TRANSACTION PRIVILEGE TAX SIMPLIFICATION TASK FORCE

FINAL REPORT

December 13, 2012

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INTRODUCTION AND PROCESS SUMMARY

In accordance with Governor Janice K. Brewer's Executive Order, the members of the Transaction Privilege Tax Simplification Task Force are proud to submit this report to the Speaker of the Arizona House of Representatives, the President of the Arizona State Senate, and to the Governor.

On May 11, 2012, Governor Janice K. Brewer issued Executive Order 2012-01 establishing the Transaction Privilege Tax Simplification Task Force. The Governor noted in the Executive Order that the need for such a Task Force was premised on three points:

- "Arizona has one of the most complex transaction privilege tax (TPT, commonly identified as the sales tax) systems in the country";
- "taxpayers have expressed very clearly their desire to see reforms enacted that will modernize and simplify the TPT"; and
- "it is in the interest of taxpayers and state and local governments to make the tax code easier to understand, comply with, and administer."

The Governor appointed tax and finance experts representing municipalities, businesses and the state to identify reforms that will simplify Arizona's sales tax code, reduce taxpayer frustration and improve compliance.

Specifically, Governor Brewer appointed the following nine individuals as voting members of the TPT Simplification Task Force (in alphabetical order):

- Steve Barela, State and Local Tax Manager, Arizona Public Service Company
- Tom Belshe, Deputy Director, Arizona League of Cities and Towns
- Lynne Herndon, City President, BBVA Compass
- Keely Hitt, Senior Tax Manager, Circle K Stores, Inc.
- Michael Hunter, Director of Legislative Affairs, Office of Governor Janice K. Brewer
- Kevin McCarthy, President, Arizona Tax Research Association
- John Olsen, Senior Tax Auditor with the Town of Gilbert
- Linda Stanfield, President, Benjamin Franklin Plumbing
- Miguel Teposte, Finance Supervisor – Tax, City of Phoenix

The Governor also appointed three non-voting advisory members to the Task Force:

- John McComish, member of the Arizona State Senate
- Rick Gray, member of the Arizona House of Representatives
- Vince Perez, Deputy Director, Arizona Department of Revenue

Michael Hunter was designated by the Governor to serve as chairman of the Task Force.

The Task Force met 17 times between July 23 and December 13. Five of these meetings were publically noticed as Task Force meetings and met in the Governor's Conference Room on the 2nd Floor of the Executive Tower. The other 12 meetings were structured as "working groups" to provide a forum where subject matter experts led stakeholders and the public in a focused and interactive forum for specified subsets of the Task Force's work. Working group meetings were conducted in a less formal manner and met in a large conference room at the Arizona League of Cities and Towns. Since these meetings were noticed as Task Force meetings – convened and adjourned by the Task Force chair – they were open to all Task Force members. Agendas, minutes, and all materials generated throughout the Task Force process were posted after each meeting on the Governor's website: http://azgovernor.gov/tpt/.

Three appointed subject matter experts each chaired four working group sessions and were charged with facilitating a public discussion in sufficient depth and detail in three primary areas of work. The three working group leaders and focus areas were:

- Patrick Irvine, Of Counsel at Fennemore Craig
  - Standardization of State and Local Tax Treatment and Practices
- Dennis Hoffman, Professor and Director of the L. William Seidman Research Institute at Arizona State University
  - Taxes on Online Retail and Remote Sales
- Craig McPike, Partner at Snell & Wilmer
  - State and Local Taxes on Contracting

The work of the Task Force also benefited greatly from the contributions from staff at the Department of Revenue, The Arizona League of Cities and Towns, County Supervisors Association, Arizona Tax Research Association, as well as several subject-matter experts representing various private and public sector stakeholders. Individuals who made notable contributions include:

Christie Comanita, Dept. of Revenue	Elaine Smith, Dept. of Revenue	Lee Grafstrom, City of Chandler
Lorna Romero, Governor's Office	Lindsay Scornavacco, Governor's Office	Duong Nguyen, Governor's Office
Chris McIsaac, Governor's Office	Barbara Dickerson, Deloitte Tax	John Arnold, Governor's Office
Mark Barnes, County Supervisors Assoc.	Michelle Ahlmer, Arizona Retailers Assoc.	Alan Maguire The Maguire Company
Jay Kaprosy, Veridus	Mike Kempner, Dept. of Revenue	Jennifer Stielow, Arizona Tax Research Assoc.
Gabe Soto, Ernst & Young	Candice Bartle, Ernst & Young	Jim Eads, Ryan
Stephen Kranz, Sutherland Asbill & Brennen	Jennifer Solis, Dept. of Revenue	Dan Court, Elliott D. Pollack & Company
Joe Rinzel Retail Industry Leaders Association	Tom Johnson Dept. of Revenue	

THE NEED FOR STANDARDIZATION IN ARIZONA'S STATE AND LOCAL TRANSACTION PRIVILEGE TAX

It is beyond the scope of this report to provide an exhaustive explanation of Arizona's TPT system, especially since such descriptive accounts are readily available elsewhere. However, it is worth beginning with a few fundamental definitions and statements of fact.

Forty-six states and the District of Columbia have a sales tax or similar tax on certain business transactions (New Hampshire, Oregon, Montana, and Delaware do not). Over 7,000 taxing jurisdictions impose sales and use taxes administered by the state except in Alabama, Colorado, Louisiana and Arizona.

