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ARIZONA TAX RESEARCH ASSOCIATION

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ATRA 2013 Legislative Program Moving

Sales Tax Reform Highlights Session Activity

ATRA's 2013 Legislative Program has experienced successful progress through the session's mid-point. To date, all of ATRA's legislative program is moving including the effort to support Governor Brewer's historic effort to reform Arizona's overly complicated state and local sales tax system. The following is a brief update on the most recent legislative action on ATRA's agenda:

TPT (Sales Tax) Reform (Lesko)

The months of work carried out by Governor Brewer's Transaction Privilege Tax Simplification Task Force resulted in legislation introduced by House Ways and Means Chair Rep. Debbie Lesko. That legislation (HB2657), which was supported by an overwhelming number of business organizations and companies burdened with the current system, cleared the Ways and Means committee on a unanimous 8-0 vote. Regrettably, progress on HB2657 slowed in the House as the bill languished in the House Appropriations Committee where the bill met stiff opposition from the committee chair Rep. John Kavanagh.

On March 20th, the updated version of the TPT Reform bill was put on HB2111 in the Senate Finance Committee in order to meet the deadline for a bill to be heard in a Senate committee. The measure cleared the committee on an impressive vote of 6-1. As passed by the Senate Finance Committee, HB2111 implements the following reforms:

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Rate increases drive down tobacco tax collections, drive up smuggling

Tax increases on tobacco products over the last decade have resulted in dramatic decreases in tobacco tax collections. These rate increases have been in the form of voter approved earmarks to early childhood programs and health care. While the rate increases were sold to voters as a way to decrease smoking, they also earmarked the new tax revenue to programs now experiencing dramatic reductions in revenue. The large reduction in taxable cigarette sales has reduced funds to every earmarked source of tobacco taxes, including the state general fund. The most recent increase, Proposition 203 in 2006, failed to hold harmless the existing recipients at the time of the vote. Revenue to the state general fund has dropped 37% since fiscal year (FY) 2006. Additionally, since FY 2008, when the Prop 203 tax increase went into effect for its first full fiscal year, total tobacco tax collections have dropped 22%. The state has also seen a substantial decrease of 28% in the total sale of cigarette stamps, which is the mechanism for imposing taxes on cigarettes. Some organizations believe the tax increase on tobacco is also increasing tobacco smuggling activities. A recent report by the Tax Foundation ranked Arizona second in the nation in 2011 in the percentage of cigarettes consumed that were presumed to be smuggled, up from seventh in 2006. The report concluded that more than half of all cigarettes consumed in Arizona were smuggled.

Background

In Arizona, cigarette distributors pay taxes by purchasing stamps from the Arizona Department of Revenue (DOR) for each pack of cigarettes. The most

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State Collection of Sales Taxes

The state Department of Revenue (DOR) would become the single entity responsible for the collection of state and local sales taxes. The Department currently collects sales taxes for the state, all fifteen counties, and 73 cities and towns. Those collections account for 82% percent of all state and local sales taxes. Currently there are 18 cities (referred to as *non-program*) that collect their own local sales tax. Beginning January 1, 2015, DOR will become the single point of contact for payment of all sales taxes for Arizona businesses. Businesses currently located in one or more of the 18 cities that collect their own sales tax will be relieved of the added compliance burdens of remitting their taxes to multiple jurisdictions.

Single Audit

The administration of Arizona's state and local sales tax audit program is even more cumbersome and chaotic than the collection program. Arizona businesses are subject to multiple audits from state government as well as city government. However, in addition to non-program cities conducting their own audits, many program cities also deploy their own auditors in their cities.

HB2111 would ensure that taxpayers be exposed to only a single audit conducted or authorized by DOR. Multijurisdictional taxpayers would only be audited by DOR. With approval from DOR, cities would be allowed to audit a single jurisdiction taxpayer with a DOR certified auditor. That audit would consist of both a state and local audit and the findings would be submitted to DOR for final approval. All appeals would be made to the state through the Office of Administrative Hearings.

Prime Contracting

The most significant changes that have occurred in the introduced version of HB2657 have been in the area of prime contracting reform. As originally introduced, HB2657 eliminated the Arizona prime contracting tax in favor of taxing construction materials at retail. In an effort to address concerns from cities regarding the potential for lost revenue, HB2111 allows cities to maintain their local prime contracting tax for residential and commercial construction. Residential and commercial construction contractors would no longer use exemption certificates when purchasing construction materials, and instead, these purchases would be taxable at retail at both the state and local level. In order to ensure cities can continue to collect taxes where the home or commercial construction occurs, they would be able to tax that sale in a manner similar to the current local tax.

In addition to the local city tax, the current prime contracting tax regime for public roads and highways is being maintained. Contractors building public highways and roads would continue to purchases materials exempt at retail and pay the existing state and local prime contracting taxes.

