State Budget Outlook

Arizona Tax Research Association

November 14, 2019

Governor's Office of Strategic Planning and Budgeting

Roadmap

- Governor's Vision for the State
  - Government at the speed of business: decide faster, respond faster, resolve faster, add more services online, save tax dollars
- General Fund Overview
  - Largest-ever cash reserves
  - 3rd structurally balanced budget in a row
- Economy
  - Arizona continues to outperform the national economy
  - Growth picked up nationwide in 2018, buoying State revenues
  - Federal tax policy changes have generated significant economic activity for Arizona, and engendered substantial State revenues
- General Fund Spending

THE ARIZONA REPUBLIC

"Forecast for Arizona's economy in 2019 includes more jobs, growth, and 100,000 new people"

The Arizona Republic (November 29, 2018)

The New York Times

"Arizona has since built upon the governor's action to become a favored partner for the tech industry… The payoff for Arizona has been a tech boon."

The New York Times (November 11, 2017)

THE WALL STREET JOURNAL

"Arizona last year attracted more than 122,000 newcomers, many fleeing states with crushing regulation and taxes… giving overtaxed Californians and New Yorkers another reason to move to the state by making it easier to work and start businesses."

The Wall Street Journal, *Arizona Occupational Welcome* (February 18, 2019)

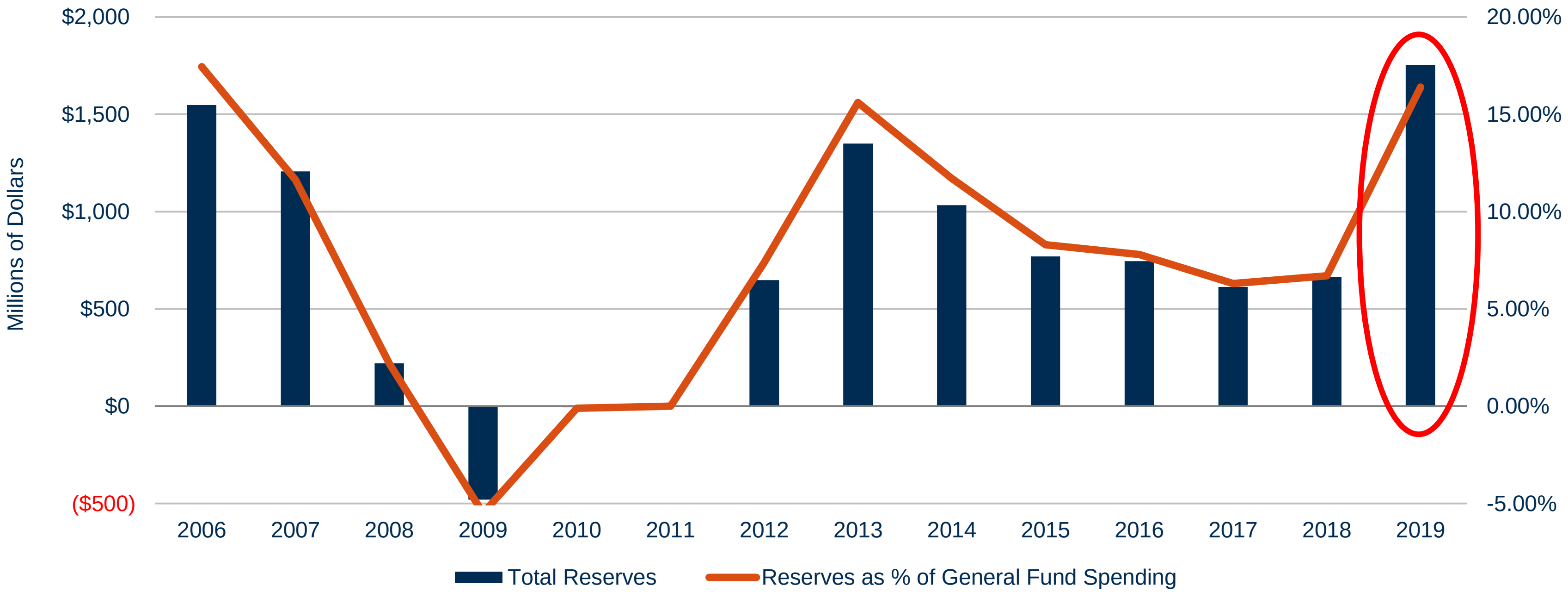
General Fund Overview

“Since 2015, we’ve reduced and simplified taxes every year, while balancing Arizona’s budget, bringing our Rainy Day Fund to a record $1 billion and growing our surplus to $1 billion.”

