‘18 Forecast – Little Discretionary Flexibility

- The projected ’18 cash balance is $101 M, but the structural balance is only $24 M
- Numbers will shift by January, but expect general theme to be the same
- With $460 M Rainy Day Fund, projected cash reserve is $560 M
  - 5.8% of revenues; rating agencies recommend 8-10%
Revenue Forecast
### ’17 YTD Continues Slow ’16 Revenue Growth

<table>
<thead>
<tr>
<th></th>
<th>’16 Actual</th>
<th>’17 YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>2.9%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Individual Income</td>
<td>5.5%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Corporate Income</td>
<td>(13.9)%</td>
<td>(31.1)%</td>
</tr>
<tr>
<td>Insurance Premium</td>
<td>9.9%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Other</td>
<td>11.1%</td>
<td>37.3%</td>
</tr>
<tr>
<td>Overall</td>
<td>3.5%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

- Includes preliminary October estimates
- Revenues exclude fund transfers and urban revenue sharing
- Through October, year-to-date revenues $53 M above forecast
October Forecast vs. Enacted Budget
- Both Based on 65% Probability

*Excludes one-time revenues, tax law changes, and urban revenue sharing

** Enacted ’17 budget did not include a ’20 estimate
Will DOR Staffing Decision Reduce Revenues?  
- Forecast Has Not Been Adjusted

- DOR reduced its collection/audit staff from 332 FTEs in ’16 to 224 FTEs in ’17
- Revenue impact is unknown
- 78 FTEs and contracted collectors added in ’11 were budgeted to increase revenue by $53 M
- DOR says it is focusing on improving voluntary compliance
Insurance Taxes Surpassing Corporate Taxes
- AHCCCS-Related Premiums Built into Federal Reimbursement

![Graph showing the comparison between Insurance Taxes (IPT) and Corporate Income Taxes (CIT) from 2010 to 2020. The graph indicates that IPT (Non-AXS) and IPT (AXS) have consistently been higher than CIT over the years. The peak for IPT (Non-AXS) was in 2015, while IPT (AXS) saw its peak in 2014. CIT has shown a declining trend from 2010 to 2020.]}
## Adjustments Reduce Growth Rate to 2.0% in ’17

<table>
<thead>
<tr>
<th></th>
<th>’18</th>
<th>’19</th>
<th>’20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Base Revenue Growth (4.0%/4.4%/5.0%)</strong></td>
<td>401</td>
<td>455</td>
<td>534</td>
</tr>
<tr>
<td><strong>One-Time Fund Transfers</strong></td>
<td>(79)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Previously Enacted Tax Legislation</strong></td>
<td>(119)</td>
<td>(78)</td>
<td>(31)</td>
</tr>
<tr>
<td><strong>Urban Revenue Sharing</strong></td>
<td>(12)</td>
<td>(7)</td>
<td>(13)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>191</td>
<td>370</td>
<td>490</td>
</tr>
<tr>
<td><strong>% Change</strong></td>
<td>2.0%</td>
<td>3.8%</td>
<td>4.9%</td>
</tr>
</tbody>
</table>
### Current State of Tax Credit Policy

- ’16 Actual Credits Taken

<table>
<thead>
<tr>
<th>Credit</th>
<th>IIT</th>
<th>CIT</th>
<th>IPT</th>
</tr>
</thead>
<tbody>
<tr>
<td>School Tuition Organizations</td>
<td>99</td>
<td>30</td>
<td>26</td>
</tr>
<tr>
<td>Public School Extracurricular</td>
<td>46</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Research &amp; Development</td>
<td>12</td>
<td>97</td>
<td>0</td>
</tr>
<tr>
<td>Charitable Organizations</td>
<td>37</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Renewable Energy / Solar</td>
<td>5</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>New Employment</td>
<td>0</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Other</td>
<td>16</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>215</strong></td>
<td><strong>148</strong></td>
<td><strong>34</strong></td>
</tr>
</tbody>
</table>

*Excludes $148 M for IIT paid to other states and $32 M for Prop 301 credit*
Spending Forecast
‘17 – ’20 Baseline Spending Projections

- Baseline reflects changes to active statutory and other funding formulas - no discretionary additions

- Continues annual suspension of $493 M of inactive formulas (including $372 M for K-12)

- Continues $931 M in K-12 “rollover” payments

- Assumes spending classified as one-time or expiring in ’17 budget does not continue
## Projected Spending Changes
- $200 M In ’18 Statutory Spending Offset By Elimination Of 1-Times

<table>
<thead>
<tr>
<th></th>
<th>$ in M Above Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>’18</td>
</tr>
<tr>
<td>K-12 – Formula</td>
<td>110</td>
</tr>
<tr>
<td>K-12 – Expiring Statutory Provisions</td>
<td>(43)</td>
</tr>
<tr>
<td>AHCCCS</td>
<td>60</td>
</tr>
<tr>
<td>DES</td>
<td>22</td>
</tr>
<tr>
<td>Corrections</td>
<td>7</td>
</tr>
<tr>
<td>Universities</td>
<td>(15)</td>
</tr>
<tr>
<td>DCS</td>
<td>0</td>
</tr>
<tr>
<td>SFB</td>
<td>(1)</td>
</tr>
<tr>
<td>DPS – Border Task Force Equipment</td>
<td>(15)</td>
</tr>
<tr>
<td>Counties – Cost Sharing Offset</td>
<td>(8)</td>
</tr>
<tr>
<td>Capital – $8 M ADOA/$10 M Vets Home</td>
<td>(18)</td>
</tr>
<tr>
<td>Capital – ADOT Highway Projects</td>
<td>(87)</td>
</tr>
<tr>
<td>Other</td>
<td>(11)</td>
</tr>
<tr>
<td><strong>Total Spending Changes</strong></td>
<td><strong>1</strong></td>
</tr>
<tr>
<td><strong>Total Spending</strong></td>
<td>$9,639</td>
</tr>
<tr>
<td><strong>% Change</strong></td>
<td>0.0%</td>
</tr>
</tbody>
</table>
Cash and Structural Balance Forecast
### FY 2018 Baseline Projection