SB1169 Prop 117; conformity (Yarbrough)

Under Sen. Steve Yarbrough's leadership, SCR1025 was successfully referred to the 2012 ballot as Prop 117, which was overwhelmingly approved by the voters last November. SB1169, again sponsored by Senator Yarbrough, conforms the Arizona Revised Statutes with the provisions passed under Prop 117, which limits the taxation of property to one value, the limited property value (LPV), and caps the annual growth on the LPV to 5%, effective in tax year 2015. *The bill currently awaits final read in the Senate.*

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HB2347 tax levy; bond costs (Lesko)

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. *The bill currently awaits third read in the Senate.*

SB1470 dedicated property tax (Driggs)/HB2544 city parcel tax; prohibition (Olson)

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 prohibits 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 that authorizes a city or town to levy a property tax that is 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 will encompass the proposals under the two measures. *The bill currently awaits House Rules*.

HB2535 independent functional utility (Olson)

HB2535 is an attempt to reverse a recently proposed ruling by the Department of Revenue (DOR) that would change the longstanding treatment of machinery and equipment (M&E) under the prime contracting class. To provide a brief historical perspective on this issue, during the 1996 session, legislation was enacted to reverse the Court of Appeals decision in <u>*Brink Electric Construction Co. v. Arizona Department of Revenue*</u> that would have done immeasurable harm to economic development in Arizona regarding the treatment of the installation of exempt M&E that did not become permanently attached to real property. Despite an existing DOR regulation that required that the M&E become permanently attached, the Court of Appeals dismissed the permanent attachment test and concluded it was taxable contracting as long as the M&E remains "until the purpose to which the realty is devoted is accomplished." Left unchanged, Arizona would have been the only state in the country that exempted the purchase of M&E from the retail sales tax only to turn around and tax the installation costs of those items through the contracting tax. Although the 1996 legislation was intended to overturn *Brink*, DOR advanced a TPT ruling that reflected the holding of *Brink* by stating that simply bolting down exempt M&E into a concrete base is considered permanently attached and therefore subject to the TPT under the prime contracting class. ATRA and DOR worked together on the final proposed language under HB2535 that makes clear that the cost of the installation, assembly, repair or maintenance of exempt M&E is exempt under the prime contracting class if it has "independent functional utility," which means that it can function without attachment to real property and without regard to the size or useful life of the M&E. *The bill currently awaits Senate Rules.*

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common stamp is a blue stamp, which is $2 and includes all cigarette taxes. Four of the six components of the tax rate are voter approved tax increases. The $2 rate is broken down as follows: 18¢ is a general tax rate distributed to the Corrections Fund (2¢) and the state general fund (16¢); 40¢ is distributed to the Tobacco Tax and Health Care Fund, approved by voters in 1994; 60¢ is distributed to the Tobacco Products Tax Fund, approved in 2002; 80¢ goes to the Early Childhood Development and Health Fund and 2¢ goes to the Smoke-Free Arizona Fund, both approved in 2006. Distributions are made within the funds primarily for health care and education.

On tribal reservations, red and green stamps are sold. If a tribe has elected to impose a tax on cigarettes, up to $1, a tribal retailer purchases red stamps when selling to tribe and non-tribe members. For tribes not levying a cigarette tax, tribal retailers obtain green stamps, which are of no cost to retailers, when selling to tribe members. In FY 2012, red stamps accounted for 23% of all stamp sales and green stamps composed just 0.2%.

Declining Stamp Sales and Revenue

Revenue from the sale of cigarettes is raised by retailers purchasing stamps, which are sold in different denominations, ranging from $0 to $2. Since FY 2006, there has been a visible shift in stamp sales as reported by the DOR. After the passage of Prop 203, sales of blue stamps, which include all tobacco taxes, have been reduced by 39%. Conversely, red stamp sales on reservations, capped at $1, have risen 94%. Before the tax increase, blue stamps accounted for 91% of all stamps sold and red stamps made up 9%. Over the next six years, the makeup of blue stamps shrunk to 76% and red stamps grew to 23% of total stamp sales. The total number of stamps sold have fallen 28% since FY 2006, from 277 million to 200 million.