Arizona's transaction privilege tax (TPT) is not a true sales tax. A sales tax is a tax on the retail sale of goods and services and is the legal obligation of purchasers or consumers. These taxes are collected by sellers as agents of the taxing authority. The tax is calculated as a percentage of the sales price.

By contrast, Arizona's TPT is a tax on the "privilege" of engaging in business in the state. The liability for the tax is on the seller/vendor, who may choose to pass the tax on to the purchaser. The tax is levied on the gross proceeds or gross income derived from the business.

Arizona's state and local governments have historically relied heavily on the TPT as a revenue source. Compared to the property or income tax, the TPT has generally been more popular at the ballot as a means to address specified revenue problems that are presented to voters. Successful passage of Proposition 301 in November of 2000 and Proposition 100 in May of 2010 are recent cases in point at the state level.

The state TPT is currently levied on 16 business classifications. Examples of state classifications include: retail, utilities, restaurants (and bars), prime contracting, transient lodging (hotel/motel), rental of personal property, telecommunications, and amusements. The retail classification makes up approximately 51 percent of total state TPT revenue, followed by restaurants and bars (11%), prime contracting (10%), and utilities (10%). The remaining 18 percent of the total is comprised of a combination of the other classifications.

State statute provides specific activities or transactions that a taxpayer (seller/vendor) may deduct from the gross proceeds of the sales or gross income in determining the tax base prior to calculating the tax. Each business classification has its own deductions and exemptions, which do not flow from one classification to another. In 1989 there were 45 deductions or exemptions under the retail classification. Currently, the retail classification includes 98 deductions or exemptions.

Arizona's use tax applies to the storage, use or consumption of tangible personal property and utility services in Arizona. It also applies to purchases from out-of-state vendors and to purchases for resale that are subsequently taken out of inventory for their own use. The use tax is measured by the purchase price and does not apply if the TPT or another state's sales or use tax has been paid on the purchase of the tangible personal property. If the other state's tax rate is lower than the Arizona use tax rate, the purchaser is required to pay the difference.

The use tax is imposed to create a level playing field for in-state businesses and to de-incentivize the purchase of tangible personal property from out-of-state businesses.

The Arizona Department of Revenue (ADOR) administers a TPT, use, and severance tax program on behalf of the state, counties, and 73 of Arizona's 91 cities and towns (called "program cities"). In FY 2012, of the $7.3 billion ADOR collected in TPT, severance and use tax, $1.1 billion was in local taxes on behalf of counties and program cities, of which $466.9 million was for local taxes for program cities.

There are 18 "non-program cities" ranging from the largest, Phoenix, to the smallest, Willcox. In FY 2011, nearly $1.6 billion in municipal taxes was collected by non-program cities, as reported to ADOR. The 18 non-program cities in alphabetical order are: Apache Junction, Avondale, Bullhead City, Chandler, Douglas, Flagstaff, Glendale, Mesa, Nogales, Peoria, Phoenix, Prescott, Scottsdale, Sedona, Somerton, Tempe, Tucson, and Willcox.

The disposition of the state's current 6.6% TPT rate also adds a layer of complexity to the system. Of that rate 0.6% is levied pursuant to Proposition 301, passed in November of 2000 and set to expire on June 30, 2021. Prop. 301 revenues are earmarked for K-12 schools, community colleges, and universities. Another temporary component of the current total rate is the 1% attributable to Proposition 100, passed by voters in May of 2010 and expiring May 31, 2013.

Of the 5% "base" TPT rate cities and counties receive TPT revenue sharing. For the retail and restaurants and bars classifications, 60% goes to the state general fund and the remaining 40% goes to the "Distribution Base Pool" as follows:

- 34.49% to the state general fund
- 38.08% to counties (based on population, secondary net assessed value, and point of sale)
- 2.43% additional to counties (based on population and point of sale)
- 25% to cities and towns (based on population)

Each classification contributes a statutorily specified share to the Distribution Base Pool. For example, prime contracting, utilities and communications contribute 20% to the Pool, while transient lodging contributes 50%. Use taxes make no contribution to the Pool at all.

In FY 2012, the Distribution Base Pool was $1.57 billion, of which counties received $636 million and municipalities received $392 million.

The multi-jurisdictional nature of Arizona's TPT system is the most significant reason why it is considered one of the most complicated in the country in terms of both taxpayer compliance and government enforcement and administration. Differences between the city codes and state statute, options and exceptions between cities, multiple points of contact and administration result in complexities that can best be summarized by the following points:

- Multiple licensing contacts
- Multiple tax returns
- Multiple state and local tax bases
- Multiple audits
- Varying state and MCTC interpretations

Model City Tax Code & State Statute

The Model City Tax Code (MCTC) was created in 1987 in response to the lack of uniformity between cities. The business community has long expressed frustration about the wide divergence in local TPT and the resulting difficulty in compliance, especially for multi-jurisdictional taxpayers who are paying tax not only to the state but also to two or more cities and towns throughout Arizona. The simultaneous, if contradictory, goals of the MCTC are to provide for greater uniformity between cities and towns while allowing them to maintain local choice. The "official master version" of the MCTC is maintained by ADOR and the Arizona League of Cities and Towns (the League) plays a significant role in the administration of the MCTC. Tax professionals representing major taxpayers are consulted through the Arizona Tax Research Association and the Arizona Chamber of Commerce and Industry. Proposed changes to the MCTC are reviewed by the Unified Audit Committee and approved by the Municipal Tax Code Commission. The code itself consists of standard language, referred to as "model" language, along with standard options that provide alternatives for a particular code section that any city or town can choose to incorporate in place of model language. Many of the options were created to exempt areas from tax rather than implement a tax, and some have become obsolete. The final piece of the MCTC is a collection of city-based exceptions that are commonly referred to as "green page" items. A green page item replaces the standard code language with alternative language that applies only to that specific city. Excessive options and green pages are at the core of the inconsistencies among the cities.