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Forward</td>
<td>$77</td>
</tr>
<tr>
<td>Ongoing Revenues</td>
<td>$9,663</td>
</tr>
<tr>
<td>Ongoing Spending</td>
<td>$(9,639)</td>
</tr>
<tr>
<td>Cash Balance</td>
<td>$101</td>
</tr>
</tbody>
</table>

$24 M Structural Balance

**’18 Cash Balance Exceeds Structural Balance**

- Excludes $460 M Rainy Day Fund Balance
General Fund Balance Improves Over Time, But…

Base Revenue | Cash Balance / One-Time | Ongoing Expenditures

Projected ending balances assumed to be allocated as part of the budget process.
Structural Balance Estimates Are Volatile
- Risks of Developing Budget Around ’19 or ’20 Estimates

- 1% variance in revenue estimates yields $625 M over 3 years
- Assumes no discretionary changes in next 3 years
- Lower revenues and higher spending reduced projected ’18 balance from $148 M to $24 M in 9 months.
Forecast Challenges

- Pending Litigation
- One-Time Funding (Or Not)
- New Initiatives
Pending Litigation

- Hospital assessment litigation – Potential $100 M - $250 M cost if plaintiffs are successful

- Rental car surcharge litigation – Potential cost of $150 M

- Possible litigation – State funding of K-12 building costs
### Is One-Time Spending Really One-Time?

- Numerous Spending Items Expire in ’17

<table>
<thead>
<tr>
<th>Item</th>
<th>$ in M</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADE Formula Spending</td>
<td>43</td>
</tr>
<tr>
<td>Local Assistance (HURF/DJC)</td>
<td>38</td>
</tr>
<tr>
<td>Universities</td>
<td>19</td>
</tr>
<tr>
<td>Department of Child Safety (’16)</td>
<td>23</td>
</tr>
</tbody>
</table>
## New Initiatives

<table>
<thead>
<tr>
<th>Initiative</th>
<th>$ in M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repeal / Replace Affordable Care Act</td>
<td>?</td>
</tr>
<tr>
<td>Prop 206 Minimum Wage Impacts</td>
<td>?</td>
</tr>
<tr>
<td>Full Day Kindergarten</td>
<td>240</td>
</tr>
<tr>
<td>Excludes construction costs</td>
<td></td>
</tr>
<tr>
<td>University Resident Student Formula</td>
<td>78</td>
</tr>
<tr>
<td>$234 M by Year 3</td>
<td></td>
</tr>
<tr>
<td>New Tax Reductions</td>
<td>?</td>
</tr>
</tbody>
</table>
National Look at State & Local Taxation Issues

ATRA’s 2016 Outlook Conference
Scottsdale Hilton Resort
November 18, 2016

Nikki E. Dobay
Council On State Taxation
(202) 484-5221
ndobay@cost.org
Agenda

- November 2016 Election: State Results
- Federal Tax Policies: Implications for State Taxes
- Pending Federal Legislation
- State Tax Reform
- U.S. Supreme Court Docket
- Sales Tax Development: Services and Digital Goods
November 2016
Election: State Results
# November 2016 Election Results: Key State Ballot Initiatives

<table>
<thead>
<tr>
<th>State</th>
<th>Initiative</th>
<th>Result</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>Issue 3 – State bonding authority cap removal and expanded local economic development bonding authority</td>
<td>PASSED</td>
<td>65% Y; 35% N</td>
</tr>
<tr>
<td>California</td>
<td>Prop. 55: Extend state’s special top individual income tax rate of 13.3% on income over $250,000 until 2030</td>
<td>PASSED</td>
<td>62% Y; 38% N</td>
</tr>
<tr>
<td>Colorado</td>
<td>Amd. 69 – Impose a 10% payroll and personal income tax on top of existing 4.63 flat rate to fund ColoradoCare (a new public option health care system)</td>
<td>FAILED</td>
<td>80% N; 20% Y</td>
</tr>
<tr>
<td>Louisiana</td>
<td>Amd. 3 – Eliminate corporate income tax deduction for federal taxes paid, triggering a 6.5% flat CIT rate</td>
<td>FAILED</td>
<td>56% N; 44% Y</td>
</tr>
<tr>
<td>Maine</td>
<td>Question 2 – Impose a 3% personal income tax rate on income over $200,000</td>
<td>PASSED (Likely)</td>
<td>50.5% Y; 49.5% N 96.5% reporting</td>
</tr>
<tr>
<td>Missouri</td>
<td>Amd. 4 – Amend constitution to ban new sales taxes on services</td>
<td>PASSED</td>
<td>57% Y; 43% N</td>
</tr>
</tbody>
</table>
## November 2016 Election Results: Key State Ballot Initiatives

<table>
<thead>
<tr>
<th>State</th>
<th>Initiative</th>
<th>Result</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nevada</td>
<td>Question 4 – Amend constitution to exempt durable medical equipment from sales tax</td>
<td>PASSED</td>
<td>72% Y; 28% N</td>
</tr>
<tr>
<td>New Jersey</td>
<td>Question 2 – Amend constitution to require gas tax revenue be deposited in Transportation Trust Fund</td>
<td>PASSED</td>
<td>54% Y; 46% N</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>State Question 779 – Additional 1% sales tax, earmarked for education funding</td>
<td>FAILED</td>
<td>59% N; 41% Y</td>
</tr>
<tr>
<td>Oregon</td>
<td>Measure 97 – Gross Receipts tax on C-Corp. income over $25 million</td>
<td>FAILED</td>
<td>59% N; 41% Y</td>
</tr>
<tr>
<td>WA</td>
<td>Initiative 732 – Impose carbon tax, offset by sales tax rate decrease</td>
<td>FAILED</td>
<td>58.5% N; 41.5% Y</td>
</tr>
<tr>
<td>Olympia, WA</td>
<td>Initiative 1 – impose 1.5% personal income tax on income over $200,000 (would be first income tax in Washington State, informing state income tax debate)</td>
<td>FAILED</td>
<td>55% N; 45% Y</td>
</tr>
</tbody>
</table>
### November 2016 Election Results: Soda Taxes Ballot Initiatives