- Governor Doug Ducey

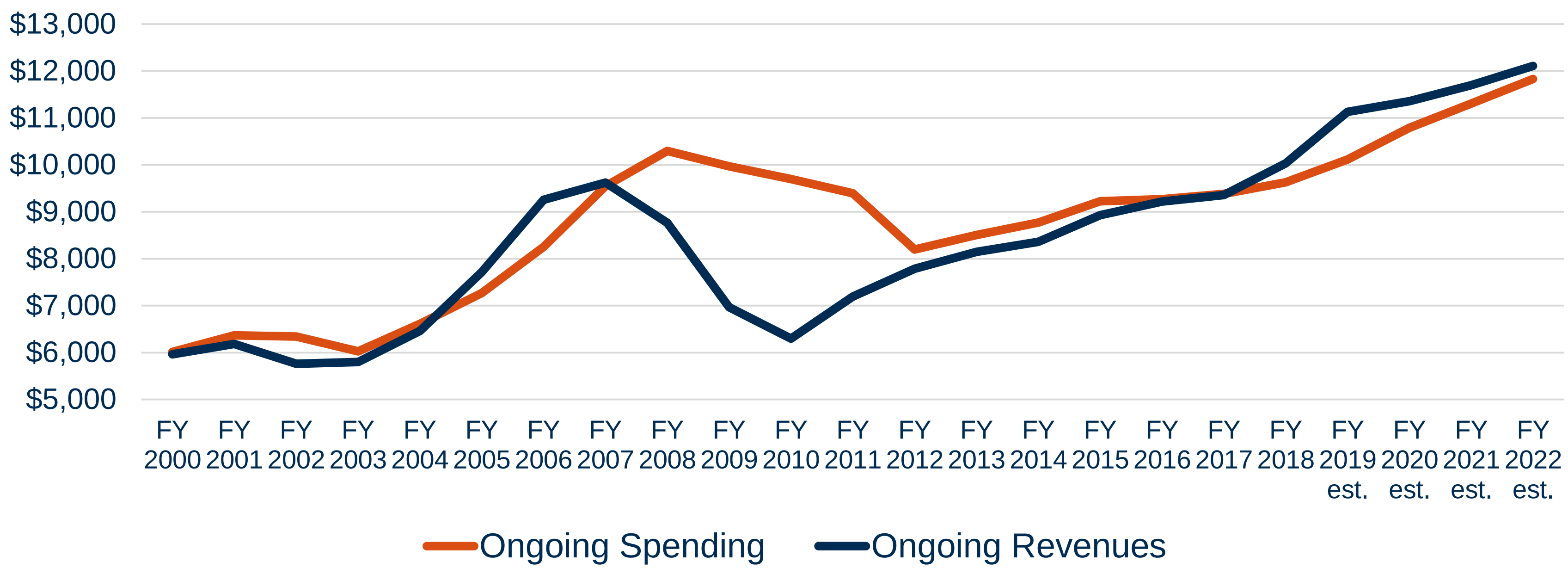
State General Fund is Positioned Well

- The FY 2020 budget's strategic investments and cautious outlook puts the fiscal health of the General Fund in its strongest position ever



Note: Total reserves reflect the balance in the General Fund and Budget Stabilization Fund, excluding other operating funds