The most significant differences between city and state tax bases exist primarily in the following areas:

- Advertising
- Speculative Builder/Owner Builder
- Residential Rental
- Commercial Lease
- License for Use
- Food for Home Consumption

Definitional differences between the cities and the state exist in the following areas:

- City-based Nexus
- Jet Fuel
- Manufactured Buildings
- Hotel Tax
- Broker Category

The League and ADOR have made efforts outside of the working group meetings to eliminate green pages, reduce the number of options and conform language between the MCTC and state statute where possible. Thus far, 27 options have been identified for removal and 14 options have been identified to be incorporated into MCTC language – a total of 41 options. In addition, in an effort to bring more conformity between the MCTC and state statute, the League stated the following technical classification changes will be made:

- Separating *Food for Home Consumption* from *Retail*
- Splitting *Real Property Rental* into distinct classifications of *Residential Rental* and *Commercial Rental*
- Adopting *Pipeline* and *Transportation* classifications in place of the *Transporting for Hire* classification

A comparison between the tax systems in Arizona, Florida, and Louisiana is illustrative. Florida's system has a single point of contact and administration, a single audit and a single tax base. Louisiana has multiple points of contact and administration, coupled with an online portal, multiple audits and a single tax base. Arizona has multiple contact points, multiple audits and multiple state and local tax bases. It takes considerably more staff for a company doing business in multiple jurisdictions to file tax returns in the state of Arizona. For example, 50 returns each month are required for a company like Circle K due to the inability to file consolidated returns in some non-program cities.

Smaller Arizona businesses face similar costs of doing business in multiple jurisdictions but lack the resources of larger companies. This fact can be a deterrent to future growth and puts Arizona at a competitive disadvantage compared to states with uniform tax codes. State and city inconsistencies lead to companies making many reporting mistakes by either assuming the Arizona tax system is similar to the majority of states or by paying taxes in multiple states. Businesses may choose not to locate in Arizona because of its unusual tax burdens and, similarly, consumers may choose not to purchase from those Arizona companies.

The League and ADOR have made a concerted effort to eliminate individual city exceptions and reduce the list of standard options. While this effort had been gradually happening apart from the work of this Task Force, ADOR and the League attribute a renewed urgency and acceleration of their work toward the standardization effort to the Task Force. As more exceptions and options are consolidated and eliminated, the state will move toward having a single tax base. Nevertheless, the continued existence and functionality of the MCTC is evidence that the goal advocated by many multi-jurisdictional taxpayers of a single tax base shared by all jurisdictions remains elusive.

It is not known precisely how much uniformity between state and local tax bases will be required by federal legislation dealing with online retail and remote sales (see discussion below). Clearly, however, a high level of standardization will be necessary. In certain specified cases, uniformity will be exceedingly difficult. For example, city taxation of food for home consumption and commercial leases are two categories where the state does not impose a tax and is not likely to adopt measures to create a uniform base. However, creating a new category for food for home consumption in state statute would allow the state to have food for home consumption in its base but taxed at a zero rate, while cities may elect to impose a rate.

Online Portal

House Bill 2466, sponsored by Representative Rick Gray and signed into law by Governor Brewer on May 11, 2012 (Laws 2012, Ch. 332), required the establishment of an online portal for taxpayers to pay their TPT and excise tax liabilities. This law presents a great opportunity to simplify the licensing and remission of taxes through the use of an electronically centralized portal for Arizona taxpayers to remit to all appropriate jurisdictions.

The online portal, when fully implemented, will provide a single point of contact for Arizona taxpayers. The portal will allow multi-jurisdictional taxpayers to submit all necessary returns with one web-based form, thereby minimizing taxpayer confusion due to the current inconsistency between state and local tax bases and rates.

One example of a state that has used an online portal is Louisiana. There, taxpayers have a single login, a single data entry page and a single payment selection with the portal. The portal saves individual taxpayer profiles, a filing history and payment options. It provides the cities ready-made files to be sent to financial institutions for payment processing. It is worth noting

that implementation of an online portal will mask the lack of uniformity in Arizona's TPT system -- it will not resolve it. Taxpayers will likely find it easier to remit their taxes, but they will still be subject to many of the complexities associated with multiple tax authorities, especially involving audits.

Audits

In Arizona, ADOR has auditing authority for all program cities. Non-program cities, however, have separate auditing authority. A city can trigger a statewide audit, even the smallest. If a city chooses to audit a company that operates in multiple jurisdictions, a taxpayer may opt to have an audit involving all jurisdictions. ADOR has the authority and the city specific information to conduct a multi-jurisdictional audit without involving program city staff. ADOR explained to the working group that their auditors are often involved in multi-jurisdictional audits. The cities believe city auditors have local knowledge that is necessary when conducting a city tax audit; ADOR also has auditors with local knowledge.