<table>
<thead>
<tr>
<th>State</th>
<th>Result</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Francisco, CA</td>
<td>PASSED</td>
<td>62% Y; 38% N</td>
</tr>
<tr>
<td>Oakland, CA</td>
<td>PASSED</td>
<td>61% Y; 39% N</td>
</tr>
<tr>
<td>Albany, CA</td>
<td>PASSED</td>
<td>71% Y; 29% N</td>
</tr>
<tr>
<td>Boulder, CO</td>
<td>PASSED</td>
<td>26,890 Y; 22,617 N</td>
</tr>
<tr>
<td>Cook County, IL</td>
<td>TBD</td>
<td>(Board of Commissioners set to vote on 1 cent per ounce tax on Nov. 10; would join Philadelphia, PA and Berkeley, CA)</td>
</tr>
</tbody>
</table>
2016 Pre-Election Legislative Control

Source: National Conference of State Legislatures
2016 Post- Election Legislative Control
(as of November 9)

Source: National Conference of State Legislatures

* WA - Republicans will have functional control as one Democrat will caucus with the Republicans.
Federal Tax Policies: Implications for State Taxation
### Candidate Trump Tax Proposals

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate tax</td>
<td>15% corporate income tax rate</td>
</tr>
<tr>
<td>Small businesses</td>
<td>15% business income tax rate for pass-through entities that retain earnings. (Small business owners won’t face double taxation; large business owners will incur dividend taxes.)</td>
</tr>
</tbody>
</table>
| International       | - 10% repatriation rate on accumulated foreign earnings  
                         - Unclear if still wants repeal of deferral                                                                                           |
| Inversions          | Lower business taxes will “end job-killing corporate inversions”                                                                            |
| Cost recovery       | Expensing for manufacturers                                                                                                                |
| Interest expense    | Manufacturers who elect expensing lose deductibility of interest expense                                                                    |
| General             | Most expenditures eliminated, except for R&D Credit                                                                                         |
## House Tax Reform Task Force
### Blueprint: Highlights

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate tax rate</td>
<td>20%</td>
</tr>
<tr>
<td>Business income pass-through tax rate</td>
<td>25%</td>
</tr>
<tr>
<td>Taxation of future foreign earnings</td>
<td>Territorial, 100% exemption for dividends paid from foreign subsidiaries *</td>
</tr>
<tr>
<td>Taxation of accumulated foreign earnings</td>
<td>8.75% for cash/cash equivalents, 3.5% otherwise</td>
</tr>
<tr>
<td>Border adjustability</td>
<td>Exports exempt from tax/imports taxed</td>
</tr>
<tr>
<td>Cost recovery</td>
<td>100% expensing</td>
</tr>
<tr>
<td>Interest expense</td>
<td>Not deductible on a net basis</td>
</tr>
<tr>
<td>Corporate tax preferences</td>
<td>Generally eliminated, except for R&amp;D credit/LIFO</td>
</tr>
<tr>
<td>Individual tax rates</td>
<td>12%, 25%, 33%</td>
</tr>
<tr>
<td>Investment income</td>
<td>50% deduction, basic rates of 6%, 12.5%, and 16.5%</td>
</tr>
<tr>
<td>Individual deductions</td>
<td>Eliminated except for mortgage interest, charitable contributions/Std deduction increased</td>
</tr>
<tr>
<td>AMT/Estate tax</td>
<td>repealed</td>
</tr>
</tbody>
</table>
Major Drivers of US Corporate Tax Reform

- **Less competitive US system** means US resident companies may relocate to more favorable jurisdictions through inversions or become vulnerable to acquisition by foreign competitors
- Patent box regimes in other countries lure IP income and R&D jobs from the US, especially given **OECD BEPS** nexus requirement
- BEPS Project, European Commission State aid investigations demonstrate that other nations are concerned about where companies pay taxes
- **EU state aid** investigations are seen as targeting US multinational companies that are accumulating large amounts of tax-deferred income abroad
IRC Section 385 Regulations

- Released in October 2016
- The debt recharacterization regulations address related party debt
- Although generally issued to address international “inversions,” the IRS regulations would apply to all purported debt transactions between related corporations, even where there is no attempted inversion and where the debt is between two domestic corporations
- The regulations recharacterize certain related party-debt as equity, thus limit corporate interest deductions
- The regulations impose onerous documentation requirements to establish bona fide debt
IRC Section 385 Regulations

- Changes in the final regulations:
  - Short-term cash pooling exception
  - If lacking documentation, taxpayers can still qualify transactions for “debt” if they overcome a rebuttable presumption
  - No bifurcation of debt and equity by the taxpayer is allowed

- What will the impact be on the states?
  - Will the regulation apply to domestic debt/equity transactions otherwise eliminated for federal consolidated group purposes?
  - Potential state tax applications: “push down” debt; debt with entities not included in a state combined group; mergers & acquisitions-related debt; interest expense add back statutes
New Federal Partnership Audit Rules

- In 2015, a federal statute was passed that made significant changes to federal rules for auditing partnerships. The IRS has issued proposed regulations to address these issues.

- The new rules significantly alter how certain “large” partnerships are treated for federal tax purposes. The new general rule is that audits will be conducted at the partnership, not the partner, level and amounts will be assessed and collected at the partnership level.