Projected Longest Run of Structural Surpluses Since 2000

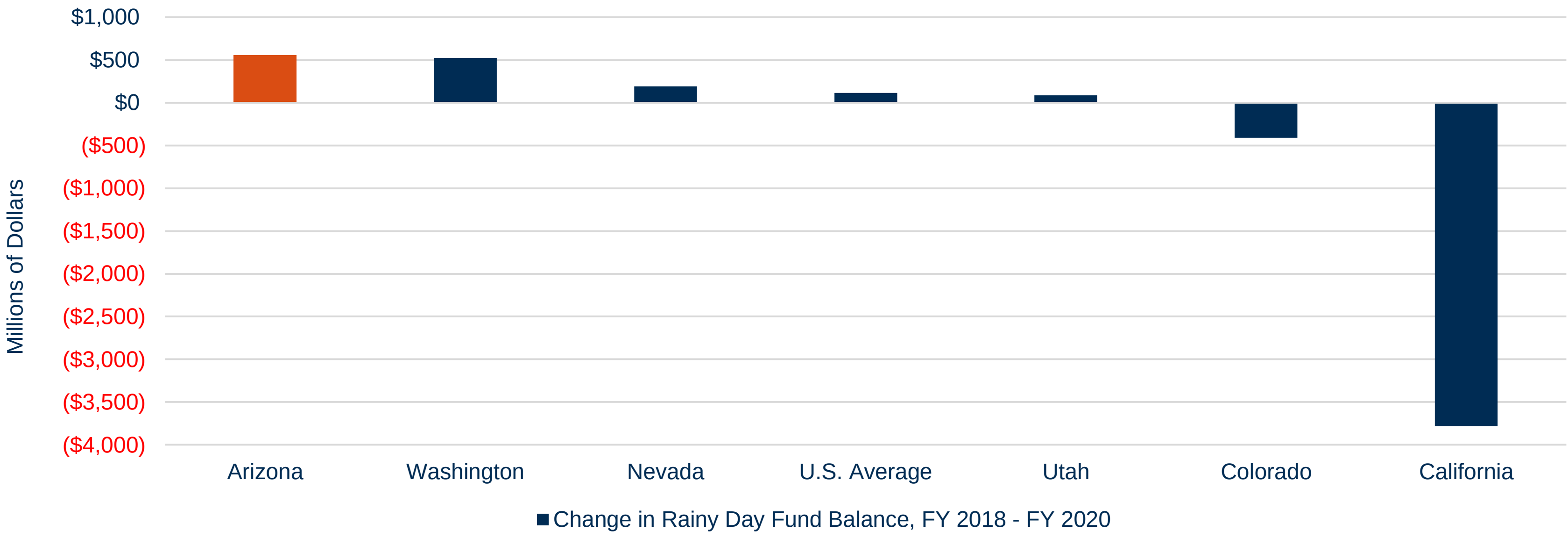


	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
Cash	$450M	$1,020M	$321M	$299M	$268M
Structural	$407	$1,022	$566	$395	$283

Source: Joint Legislative Budget Committee, FY 2020 Appropriations Report

Arizona is a National Leader in Saving

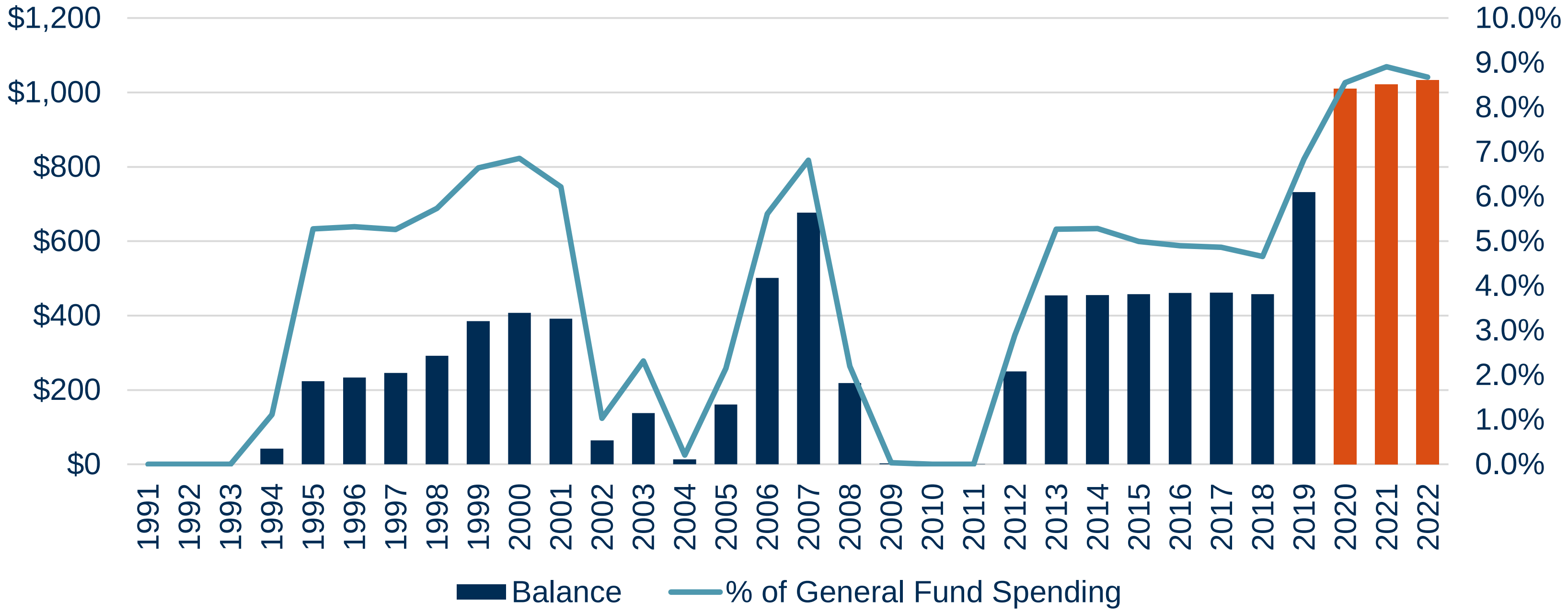
- Arizona will continue to heed the lessons of the past and combine conservative, structurally balanced budgets with fiscal prudence