THE STATUS OF TAXATION OF ONLINE AND OTHER REMOTE SALES

Arizona's tax code does not provide for any unique treatment of purchases that occur online. The amount of tax that is due on a purchase does not vary based on whether the transaction occurs in person, online, over the phone or through the mail. The question surrounding the taxation of online retail centers not on whether tax is due but on whether Arizona can require a seller to pay the tax that is due. Answering that question requires an understanding of the distinction between an *in-state sale* and a *remote sale*.

A purchase by a customer located in Arizona is considered an in-state sale if the seller receives the order at a location in Arizona. Examples of in-state sales include:

1. A customer purchases a product at a store located in Arizona.
2. A customer purchases a product at a store located in Arizona and the product is delivered to a location in Arizona.
3. A customer purchases a product online from a seller that has a physical location. The seller's physical location is in Arizona and the product is delivered to a location in Arizona.
4. A customer purchases a product online from a seller that has physical locations in multiple states, including Arizona. The seller receives the order from the customer at a business location in Arizona and the product is delivered to a location in Arizona.

A purchase by a customer located in Arizona is considered a remote sale if the seller does not have a physical presence in Arizona and receives the order at a business location outside Arizona, delivering the product to an Arizona location via common carrier. Examples of remote sales include:

1. A customer purchases a product online from a seller that has physical locations in multiple states, excluding Arizona. The seller receives the order from the customer at a business location outside Arizona and the product is delivered to a location in Arizona.
2. A customer purchases a product online from a seller that lacks the physical presence to establish nexus in Arizona and the product is delivered to a location in Arizona.

As a result of the 1992 U.S. Supreme Court decision in *Quill Corp. v North Dakota,* Arizona is prohibited from requiring a seller to remit TPT when the remote seller lacks sufficient physical presence to establish nexus in Arizona. Arizona can require a seller to remit TPT when sufficient physical presence exists. This means that if a customer located in Arizona purchases a product online from a seller that also has a physical presence in the state, that seller is required to remit TPT on that purchase. On the other hand, if the customer located in Arizona purchases the same product online from a seller that does not have a physical presence in the state, that seller is not required to remit TPT; however, use tax is due on that purchase.

While there is no requirement to remit TPT when the seller does not have nexus in Arizona, the transaction still creates a use tax liability for the individual or business who makes the purchase. Arizona's use tax rate is equal to the TPT rate and is owed by a consumer when a retailer does not have the liability to remit the TPT. However, the use tax is rarely collected from individuals because it relies on taxpayers to voluntarily report their purchases from remote sellers. Due to the lack of enforcement against use tax non-compliance, it is likely that many Arizona consumers are unaware that the use tax exists and remain under the impression that online remote sales are "tax free."

It is widely held that the shift in consumer behavior toward online shopping over the past decade has cost Arizona tax revenue, jobs, and local economic activity. Evidence of the shift is captured by U.S. Census data showing that nationally the share of retail sales occurring online grew from less than one percent in 2000 to around five percent today. While tax is remitted on many of these purchases because the online seller also has a physical presence in the state where the customer is located, tax is not remitted on many others because the seller does not have a physical presence in the state where the customer is located. From the perspective of the Arizona Retailers Association, the absence of a requirement on all remote sellers to remit tax creates a distortion that places retailers with a physical presence in Arizona at a competitive disadvantage. Elliott D. Pollack and Co. estimated that in 2009 this distortion reduced tax revenues by $273 million, reduced the number of jobs in Arizona by 5,066, and reduced total economic activity in Arizona by $771 million.

Various proposals aimed at requiring collection of sales tax by all remote sellers have been introduced at the federal level and in states across the country. There are three primary strategies being used to require tax collection by all remote sellers. At the state level, legislative proposals work within the constraints of the *Quill* decision and focus on creating a definition of nexus that captures the activities of many large online-only retailers. In Arizona, such legislation was introduced in both 2011 and 2012 but neither was passed out of the legislature.

Also at the state level, departments of revenue are interpreting nexus definitions more aggressively. The increased collection efforts have yielded settlements with large online-only retailers in a number of states. ADOR and Amazon.com recently resolved a dispute over TPT remittance between 2006 and 2010. As part of the resolution of this dispute, Amazon.com and its wholly owned retailers will begin remitting TPT beginning on February 1, 2013.[1]

Unlike the state legislative and enforcement efforts, the proposals at the federal level address the fundamental issue that was raised in the *Quill* decision: required collection of sales tax by remote sellers who do not have nexus in a state is unconstitutional. In the opinion, the court specifically noted that Congress could allow for such collection if the complexity of collection was sufficiently reduced. After 20 years of inaction on that invitation by the Supreme Court for

[1] Amazon.com, Inc., FY 12-Q3 Form 10-Q for the Period Ending September 30, 2012 (filed Oct. 26, 2012), p. 11.

Congress to act, there are currently three different proposals pending in Congress to allow states to require collection of sales tax on all remote sales.