- The Multistate Tax Commission, ABA, COST, TEI and other groups are developing a list of state level issues that will need to be addressed. These include:
  - Partnership-level audits
  - Apportionment
  - Composite returns
  - Withholding for non-resident partners
  - Federal changes
Flow Through Entity Taxation Compared with C Corporations

- In 1980, pass through businesses accounted for 20 percent of total business income in the U.S. In 2012, pass through entities accounted for about 60 percent of business income.

- According to a study by the National Bureau of Economic Research, the average federal income tax rate on pass through business income was 19% compared to the average federal income tax rate for C corporations of 31.8%.

- This shift is primarily due to the 1986 federal tax changes (more flexibility with S corporations); the rise of LLC’s and their tax treatment as flow throughs; and the double taxation of C Corporations and shareholder.
### Federal Tax Reform: Impact on the States

#### Federal
- CIT marginal rate change
- Base broadening to make proposal revenue neutral
- Reduced rate for repatriation
- Inversions
- Debt equity rule change
- Country by Country Reporting
- Corporate tax integration

#### States
- No impact/ states have own rates
- Significant revenue increase/ states link to federal deductions
- Minimal impact
- TBD
- Significant change in transactions eliminated for federal purposes
- Unclear if states will get access
- Significant potential change in taxes under both CIT and PIT
Pending Federal Legislation
Relief for Nonresident Employees

Mobile Workforce State Income Tax Simplification Act of 2015 (MWA)

- S. 386 introduced by Senator John Thune (R-SD) and Senator Sherrod Brown (D-OH), 52 Senate cosponsors
- H.R. 2315 introduced by Mike Bishop (R-MI) and Hank Johnson (D-GA)
- House Judiciary Committee passed H.R. 2315 by a 23-4 vote on June 17, 2015, full House approved by voice vote on Sept. 21 (181 House cosponsors)
  - Would create a bright-line 30-day threshold to determine nonresident income tax liability and employer withholding
  - Exceptions for entertainers, athletes & prominent public figures
  - 308 company and association coalition members
A Patchwork of Nonresident State Income Tax Withholding Laws

When is a nonresident employee subject to withholding?

**New York** is the most onerous. Requirements for employers & employees don’t match.

- **On the first day of travel within the state**
- **After reaching specific threshold** (see notes on mobileworkforcecoalition.org)
- **No general state income tax**
State Remote Seller Collection Authority

Since 2005, the following types of legislative bills have been introduced or proposed:

• Main Street Fairness Acts (MSFA)
• Marketplace Equity Act (MEA)
• Marketplace Fairness Act (MFA)
  • S. 698
  • Retail Transaction Parity Act (RTPA)
    • H.R. 2775
• No Registration without Representation Act (H.R. 5893)
  • Codifies *Quill* standard and repeals all other non-physical presence nexus provisions in all states
• Online Sales Tax Simplification Act (draft)

Green = Actual legislation introduced this session of Congress
Simplification of the Sales, Use or Similar Transaction Tax System – Streamlined State Status, January 1, 2014

- **Full Member States**
- **Advisory States – Not Conforming**
- **Project States – Not Advisory**
- **Associate Member States – Flex to Full**
- **Non-Participating States**
- **No Sales Tax states**

Map showing the status of states in the Streamlined Sales and Use Tax System.
State Tax Reform
2015 State Tax Reform: Why It Happened

- Puerto Rico – significant budget shortfalls, taxpayer non-compliance with the SUT system, need for a more stable revenue source
- Illinois and Pennsylvania – a tale of two states facing very similar issues
  - New governors with opposite party controlling the legislature
  - Severe budget shortfalls
  - Need to reform their tax codes and pension systems, fund education
- Nevada – a need to fund education led to the enactment of the new Commerce Tax
- Kansas – 2012 tax relief that exempted income from a pass-through entity from individual income tax is causing significant budget shortfalls; governor and both houses of the legislature at odds on how to fix
- Connecticut and Louisiana – both states faced significant budget shortfalls; tax increases enacted but was it enough?
2016 State Tax Reform: Where It Could Happen

- We will likely see Oregon consider repeal of corporate income tax and the enactment of an Ohio-style CAT following the defeat of Measure 97.
  - Rumblings of something similar in Connecticut.
- Louisiana’s new governor facing significant budget shortfalls due to decreasing oil revenues, insufficient revenues from tax changes during the 2015 regular session and two 2016 special sessions. Tax reform is likely in the future.
- Illinois and Pennsylvania on repeat…both states are still face budget shortfalls (still have not yet passed budgets) and need to fix their pension systems.
- Will continued under performing revenues and the need to adequately fund education cause Kansas to reconsider rolling-back some of the 2012 tax relief?
- Indian transfer pricing litigation led to combined reporting legislation, which was turned into study. Study released October 1, 2016, showing long term revenue impacts are mixed.
- Potential reform following the election—Kansas reform looking more likely and Kentucky Governor has called for tax reform
U.S. Supreme Court Docket
Crystal Ball for SCOTUS

State and local tax issues that may be reviewed by the Court:

- **Retroactive Legislation**
  - *DOT Foods* – Retroactive Washington B&O tax change
  - *IBM/Gillette* – Michigan’s retroactive elimination of MTC apportionment election

- **Discriminatory Laws/ Nexus**
  - *DMA* – Colorado’s notice and reporting regulation
  - South Dakota/Alabama – Direct challenge to *Quill*
  - Ohio – Factor Nexus – *Newegg, Crutchfield*, and *Mason Cos.*
The *Carlton* Two Part Test

- In *Carlton*, the U.S. Supreme Court established a two-part test to determine if retroactive tax legislation violates the Due Process Clause of the U.S. Constitution (*United States v. Carlton*, 512 U.S. 26 (1994)).
  