** According to the NASBO Fiscal Survey of States, Spring 2019*

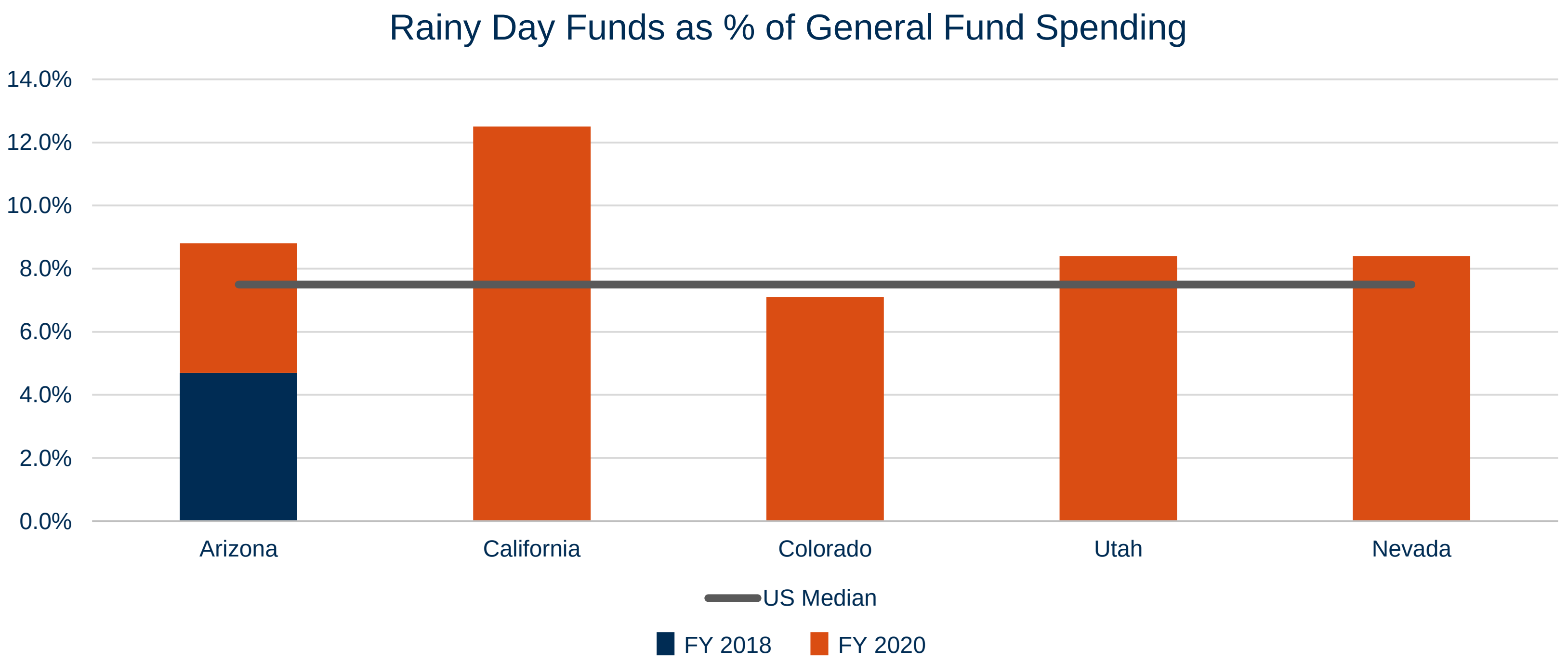
Arizona’s Rainy Day Fund

- As of November 2019, the Budget Stabilization Fund balance is over $1.0 billion, its largest level ever on both a cash and percent of General Fund spending basis



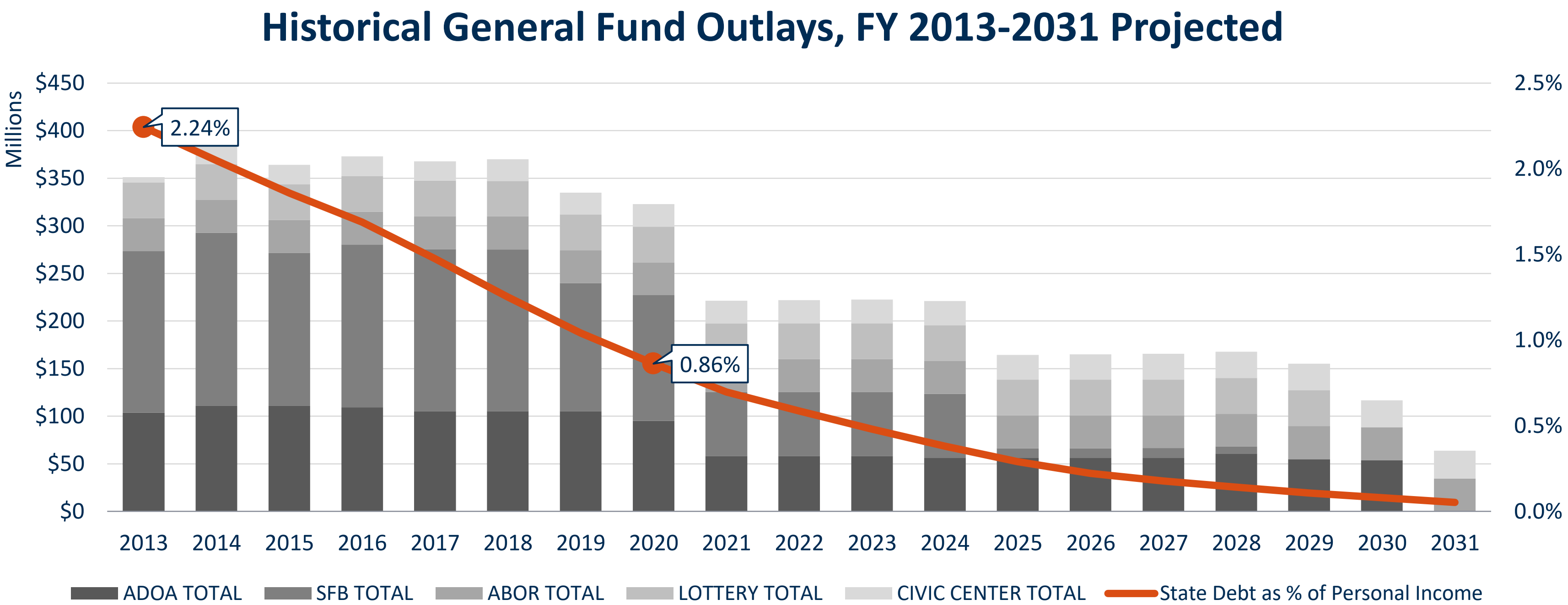
Arizona's Rainy Day Fund Now Ahead of National Peers

- Since FY 2018, Arizona's savings account has grown from just over 4.5% to 8.8% of General Fund spending – exceeding many of its national peers



Debt Retirement

- The retirement and refinancing of recession-era debt will save the General Fund $150 million per year between FY 2018 and FY 2021



2019 Tax Omnibus Modernized the Tax Code

- Thanks to the opportunity created by Federal tax reform, Arizona last year was able to enact a comprehensive modernization of its tax code