The basic structure of all three proposals is to grant states the authority to require collection of sales tax on remote sales provided that they meet certain requirements related to simplification and standardization of the tax code. While there are differences among them, all three versions would force Arizona to make fundamental changes in the current TPT system in order to require remote sellers to remit tax. Some of the proposed requirements include:

- **Statewide administration.** ADOR would administer TPT on behalf of the state and all municipalities. Currently, 18 Arizona cities administer their own TPT.
- **Statewide tax base.** The state and all municipalities would adopt a common tax base. Currently, each city in Arizona that imposes a tax may have a unique tax base under the MCTC that varies from the state base.
- **Destination based sourcing for all remote sales.** For the purposes of municipal tax, all remote sales would be sourced to the purchaser's delivery location. Currently, a municipality only imposes local tax on remote sales if the seller has nexus in the municipality. In the near term, this change may shift local tax revenues from municipalities where remote sellers have nexus to municipalities where the purchaser takes delivery, regardless of whether the remote sellers have nexus in the municipality. However, if Congress enacts legislation that allows collection of tax on all remote sales, the overall amount of local tax remitted on remote sales would increase.

The timing of any Congressional action on this issue remains uncertain. However, the working group recognized that Arizona should begin the process of making the reforms necessary to position the state to avail itself of the authority granted by Congress regarding taxation of all remote sales.

Online Travel Companies

Fundamental tax controversies may emerge from business innovations in cyberspace. The tax treatment of hotel room sales that occur through an online travel company (OTC), such as Travelocity or Expedia, provide a case in point. When a customer purchases a room directly from the hotel, tax is imposed on the full amount paid by the customer to the hotel. In the case of purchases through travel intermediaries, including OTCs and travel agents, there have been disputes in other states over whether sales tax should be collected on the full amount paid by the customer to the OTC, including the portion of the payment that the OTC keeps, versus the portion of the payment that is paid by the OTC to the hotel. OTCs argue that the amount they retain is a fee for the service they provide to the customer and is therefore not taxable in states that do not tax services. The state TPT only applies to the operation of a hotel. OTC's do not operate the hotel; therefore, they are not subject to state TPT. The hotel is subject to state TPT on the amount it receives from the OTC.

The MCTC contains a broker provision that the State statute does not, which imposes the tax on any person that engages in a transaction on behalf of another. While municipalities in Arizona are attempting to impose TPT on the full amount, courts in states across the country are divided on this issue. Some states enacted legislation that has the effect of requiring collection of sales tax on the full amount charged to customers.

Cloud Computing & Digital Goods

A third topic that the working group considered was the tax treatment of cloud computing services and digital goods. Examples of digital goods include movies, songs, books and software that exist exclusively in a digital format. Cloud computing providers offer various combinations of digital goods and services including data processing, information service, hardware lease and rental, telecommunications services, and software. In many cases, these do not fit neatly into traditional sales tax categories which lead to questions regarding taxability, as well as questions related to the sourcing of those that are taxable.

Across the country, the taxability of digital goods and cloud computing varies. Some states tax digital goods, but the justification for levying the tax varies among those states. For example, Arizona considers digital goods tangible personal property, the sale of which is taxable. Other states have enacted legislation that creates a taxable category specific to digital goods.

Determining the taxability of cloud computing activities is even more challenging. For example, if an individual purchases a computer for the purpose of storing data, the computer is considered tangible property and therefore taxable. However, if the individual instead purchases storage space from a cloud computing provider, the taxability of that purchase is less clear. An additional level of complexity is introduced if the cloud computing provider is actually storing the data in a computer located in another state, which raises questions related to sourcing.

THE NEED TO REFORM STATE AND LOCAL TAXES ON CONTRACTING ACTIVITY

The tax on prime contracting is arguably the most complex, inefficient, and controversial area of Arizona's tax code. Unlike most other states, Arizona and its cities and towns do not impose TPT at the point of sale when a contractor purchases materials that are used in construction projects, repairs, and other contracting activities. Instead, the state and cities impose TPT on 65% of the amount the contractor charges the customer. From the perspective of the contractor, this causes complexity related to obtaining a TPT exemption certificate, determining whether an activity is taxable in a given jurisdiction, and calculating the correct amount of tax based on the activity performed, the location at which the activity was performed, and the value of any deductions.

For contractors that operate in multiple jurisdictions across Arizona, the lack of tax base uniformity creates complexity in determining whether an activity is taxable. For example, an activity may be taxable at the state level, taxable in Phoenix, but not taxable in Glendale. In service industries like plumbing, landscaping, HVAC repair, and others, it is often the front line employee that must calculate the correct amount of tax. When the employee is working in multiple cities, this requires an understanding of the tax code in each city. Even if there is uniformity in terms of how the tax code is written, jurisdictions differ in their interpretations and application of the code.

Excessive complexity in the statute and MCTC forces companies to dedicate resources toward tax compliance and away from the core operations of the business. For large businesses that employ teams of sophisticated accountants and lawyers, this may not be a major concern. However, for a small company with a core competence in plumbing or air conditioner repair, tax compliance can be an expensive nightmare. The system is equally inefficient for the jurisdictions that administer the TPT because excessive complexity increases the levels of taxpayer non-compliance and cost of administration, both intentional and unintentional. The result is less tax revenue for both the state and municipalities.

The challenges associated with fixing this complex and inefficient system make prime contracting reform a controversial issue. Two major points of contention that derailed previous attempts to reform prime contracting are revenue shifts among cities and among counties and potential revenue loss to the state general fund. Any credible proposal to transition to a materials-based tax must take these impacts into account.

The first major point of contention is that a transition to a materials-based tax will cause a shift in municipal and county tax revenues. Under the current system, tax applies at the location where the prime contracting activity occurs. Under a materials-based tax, the tax would apply at the location where the materials were purchased. All else being equal, this will shift the tax revenues to the municipalities and counties where the contracting suppliers are located.