The decrease in stamp sales has led to a corresponding decrease in tobacco tax collections. The first fiscal year following the approval of Propositions 201 and 203 in 2006, which increased the tax rate on a pack of cigarettes from $1.18 to $2, marked peak tobacco tax revenue of $407 million. Since then, revenue collections have steadily dropped year after year. In FY 2012, the state collected $319 million, down 22% from the high water mark set in FY 2008. None of the components were immune to the recent drops in revenue as the sliding tobacco tax revenue has meant a hit to the state's budget. The only portion of the tax that reaches the general fund is a 16¢ distribution, approximately 8% of all collections, and 19% of that distribution is dedicated to State Aid to Education. Tobacco taxes distributed to the general fund are down 37% since 2006 which, in terms of dollars, is $12.6 million funneled away from the general fund. Equally as devastating has been the combined loss in the Tobacco Tax Health Care Fund and the Tobacco Products Tax Fund during the same time frame. Once accounting for 85% of tobacco tax collections, revenue distributed to these funds have plummeted 38% and now account for less than half of tobacco-related revenue. To put these losses into perspective, Prop 203 revenue has only dropped 21% since its peak collection year, which also happened to be its first full fiscal year in effect. Revenue generated by Prop 203 is the largest component of tobacco tax collections, raking in $129 million in FY 2012 or 41% of all collections.

Increased Smuggling

Some economists claim that high tobacco taxes are linked to increased cigarette smuggling activities. Smugglers typically bring discounted cigarettes from low tax states to sell in high tax states. Other forms of smuggling include the use of counterfeit stamps and counterfeit cigarettes, which smokers may order online, typically from overseas companies, without any tax obligation. In Arizona, the substantial increase in stamp sales on Indian reservations, where non-tribe members are able to purchase cigarettes at half the applicable tax rate off of the reservation, is evidence of smokers' desire to cut their exposure to taxes. A report released by

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the Tax Foundation ranked Arizona second of 47 states in percentage of cigarettes consumed that were smuggled at 54%. New York took the top spot at 61%. Alaska, Hawaii, North Carolina, and Washington, D.C. were not considered in the study due to insufficient data.

Smuggling Rank	State	2011 Tax	2011 % Smuggled	2006 % Smuggled	Rank Change	Rate Change
1	New York	$4.35	60.9%	35.8%	+4	190%
2	Arizona	$2.00	54.4%	32.1%	+5	69%
3	New Mexico	$1.66	53.0%	39.9%	-1	82%
4	Washington	$3.025	48.5%	38.2%	0	49%
5	Rhode Island	$3.46	39.8%	43.2%	-4	41%
6	Wisconsin	$2.52	36.4%	13.1%	+12	227%
7	California	$0.87	36.1%	34.6%	-1	0%
8	Texas	$1.41	33.8%	14.8%	+8	244%
9	Utah	$1.70	32.0%	12.9%	+11	145%
10	Michigan	$2.00	29.3%	31.0%	-1	0%

In 2006, 32% of Arizona's consumed cigarettes were estimated to be smuggled, putting the state seventh highest in the country. Since then, the state's tobacco tax rate has grown 69%, contributing to the state's growth in smuggled cigarettes. Surprisingly, the state's tax rate growth was only the 19th highest of 29 states to increase tax rates. The greatest tax rate increase was in Florida, which increased its rate 294% from $0.339 to $1.339. New York increased its rate 190% from $1.50 to $4.35. In terms of rankings, Iowa made the largest gain, moving up 18 spots to 15th after a 278% tax rate increase since 2006. New Jersey dropped 17 spots from 3rd after a modest 13% tax rate increase. Twenty-two states did not change tax rates and each of these states, with the exception of two, decreased their smuggling rankings.

As shown by the data, increases in smuggling rates are not only tied to tax rate increases in a particular state, but tax increases in surrounding states. Arizona, along with most of its neighbors, ranks in the top 10 states for smuggled cigarettes. New Mexico ranks 3rd, California is 7th, Utah is 9th, and Nevada, on the other hand, ranks 42nd. Arizona has the highest tax rate among its neighbors, followed by Utah ($1.70), New Mexico ($1.66), California ($0.87), and Nevada ($0.80). Of these states, Utah had the largest tax increase since 2006 of 145% resulting in a remarkable increase in ranking from 20th to 9th. Before the tax increase, only 13% of cigarettes consumed in Utah were smuggled, but after the tax rate increase, 32% of cigarettes were smuggled. Nevada has the lowest tax rate of states bordering Arizona and did not change its rate from 2006, dropping the state 13 spots in the ranking. In fact, the study suggests that 20% of its cigarettes are smuggled out of state, driving up smuggling rates in neighboring states. California's tax rate, though, is only seven cents higher at $0.87 and also did not increase its rate but ranks 7th nationally in the consumption of smuggled cigarettes at 35%.

Ben Nowicki

State	Tax Rate	% Smuggled 2011	% Smuggled 2006	Rank Change	Rate Increase	2011 Rank
Arizona	$2.00	54.4%	32.1%	+5	69%	2
California	$0.87	36.1%	34.6%	-1	0%	7
Nevada	$0.80	-20.0%	4.8%	-13	0%	42
New Mexico	$1.66	53.0%	39.9%	-1	82%	3
Utah	$1.70	32.0%	12.9%	+11	145%	9