class 6 (Burges): Sponsored by Senator Burges, SB1268 would reclassify residential property that is currently classified under class 3 and assessed at 10% to class 6 at 5% for individuals that meet the age and income requirements under the "Senior Valuation Freeze." To qualify for the program, individuals must be at least 65 years of age and the total income from all sources cannot exceed 400% ($36,000 for individuals) or 500% ($45,000 for two or more individuals) of the social security income benefit. There is no valuation cap on the property, and once qualified, the taxable value of the property is frozen for three years with options for renewal.

ATRA has been consistent in its opposition to legislation that seeks to expand the inequitable tax treatment provided under Class 6. More importantly, classifying residential property based on a person's age and income provides inequitable treatment among similarly situated properties of others that do not meet those specific thresholds. The uniformity clause under Article 9, § 1 of the Arizona Constitution requires "all taxes shall be uniform on the same class of property." Although the Legislature has broad discretion in classifying property, the courts have held that the Legislature may not unfairly and unreasonably discriminate "between taxpayers of the same class, or be arbitrary, specious, or fanciful."

According to statistics produced by the Maricopa County Assessor's office, 13,000-plus parcels qualified for the senior valuation freeze in tax year 2018. However, although the income thresholds for this benefit appear to be low, the value of some of the properties that have qualified can be very high, and in a few cases exceed $1 million.

The Maricopa County Treasurer's office is the main advocate of this legislation and have resorted to telling legislators that somehow "thousands of seniors will lose their homes" if this bill doesn't pass. The Treasurer blames the Legislature's repeal of the Elderly Assistance Fund (EAF) in 2015 that only existed in Maricopa County. Ironically, the EAF was solely funded by assessing a 16% interest penalty on property owners that had delinquent property tax liability. ATRA supported the elimination of the EAF funding source since it was a punitive penalty on property owners that couldn't afford to pay their taxes in order to pay down the taxes of others. Although the funding mechanism was eliminated in 2015, the EAF maintains an ample fund balance to continue the current subsidy. *SB1268 currently awaits House Rules.*

SB1501 Biodiesel Class 6 Extension (Smith): SB1501 was a measure introduced by Senator Smith that would have extended the class 6 tax break another five years for property used to manufacture biodiesel fuel.

ATRA opposed this legislation when it was introduced in 2006. In its initial form, the bill would have authorized the tax break for biodiesel property indefinitely, however, the bill would later be amended to insert a ten-year sunset date. Although advocates for the bill struggled to get it across the finish line through the session, they were finally successful on sine die night that year. Not surprisingly, in 2013 when the law was amended to extend the sunset date another ten years to 2023, that vote was also taken on sine die night that year. The odds are good that many lawmakers likely didn't realize they were voting to provide a massive property tax break for this small industry on either occasion.

Although the current sunset date for this tax break doesn't expire until 2023, this industry was back advocating for another five years through 2028 with SB1501. ATRA testified in opposition to the bill in the Senate Finance Committee, and following discussion by committee members, the bill was held since it clearly did not have the votes to pass. It is obvious that the advocates for this incentive never intended for it to be temporary, as they initially advocated for in 2006, and they are likely to return for more.

Regrettably, the property tax classification system provides an ongoing temptation for policymakers to discriminate in allocating the property tax burden. Instead of creating greater disparities, ATRA has consistently encouraged policymakers to reduce disparities across the classification system.

SB1409 TPT; prime contracting; alteration; replacement (Fann)

SB1409 reverses the benefits created under the 2013 TPT Simplification Reform that moved certain contracts for the "alteration" and "replacement" of property out of the prime contracting classification to paying tax on materials at retail.

In 2013, then Governor Brewer's TPT Simplification Task Force adopted the aggressive recommendation to eliminate Arizona's unique and complicated prime contracting tax. That recommendation drew significant opposition from the cities as they viewed the change as a major loss in sales tax revenues since taxpayers would only be required to pay tax on materials under the retail classification rather than paying tax on 65% of the contract price under prime contracting. Consequently, the enacted version removed only those contracts for the maintenance and repair from the prime contracting class.

In 2015, clarifying language was enacted to provide that contracts for maintenance, repair, replacement or alteration (MRRA) activities within specified thresholds would not be taxable under the prime contracting classification. For residential alterations to qualify under the MRRA exclusion, the contract price would need to be 25% or less than the property's full cash value. For commercial property, the contract amount would need to be $750,000 or less, the scope of the work is 40% or less of the existing square footage, and an expansion of square footage could only be 10% or less than the existing square footage. A 25% "safe harbor" was included in the legislation to protect contractors who initially qualify under MRRA from getting pulled back into prime contracting as a result of a change order.

Although the creation of MRRA wasn't the ideal fix, it was a major step in preventing small contractors from unknowingly getting pulled into prime contracting while doing minor work such as HVAC equipment maintenance and repairs, as well as minor remodels. Alteration was an integral part of MRRA and, if removed, greatly increases the risk for small contractors now operating under MRRA. Any work that currently qualifies under the alteration exemption now pushes the job into prime contracting. Whatever progress was made for small contractors with MRRA will undoubtedly be undone if SB1409 is enacted. The bill removes all alteration contracts from MRRA and puts them back into prime contracting. Furthermore, the bill amends the definition of "replacement" contracts by prohibiting any expansion to the existing square footage from qualifying under MRRA.

Since the beginning of session, ATRA also has argued that the reversal of MRRA would result in a tax increase. Following the bill's passage out of the Senate, JLBC released its fiscal note on the bill. According to JLBC's estimates, state general fund revenues could increase by as much as $21 million in FY 2019, and up to $50 million in FY 2020. The advocates for SB1409 have consistently maintained they prefer simplicity over paying higher taxes since the additional liability can be passed onto the owners who hire them to do the work.

Since MRRA has been in place over the last few years, contractors have undoubtedly gone through a learning curve. Although it would be ideal for contractors and taxpayers if prime contracting were completely eliminated, state policymakers continue to struggle with the fiscal impacts. As such, Rep. Cobb introduced a bill this year under HB2416 that would appropriate $75,000 for a study to determine how much non-compliance exists under the prime contracting classification. This measure has received unanimous support among all stakeholders, including ATRA and others in the business community, the contractors, as well as the cities. If lawmakers are compelled to do something this year, they should consider expanding the contracts that qualify for MRRA rather than reverse the progress made through TPT Simplification. *SB1409 currently awaits House Rules.*