Understandably, some municipalities and counties are reluctant to make this change if it could result in a significant reduction in the amount of revenue that they collect. Another concern was that the suppliers could move to a county island where they would not be required to pay city tax.

A transition to a materials-based tax, without other offsetting measures, may reduce the amount of tax revenue that flows into the state general fund. One of the reasons for the decline is that the formula used to share prime contracting revenues with cities and counties differs from the formula used to share revenues from retail sales. Specifically, 40% of the amount of tax generated by retail transactions is distributed to the cities and counties, whereas for prime contracting revenue, only 20% is distributed. Under a materials-based tax, purchases related to contracting activity would be taxed under the retail classification. This would shift more revenue into the distribution formula and cause a corresponding reduction in general fund revenue.

At the request of the Task Force, ADOR developed a model to estimate the impact on state collections and revenue sharing. The results of the model and key assumptions are presented below:

Key Assumptions

The model projected FY 2013 TPT collections and distributions under both the current system and a materials-based system. Only state taxes and state revenue sharing were part of the analysis. Local tax levies were not part of this analysis.

Cost of Materials

Under the current system, 65% of the value of the contracting activity is subject to TPT. This number evolved over time and is now codified. It was meant to be a crude estimate of the contractor's cost breakdown between materials and labor. The current number implies that materials account for 65% of a contractor's cost, while labor accounts for 35%. A previous study by Arthur Anderson estimated that the cost of materials was actually closer to 41%. For the purposes of the analysis, ADOR adopted the Anderson assumption of 41%. Both analyses acknowledged that materials cost varies by the type of contracting activity. This assumption has the effect of generally reducing TPT revenues because tax will now be remitted on 41%, the assumed cost of materials versus 65% of the value of the contracting activity.

Non-Compliance and Deductions

The complexity of the current structure breeds non-compliance and is evidenced by several factors:

- The disproportionate amount of controversy related to the contracting industry compared to the relative dollars collected;
- The fact that a 20+ page draft ruling from ADOR led to significant input from stakeholders;
- The differing tax laws applicable to any one contractor operating in more than one jurisdiction – a contractor currently operating in multiple jurisdictions must be licensed in multiple jurisdictions, must understand the varying tax laws of those jurisdictions, and must file separate returns for many jurisdictions;
- The lack of consistency for some audit issues between state and local jurisdictions even where the law is the same.

Non-compliance comes in many forms, and the extent of non-compliance is not certain. Many contractors do not understand how the tax works, especially in the "service" industry, but also some general contractors. Use of an exemption certificate for items that are not properly purchased tax-free is relatively low risk – it is easy to hide and audits are rare. Non-licensed contractors exist – these contractors are wholly outside the current contracting tax system, and it is unclear how many are avoiding tax on purchases of materials. Finally, there is a growing concern that the contracting tax system is being used for retail sales that do not involve the modification of real property.

Taxpayer non-compliance in the current system costs the state, cities, and counties millions of dollars in uncollected tax revenue. In a materials-based tax system, opportunities for contractors to either make mistakes or willingly avoid taxes are eliminated. Also, current deductions for the cost of land, pollution control equipment, development fees, and other contracting expenses will be eliminated. Both of these factors will mitigate any decreased revenue collection. The exact amount of revenue depends on the current amount of non-compliance and use of deductions that will be eliminated. Estimates of non-compliance range from around 20% to over 40%. After analyzing the assumptions that were used in each of those estimates, ADOR settled on an estimated non-compliance level of 31%.

Materials Subject to Use Tax

Under a materials-based system, purchases from out of state suppliers will now be subject to use tax. Under current law, this will have an impact on revenue distribution because use tax is not shared with cities and counties. However, for this analysis it is assumed that materials subject to use tax would be shared with the cities and counties in the same manner as retail transactions.

The Results

Scenario #1

	FY 12 Actuals	FY 13 Estimate	Materials Tax	$ Difference
Impact				
Distribution Base	$1,569,903,647	$1,639,053,245	$1,740,505,436	$101,452,192
Non Shared Revenue	$3,115,683,380	$3,248,823,225	$3,149,257,013	($99,566,213)
State Tax Liability	$4,685,587,027	$4,887,876,470	$4,889,762,449	$1,885,979
Education Tax	$542,394,529	$565,820,304	$566,046,621	$226,317
Combined State Tax	$5,227,981,556	$5,453,696,774	$5,455,809,070	$2,112,296
Distribution				
State General Fund	$3,657,481,449	$3,814,132,689	$3,749,557,338	($64,575,352)
County Revenue Sharing	$635,937,967	$663,980,469	$705,078,752	$41,098,283
City Revenue Sharing	$392,475,912	$409,763,311	$435,126,359	$25,363,048
State Tax	$4,685,895,378	$4,887,876,470	$4,889,762,449	$1,885,979

Assumptions

Materials Assumption	41%	Retail Dist. Base	40%
Non compliance assumption	31%	Materials Use DB	40%
Materials Subject to Use Tax	5%		
Retail taxable sales from sourcing	0%		

In scenario #1, the state transitions to a materials-based tax and makes no other changes to the tax code. Assuming a 41% cost of materials, 31% non-compliance, and a 5% use tax rate on materials purchased from out of state, the total amount of revenue collected increases by $2 million. However, the revenue shifts to the distribution base and away from the state general fund. The result is a $64 million reduction in state general fund revenues, a $41 million increase in county distributions, and a $25 million increase in city distributions.