  - **First**, the Court looked to whether the legislation was enacted for a “legitimate legislative purpose furthered by rational means.”
  
  - **Second**, the Court looked to whether Congress “acted promptly and established only a modest period of retroactivity.”
  
- Petitioners from Washington (*Dot Foods*) and Michigan (the MTC Compact cases) are seeking certiorari at the U.S. Supreme Court on the constitutionality of retroactive tax legislation.
The Washington Dot Foods Case

- In 1983, the Washington Legislature enacted an exemption from B&O tax for certain out-of-state sellers from.
- In 1999, the DOR changed its interpretation of the provision.
- In 2010, the Washington Supreme Court ruled the taxpayer was entitled to the B&O exemption and that the DOR’s revised interpretation was contrary to the statute’s plain and unambiguous language.
- In 2010, shortly after the court decision, the Washington Legislature enacted legislation retroactively reinterpreting the 1983 statute to deny the exemption to the taxpayer (the retroactive period was limited to 4 years by the statute of limitations).
- In 2016, the Washington Supreme Court upheld the retroactive tax legislation as valid under the Carlton precedent.
The Michigan Multistate Tax Compact Cases

- In 2008 (effective date), the Michigan Legislature enacted legislation that allowed taxpayers under the MBT (Michigan Business Tax) to elect to use the Multistate Tax Compact’s three-factor apportionment formula.
- In 2011, the Michigan Legislature replaced the MBT with the Michigan Corporate Income Tax and provided that the Compact’s election no longer applied to the MBT retroactive to January 1, 2011.
- In 2014, the Michigan Supreme Court ruled that for tax years 2008 through 2010, the taxpayers were entitled to use the Compact’s election under the 2008 law.
- Shortly thereafter, in September 2014, after receiving a DOR revenue loss estimate of $1.1 billion, the Michigan Legislature repealed the Compact (and its election) retroactive to January 1, 2008.
- In 2015, the Michigan Appeals Court upheld the retroactive legislation as constitutional under the Due Process Clause (and Carlton precedent); and, the Michigan Supreme Court declined to review the case.
“DMA I”– Applicability of Tax Injunction Act


- Tax Injunction Act ("TIA") provides that federal district courts “shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State.” 28 USC § 1341.
- Colorado use tax reporting scheme not an assessment, levy, or collection of tax – so not barred by TIA.
- SCOTUS did not address Comity Doctrine (which counsels federal courts to refrain from interfering with fiscal operations of state governments) – which still creates hurdles to get to federal district courts.
- Justice Kennedy gives “unqualified” concurrence to majority opinion; however, he goes out of his way to say Quill needs to be reconsidered – it “now harms States to a degree far greater than could have been anticipated earlier.”
 DMA II – 10th Circuit Opinion on Remand

- On February 22, 2016, the 10th Circuit, decided “DMA II,” reversing the District Court and upholding the Colorado regulations. DMA’s petition for rehearing en banc was denied on April 1, 2016.
  - The Court concluded that Colorado’s remote seller reporting requirements do not discriminate against or unduly burden interstate commerce, even though the regulation only applies to remote sellers with no physical presence in Colorado.

- State Actions targeting Quill in 2016
  - 35 bills targeting remote sellers for nexus were introduced in 2016
  - En banc review denied, case has been appealed to the US Supreme Court.
States with Use Tax Notice Laws

- **Colorado** – *DIRECT MKTG. ASS’N v. HUBER*

- **Oklahoma** – Eff. 10/1/10, if over $100K sales, can give notice via website, no "extra" penalties – OK HB 2531 enacted this year also requires remote sellers provide annual notification by 2/1 of the following year to OK purchasers (still no penalty in the law) and no $ threshold

- **South Dakota** – Eff. 3/14/11, explicitly no penalties

- **Vermont** – Eff. 5/24/11, explicitly no penalties – recently modified by H. 873 (5/2016) which adds penalties and ties to DMA decision

- **2016 measures** – **Louisiana** H.B. 1121 enacted; Colorado-style notice and reporting (also click-through nexus and expanded affiliate nexus – H.B. 30)
Is *Quill* Dead? States are Frustrated

- **Alabama DOR Regulation** – The AL DOR promulgated a regulation asserting the DOR will now assert nexus against remote sellers that have over $250,000 in sales in the state using the state’s existing nexus law
  - *Newegg Inc. v. Ala. Dep’t of Revenue*
- **NCSL** – Several state legislators attending a task force meeting on state and local taxation indicated they were preparing to litigate for the Court to overturn *Quill*
- **South Dakota (S.B. 106)** – Tracks NCSL approach; bill includes language that “it is neither unusually difficult nor burdensome for remote sellers to collect and remit sales taxes associated with sales into South Dakota”
  - *South Dakota v. Wayfair et al.*
  - *ACMA & NetChoice v. Gerlach*
- **Vermont** (H. 873)
- **Tennessee** proposed economic nexus regulation for sales tax
Nexus – Factor Presence Statute Challenges


- Online sellers with no physical presence in Ohio, but over $500,000 in gross receipts found to be subject to CAT - BTA not authorized to address U.S. constitutional issues
- Ohio was the first state to pass the MTC’s factor nexus model legislation with its 2005 tax reform
- Cases have been consolidated and oral arguments held on May 3 – do applets and cookies on customers computer devices create nexus?
- At least nine other states have factor nexus provisions (AL, CA, CO, CT, MI, NY, OK, TN and WA)
Sales Tax Development: Services and Digital Goods
Legislative proposals and activities surrounding taxing services

**Bold indicates an enacted proposal**

**2013**
- **LA:** Broad-based services tax proposed
- **NE:** Broad-based service tax put on hold; study instead
- **MN:** Expanded sales tax to certain repair/maintenance, storage services, and digital goods
- **OH:** Broad-based service tax proposed; ultimately only certain digital products taxed
- Other states: MA; NC; ME