Scenario #2

Impact				
	FY 12 Actuals	FY 13 Estimate	Materials Tax	$ Difference
Distribution Base	$1,569,903,647	$1,639,053,245	$1,780,823,966	$141,770,721
Non Shared Revenue	$3,115,683,380	$3,248,823,225	$3,209,734,807	($39,088,418)
State Tax Liability	$4,685,587,027	$4,887,876,470	$4,990,558,773	$102,682,303
Education Tax	$542,394,529	$565,820,304	$578,142,180	$12,321,876
Combined State Tax	$5,227,981,556	$5,453,696,774	$5,568,700,953	$115,004,179
Distribution				
State General Fund	$3,657,481,449	$3,814,132,689	$3,823,940,993	$9,808,303
County Revenue Sharing	$635,937,967	$663,980,469	$721,411,789	$57,431,319
City Revenue Sharing	$392,475,912	$409,763,311	$445,205,991	$35,442,680
State Tax	$4,685,895,378	$4,887,876,470	$4,990,558,773	$102,682,303
Assumptions				
Materials Assumption	41%		Retail Dist. Base	40%
Non compliance assumption	31%		Materials Use DB	40%
Materials Subject to Use Tax	5%			
Retail taxable sales from sourcing	4%			

In scenario #2, the model assumes that changing to destination based sourcing for all remote sales, as well as acknowledgement of additional revenues from remote sales that are currently taxable, will increase the size of the retail tax base by 4%. When combined with the shift to a materials-based tax, the result will generate positive revenue impacts at the state, city, and county levels.

TASK FORCE RECOMMENDATIONS

State and local governmental entities, in cooperation with taxpayers, should aggressively work to standardize the tax base, definitions, and interpretations of taxable transactions to the maximum extent possible.

- Standardize the administration of the TPT to benefit taxpayers and government by simplifying compliance and enforcement, including taxpayers' voluntary disclosure process.
- Reduce compliance costs for taxpayers and placing Arizona in a position to benefit from the potential federal legislation authorizing taxation of online and other remote sales.
- Eliminate all individual city exceptions from the MCTC by January 1, 2014.
- Reduce current MCTC options. At present, 27 options are identified for removal; 14 options are identified for incorporation into the standard MCTC language. The remainder will be renumbered into a more simple single series.
- Split residential and commercial rental and adopt pipeline and transportation classifications under the MCTC
- Change state statute to include food for home consumption (with a 0.0% rate)
- Consideration should be given to changing the county excise tax statutes to authorize a use tax component. Adding a use tax component to the county excise tax authority would further eliminate disparate tax treatment.

Any future proposed changes to the tax base by either the state or a municipality should be scrutinized and should not be enacted without a clear understanding of the potential impact of such a change on state and local standardization and budgets.

- Considerable efforts to standardize the tax base between the state statute and Arizona's cities and towns have occurred prior to this Task Force and indications are that they will continue after this Task Force process has ended. It is important that state and local governments not lose sight of the need for and benefits of continued progress toward simplification of the system.

State law should provide for statewide TPT administration.

- ADOR will administer TPT on behalf of the state, counties and all municipalities, taking into account the needs of various jurisdictions for detailed information and cash flow. This reform should be enacted by June 30, 2014 and be effective January 1, 2015.
- The League will oppose any such legislation. Cities and towns are concerned that ADOR lacks the necessary resources to administer TPT on behalf of all municipalities. The current tax returns and reporting capabilities need to be revamped to provide the detail required by the cities. Further, to the extent that state administration is deemed necessary to impose TPT on remote sales, it should be noted that testimony on the subject suggested that the online portal creating a single tax return and single point of licensing, coupled with the agreed changes to the retail classification may be sufficient for the state to participate in any potential revenues from the taxation of remote sales.

State, cities and towns should standardize TPT licensing.

- Such reforms will have the goal of establishing: 1) a single license fee per jurisdiction; 2) annual license renewal; 3) quarterly proration for the first year; 4) uniform temporary license provisions; and 5) consistent penalty waiver provisions.
- These reforms should be enacted by June 30, 2013 in order to be effective by January 1, 2014.
- A permanent license option should be maintained for now.

When fully implemented, the online portal required by HB 2466 should be expanded to have all licenses be issued and all TPT tax returns filed through the portal.

- The licensing process could be made simpler by expanding the functions of the online portal. Businesses currently must apply for a license with the state and with each non-program city in which they operate. A standard application would greatly simplify the licensing process for businesses. This effort would not be difficult because cities currently collect the same information for licensing. Currently, only a small percentage of businesses apply for a license online and the goal is to have 100% of businesses apply online. The non-program cities expressed concern with a standard application process because these cities currently impose annual renewal fees. These annual fees support at least in part ongoing operations.
- Legislation relating to the portal should take into account the needs of the cities and towns for detailed information. It should also be mindful of the expressed need for prompt cash flow to the municipalities.

State law should allow only a single audit, in accordance with existing statutory schedules, including a multi-jurisdictional audit if applicable.