**2014**
- **DC:** Expanded sales tax to limited services ("yoga tax")
  - **KY:** Tax proposal included taxing certain services
  - **MN:** Repealed sales taxes on repair and warehousing services enacted in 2013
  - **VA:** HB 729- a comprehensive services tax bill did not advance

**2015**
- **CT:** Tax expanded to certain website and car wash services
  - **CA:** Bill proposed tax on all services (exempting only health and education)
  - **KY:** Bill introduced to tax specified services
  - **IN:** Bill introduced to tax numerous services
  - **OH:** Governor’s budget proposes taxing certain services
  - **ME:** Major tax reform proposal includes taxing services
  - **MO:** House Joint Resolution would propose constitutional amendment to replace current sales tax with a tax on specified retail sales and services
  - **NC:** Bill proposed to tax specified services (repair/maintenance, advertising, veterinary, etc.) **Tax expanded to certain repair and installation services**
  - **PA:** Governor’s budget proposed taxing services
  - **SC:** Fair tax legislation would impose tax on almost all property and services, would provide a family consumption allowance
Significant Base Expansion Enactments—2016 Proposals

- **Louisiana** – Limits sales tax exclusions and exemptions by applying varying rates (0% to 5%) for varying time periods (Act 25/Act 26)
  - April 1, 2016 – June 30, 2016
  - July 1, 2016 – June 30, 2018
  - July 1, 2018 – March 31, 2019

- **Pennsylvania** – Significant base expansion to digital products/software (Act 84)
  - Taxes digital downloads (including games, books, and apps) and video streaming
  - Provides that canned computer software is taxable tangible personal property
  - Provides that software maintenance, updates, and support for canned software is taxable
Significant Base Expansion Enactments—2016 Proposals cont.

- **California S.B. 8/S.B. 1445, Senator Hertzberg’s Proposal**
  - Would establish a “Retail Sales Tax on Services Fund” to collect and distribute the revenue raised by base expansion.
  - Concept bill to: “Broaden the tax base by imposing a modest sales tax on services. These changes would more fairly apportion taxes between goods and services and would produce more stable revenues. Local jurisdictions would not be authorized to increase sales tax on services, as they now can do with the sales tax on goods. Health care services, education services, child care, rent, interest, and services represented by very small businesses would be exempted from the sales tax on services…”
Sales Taxation of Business Inputs

State and Local Sales Taxes Imposed on Business Input Purchases

[Map showing state percentages for sales taxation of business inputs]
Challenges of Taxing Digital, Global Economy

- Where does consumption take place?
  - Issue for both income tax and consumption tax
  - Location is less identifiable
  - Particular problem with business to business sales
- “Reasonable approximation” sourcing
- Growth of the services and the continued pressure to expand the sales tax base
- Global trade agreements = move to a more global economy
- How do taxpayers comply with all the various taxing systems, different rules
- Use of advance technology to automatically provide data to governments
- Prevent fraud, leakage of information
Sales Tax on Cloud Computing/Digital Goods/SaaS

- **Classification of Goods**
  - Software
    - Method of Delivery
  - Information Services
  - Data Processing Services
  - Hosting Services
  - Lease of Tangible personal property

Taxable/non-taxable
Sales Tax on Cloud Computing/Digital Goods/SaaS

- **Sourcing**
  - By server location
  - By user location
  - By billing address or headquarters
  - State where purchaser “enjoys” the software regardless of where the seller or servers are located (CT, IN, MA, NY, TX, WA)
    - Location of the server is often default in these states
Sales Tax on Cloud Computing/Digital Goods/SaaS

- **Compliance Issues**
  - Customers may need detailed information regarding users or server location to determine their sales tax exposure
  - Automation of collection of sales and use tax for multiple user location
    - Are look throughs required?
Recent Developments in Digital Goods

- **Membership fees not taxable in Indiana** - Indiana Revenue Ruling ST 14-01 (10/30/2015, released 11/25/2015)

- **Streaming service taxable in Connecticut** - Ruling No. 2015-5, Connecticut Department of Revenue Services (11/3/2015)


- **Electronically delivered reports not taxable in Indiana** - Revenue Ruling No. 2013-07 ST (10/2/2015, released 10/28/2015)

- **Online marketing company considered a QHTC in DC** - District of Columbia Declaratory Order, DO 2015-2 (10/19/2015)

- **Streaming services not taxable in Kentucky** - *Netflix Inc. v. Fin. & Admin. Cabinet*, Order No. K-24900; Kentucky Board of Tax Appeals (9/23/2015)
Recent Developments in Digital Goods

- Electronically delivered photographs not taxable in South Carolina - Revenue Ruling No. 15-10, South Carolina Department of Revenue (8/3/2015)

- Alabama withdraws amendment taxing digital transmissions - Rule 810-6-5-.09, Leasing and Rental of Tangible Personal Property, effective 10/1/2015


- Chicago extends amusement tax to online amusements - Chicago Dept. of Revenue Amusement Tax Ruling No. 5 (6/9/2015)


Recent Developments in Digital Goods

- Access to video game digital products taxable in Tennessee - HB 644, enacted 5/20/2015; See also Important Notice No. 15-13, Tennessee Department of Revenue (6/1/2015)

- Domain name registration taxable in Washington - Tax Topics: Domain Name Registration Services, Washington Department of Revenue (5/7/2015)

- North Dakota to exempt internet access service - SB 2096, signed by Governor 4/1/2015

- Streaming services not taxable in Idaho - HB 209, signed by Governor on 3/30/2015; See also Temporary Rule 35.01.02.027, Idaho State Tax Commission, effective 6/10/2015

- Kansas issues guidance on sales of online gaming products - Private Letter Ruling No. P-2015-001, Kansas Department of Revenue (revised 3/25/2015)
Sales Tax on Sales as a Software (SaaS)

Taxable:
- WA
- ID
- AZ
- NM
- LA
- AL
- ME
- HI
- CT
- DE
- MA
- AK
- AR
- CO
- MD
- CA
- KS
- IL
- MI
- MN
- MO
- MT
- NC
- SC
- VA
- WV
- WY
- OK
- NY
- PA
- OR
- ND
- NV
- NH
- OH
- RI
- VT
- NJ
- TX
- UT
- SD
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- TN

Nontaxable:

No specific formal guidance:
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Sales Tax on Sales as a Digital Goods

Digital Goods Taxed by DOR, Position or Case Law

Digital Goods Non-Taxable

Digital Goods Taxed by Statute
QUESTIONS?
THANK YOU!
Government Property Lease Excise Tax (GPLET)

Kevin McCarthy
GPLET Definition

- Mechanism to tax private concerns on certain government properties
- Officially an “excise” tax that is based on the square footage & use of a building rather than property value
- Enacted in 1996 to replace tax on possessory interests that was repealed in 1995
- GPLET is levied on property that is owned by a city, town, county or county stadium district and leased to a private concern
GPLET - How did we get here?

- Early 80’s, cities began to aggressively use their tax exempt status to shield private development from property tax
- Legislature enacted a possessory interest tax in 1985 - a property tax on privately held improvements on government-owned property
- Newly created tax provided exemptions to existing deals created prior to April 1, 1985
- In 1993, Court struck down exemptions as unconstitutional in the Scottsdale Princess case

The taxpayer’s watchdog for over 75 years
GPLET Enacted in 1996

- The Legislature stated the purpose was to:
  - Be an excise tax, and not an *ad valorem* tax
  - Address the problems that existed with the possessory interest tax (i.e. exemptions)
  - Make whole the taxing jurisdictions that depended on revenues under the prior law
GPLET 1996 Structure

- Applied to cities, counties and county stadium districts
- Based on square footage & type of building - not its value
- Exemptions found unconstitutional under the possessory interest tax included as exemptions under GPLET
- GPLET collections distributed to taxing jurisdictions as follows:
  - Schools 73%, Counties 13%, Comm Colleges 7%, Cities 7%
- Maintained 8-year tax abatement in central business district
GPLET-Shortfalls of 1996 law

• Despite legislative intent GPLET fell well short of goals
• GPLET became an incentive not a hammer
• Huge tax advantage compared to possessory interest tax
• Rates reduced 20% every 10 years until reaching zero in the 50\textsuperscript{th} year
• By late 90’s, dramatic expansion of GPLET got attention of policymakers
• Citizens Finance Review Commission recommends significant reforms:
  – Expand to all government jurisdictions
  – After abatement property should pay tax commensurate with the property tax in the area
Where are we now? 2010 GPLET Reforms:

- Maximum lease 25 years, including 8-year abatement
- Rates nearly doubled but still lower than property taxes
- Rates adjusted annually by new construction inflation index
- CBD defined-single & contiguous geographical area within slum/blight, no larger than > of 5% of total land area or 640 acres
- City required to notify all taxing entities 60 days prior to approval, provide economic fiscal benefit analysis 30 days prior
- GPLET lease filed with County Recorder, Treasurer, and DOR
AG 2015 Audit Revealed Major Flaws

• 2010 revisions have not resulted in increased revenue as expected
  – Nearly half of 268 leases are under 8-yr abatement
  – 45% paying GPLET under old rate structure/only 6% pay new rates
• Many cases in which GPLET incorrectly calculated
• GPLET distributions to jurisdictions done incorrectly
• Only 3 of 7 counties with GPLET reported GPLET values to ADE
• County Treasurers failed to assess penalties and interest on delinquent GPLET payments-loss of revenue to counties
• Overall, governmental entities indicated a general lack of understanding of GPLET requirements
• Success of tax abatement in promoting redevelopment unknown
Why is this so important?

- Central planners picking winners & losers
- GPLET increases state aid payments to school districts – impacting all taxpayers statewide
- Higher property tax rates on other properties
- Increased 1% Cap costs for state GF
Cities picking winners & Losers

- There is no clear criteria for who receives a GPLET and who is denied
- Path dependency leads to more GPLETS
- Similarly situated businesses put on dramatically uneven playing fields
- Central planners – not the free market – decide which developments succeed and fail
Multifamily Housing Roosevelt Row

Portland @ Park Condos
New Taxpayer

Post Roosevelt Square
GPLET through 2061

Union @ Roosevelt
GPLET - Abated

Stewart –
Circles Bldg
Planned
GPLET

The Derby Apts
GPLET - Abated

The Met Apts
2016: $193k

St. Croix Villas
2016: $42k

Prox 333 Apts
New Taxpayer

Artisan Homes
2016: $96k

Alliance Apts
New Taxpayer

En Hance
Condos
New Taxpayer

Skyline Lofts
GPLET- Abated 2017

Native American
Connections
2016: $18k

Townhomes on 3rd
McKinley Row
Embassy Condos
All Taxpayers

Property Taxpayers & estimated 2016 property tax
State aid to schools

• State aid to school districts varies depending on district property values

• GPLET/Tax abatement increases state aid payments to school – exporting that burden to other jurisdictions
Higher property tax rates

• Loss of property value on tax roll leads to higher tax rates for schools, counties, community colleges and cities

• Total tax rate for Phoenix Elementary/Phoenix Union/City of Phoenix has climbed from $14.41 to $18.52 in 10 years – a 29% increase
Increases 1% cap costs to GF

- The rate to be a 1% cap district in 2016 is $11.96
  - Roosevelt El/Phx Union: $12.2679
  - Phoenix El/Phx Union: $12.1485
  - Isaac El/Phx Union: $14.2839
  - Wilson El/Phx Union: $12.3364
  - Cartwright El/Phx Union: $12.2091
State Farm on ABOR property
Where Should We Go?  More Reforms Needed