- A majority of the Task Force maintains that it would be a vast improvement on our system if all audits were the responsibility of one statewide entity, ADOR. This would be contingent upon sufficient appropriations to fund an adequate number of ADOR staff auditors. If such a change were made, it would be important to ensure that ADOR cooperates with municipal tax managers to ensure specific audit needs, concerns, and reporting requirements necessary for local governance and decision-making.
- The current multi-jurisdictional audit process has been in place for more than ten years, offering every taxpayer the right to a single audit if they opt in. Very few taxpayers opt into a single audit. Over this period of time, ADOR has been performing multi-jurisdictional audits for all cities and towns, and the cities and towns have done the same for ADOR, increasing the number of taxpayers that are audited in any given year. Also, it should be noted that not only do the 18 non-program cities maintain an audit staff, but so do 26 program cities that have selected Supplemental Audit Authority. These cities maintain that their choice to do their own auditing is because ADOR does not have the resources and staff to adequately serve the cities and towns and address the smaller taxpayers that are generally the focus of local audits.

State and local governments and taxpayers should continue to monitor and provide feedback to Arizona's congressional delegation regarding federal legislation allowing state taxation of online retail and remote sales.

- At the time of this writing, as many as four legislative proposals are in play in the United States Congress. Each of these bills will require Arizona's TPT system to be significantly standardized and simplified.

The Arizona State Legislature should act to ensure Arizona is well-positioned to benefit from the taxation of online retail and remote sales by passing legislation clarifying that taxable transactions are sourced at the destination for both state and local taxes.

- Throughout the Task Force process, ADOR and the League have been drafting legislative language that would be the basis for such legislation. The legislation will also conform state and local treatment of two unnecessary state exemptions: 1) sales to nonresidents for use outside Arizona if the property is shipped or delivered outside the state and 2) tangible personal property shipped or delivered directly to a foreign country for use in that country.

Economic analysis of the impact of taxation on online retail and remote sales should be continued.

- Because this area of tax practice and law is relatively new and evolving rapidly, it is important to keep policymakers informed as they deliberate on appropriate responses to technological changes in retail and other economic activity.
- It is important that policy makers keep apprised of innovations associated with rapidly growing online consumer services, such as those associated with online travel companies.
- State and local governments and taxpayer organizations should consider engaging one or more of the numerous resources housed in Arizona's state universities, such as the L. William Seidman Research Institute, to continue this important analytical work.

The current tax structure for contracting activity is not desirable for many reasons, both practical and from a policy perspective; therefore state and local governments should act aggressively to transition from the current practice to a tax on materials at the point of sale.

- One of the most significant complicating features of the Arizona tax code is that Arizona is one of only a few states that do not tax materials for construction as retail at the point of sale. Instead, Arizona taxes prime contracting activities. Cities and towns use a similar, but separate speculative builder tax. The complexities associated with this practice have resulted in controversy, litigation, legislation, and frustration far disproportionate to the revenues generated.
- The use of exemption certificates and other practices result in numerous opportunities for non-compliance. The non-compliance factor is estimated to upwards of 30%.

- Taxing materials will result in some level of tax relief for contractors who have been compliant. However, there will be significantly less opportunity for tax avoidance. It would remove the administration of a key component of our tax revenues – those derived from contracting activity – from the backs of these skilled trades, allowing them to focus on what they do best, without significantly increasing the burden on existing vendors who are already required to be licensed and to report regularly.
- One of the biggest complications in an effort to reform this area of the tax code stems from the fact that only 20% of prime contracting taxes go into the Distribution Base Pool to be shared with cities and counties. By contrast 40% of tax revenues from retail become part of the revenue sharing base.
- This means that cities and counties would benefit from getting more money distributed to them, at the cost of the state general fund. Revenue sharing formulas can be adjusted to address this.
- Other tax reform options may also help state and local governments deal with any potential fiscal impacts on recipients of shared revenue. For example, counties do not currently have a use tax.
- There is a consensus among Task Force members on the reasonableness of the ADOR analysis and assumptions on state general fund and high-level revenue-sharing impacts. However, data currently available to the Task Force is insufficient to provide estimates on the impact for a county-by-county impact on the revenue-sharing distribution.
- Cities, towns and counties are extremely concerned about the shifting of local sales tax revenues, particularly away from the smaller rural political subdivisions to the larger urban political subdivisions. They are also concerned that this change in taxation will result in significant reductions in total city, town and county revenues by shifting the taxable measure from 65% of gross receipts to an unknown percentage, lower than the 41% assumption made in the ADOR analysis. Given the significant changes that this action will certainly cause, the cities, towns and counties expressed strongly that an independent study of all impacts, practices in neighboring states, and a more refined projection of revenue shifts should be undertaken prior to moving in this direction. In addition to the potential impact related to the collection of local county excise taxes, the counties are concerned with the secondary impact this proposal may have on the statutory formula that is used to distribute state shared transaction privilege taxes to the counties.
- The Task Force recognizes that there are questions about potential budgetary consequences at the local level that will not have been answered within the timeframe of the Task Force's work. Cities and towns, counties and taxpayers should move expeditiously in providing the data necessary for continued analysis. The level of analysis and empirical assurances requested by cities, towns, and counties is a laudable goal. It is noteworthy, however, that similar levels of analysis and assurances on the impacts to taxpaying households and business are rarely, if ever, requested by governments before making reforms they see as beneficial to public funds.

Notwithstanding the legitimate desire to have as much information as possible, a lack of perfect detail should not avert the state from aggressively pursuing the long overdue reform of this area of the tax code.