- Prospectively require all GPLET’s to pay K12 school taxes during abatement period
- Repeal 2010 Grandfathering provision – all new GPLET’s fall under 2010 rates
- Add all state & local governments to the Lessor Definition
- Government lessor calculates GPLET tax – not lessee
Deseg/OCR Update

Sean McCarthy
Deseg: Brief Intro

• $4.5 billion levied for Deseg/OCR since 1986
  – 18 School Districts
  – More than half to Phoenix Union & Tucson Unified
  – 97% goes to metro Phoenix & Tucson schools
• $211 million levied annually via primary property taxes
• Not equalized by state; outside RCL
• Capped in 2009, not tied to pupils or inflation
• Not voter approved; no planned phase out

Highlighted as the most problematic inequity issue for K-12 finance
Deseg: The Good News

- Debate has shifted
  - Nearly all stipulate that Deseg/OCR has run its course
  - District reps no longer misleading on legal implications
- Focus is how and when to phase it out
  - Districts asking for new, targeted funding
  - Hold harmless phase out
  - ELL & poverty weights
- Bad news: no real progress; taxpayers suffer
2017 Deseg Bill Concepts

• TNT hearings required for FY18, FY19
  – Transparency to district; explain Deseg/OCR levy
  – Standard TNT reporting & board hearing requirements

• Voter approval for all Deseg/OCR levies, 5 yr renewal
  – Beginning with the FY20 levy (Nov ‘18 election)
  – Shifts Deseg/OCR levies to secondary property tax
  – Alleviates 1% cap issue

• New cap: lesser of current cap or an override
  – 15% of RCL, same as M&O override: improves equity
  – 6 of 19 districts would phase out delta over 5 yrs
Prop 117

• Stabilize Arizona’s Property Tax System
  – Greater predictability for government & taxpayers

• End the roller-coaster
  – Insulate taxpayers from dramatic swings in tax bills
due to major fluctuations in R.E. market

• Simplify Property Tax System
  – From dual to single valuation taxation-5% limit
## 10-Year Property Values

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>FCV</th>
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<tbody>
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<td>2007</td>
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The taxpayer’s watchdog for over 75 years
10-Year Property Tax Levies

Property Tax Levies (2006-2016)

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Tax Collections (In Billions)

The taxpayer’s watchdog for over 75 years
Statewide Average Tax Rates

The taxpayer’s watchdog for over 75 years

Arizona Tax Research Association
Levy Growth during NAV Growth

- ‘96-’08: Boom years
  - Strong, steady growth in values
  - Levy growth averaged 14% over 2 years

- Last two years:
  - FCV grew 22%
  - NAV up only 5.7%
  - Levy growth 6.9%
Prop 117: What We Thought Would Happen

- First two years of Prop 117 in the books
  - Primary statewide property tax rate flat: 8.75 to 8.73
  - Most increases voter approved: 3.92 to 4.22
- Levy growth HALF that of historical rate
  - 6.9% over last two years down from 14% average
- Tempered growth slows tax increases
- “Leaving the rate the same” no longer an avenue to significant tax increases
- Significant tax levy increases will require transparent and public rate increase hearings
  - Examples: City of Phoenix, Town of Gilbert
1% Homeowner Cap

- 1980 Constitutional reform to protect homeowners
- Total **primary** property taxes cannot exceed 1% of limited property value
  - Limited to $10 rate per $100 of assessed value
  - Includes all jurisdictions: State, K-12, City, County, Community College
- Protects no other class of property
  - Renters, ranchers, farmers, businesses, etc.
- Insulates capped homeowners from tax increases
- Incomplete version of California Prop 13
- State “picked up the tab” for 35 years (statutory)
1% Homeowner Cap

All other taxpayers have no $10 cap
Renters, Businesses, Agricultural, etc
They pay the full primary and secondary tax rate

**All taxpayers pay the full secondary tax rate**
Managing the 1% Cap

• For decades, ATRA has encouraged lawmakers to avoid changes which collide with the 1% cap

• System designed to minimize 1% Cap violations
  – School QTR follows changes in assessed value
  – Homeowner rebate intended to decrease the primary rate
  – Caps on rate growth for cities, counties & community colleges
  – State rate is low ($0.50)

• Policymakers must consider 1% cap implications in all property tax reforms
What Drives the 1% Cap?

• High Tax Counties: Pima, Pinal
• High Tax School Districts: Deseg, Small Schools
• High Tax Cities: Maricopa, Superior

• If addressed, the vast majority of 1% cap costs are eliminated
1% Homeowner Cap Struck Down

• Governor Ducey’s 2015 budget intent: end the unlimited state subsidy of high taxing jurisdictions
  – Shift responsibility to local taxing authorities with above average tax rates
  – PTOC would calculate penalties
• July: Superior court struck down entire law
  – Concurred with plaintiffs: PTOC inappropriate lever
  – “Impermissibly delegating the legislative power of taxation”
  – Result: State GF back on hook financially
  – Other plaintiff claims not addressed
Taxpayers Need a 1% Cap Fix

• ATRA predicted new formula would simply raise tax rates
  – Tax rate increases from several 1% cap liable jurisdictions
    • Pima County, Pinal County, Pinal County Community College District (Central AZ College), Town of Superior
  – Homeowners insulated from increases again
  – As rates rise, liability for 1% cap also rises
  – Property taxpayers put in death spiral
• Fix necessary
  – 1% cap fix shouldn’t expose non-class 3 properties to even higher taxes
  – Precedent: Maximum school tax rate law for high rates in 1% cap areas
ATRA Recommendations

• Direct Approach: Address High Primary Taxes
  – Deseg Levies
  – Small Schools
  – High Tax Rate Cities
  – Pima County Sales Tax Change

• Indirect Approach: Taxpayers Need Protection with Rate Caps