- We reduced and simplified income taxes – eliminating exemptions, reducing brackets, and cutting rates by a total of over $300 million (gross cuts)

- We applied TPT to out-of-state sellers - stopping the revenue loss created by the e-commerce revolution, offsetting our income tax cuts, and providing a stable and fair consumption-tax-based future

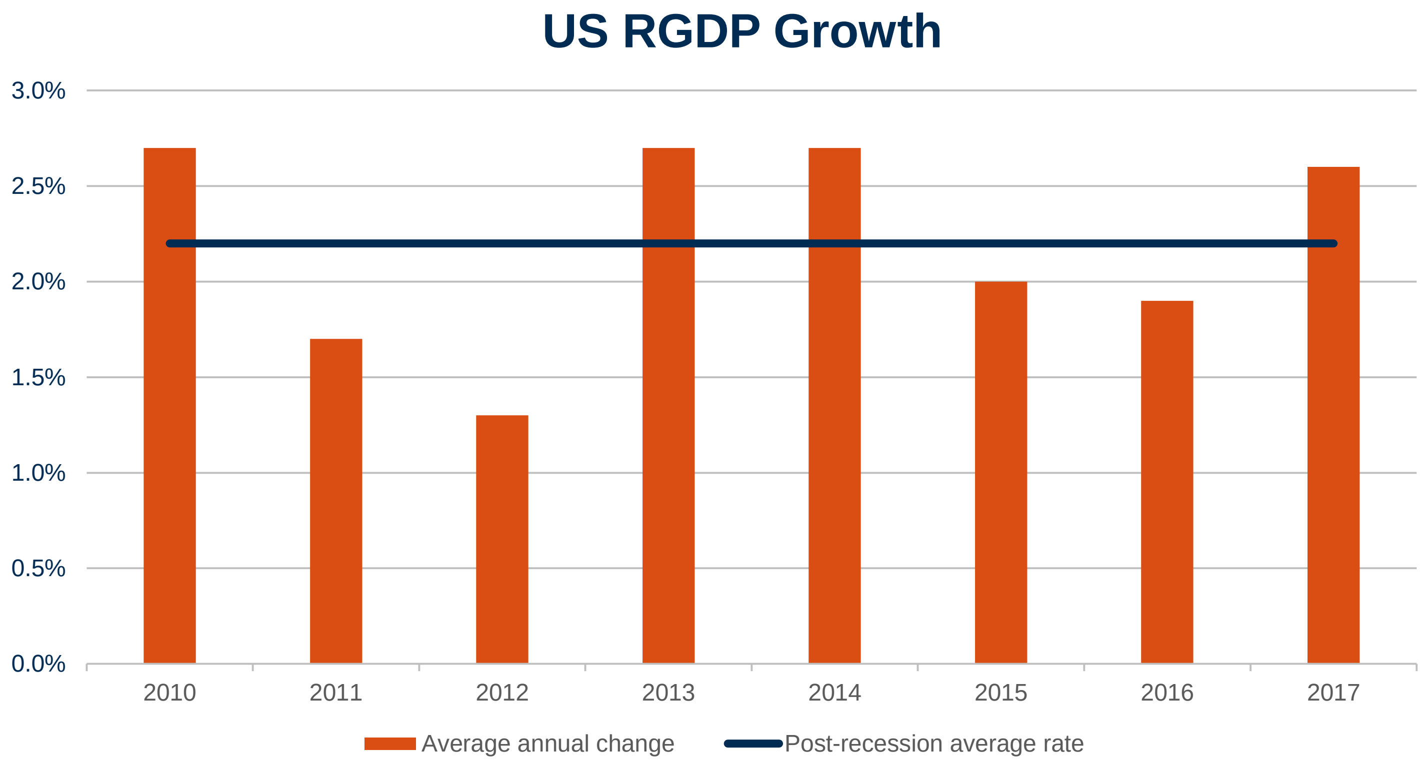
Economy & Demographics

"With over 300,000 jobs added since 2015, rising paychecks, and the strongest manufacturing growth in 30 years, Arizona's economy is on a roll. This is a testament to a talented workforce, strong leaders, innovative entrepreneurs and business-friendly policies that continue to drive Arizona's economic momentum."

- Governor Doug Ducey

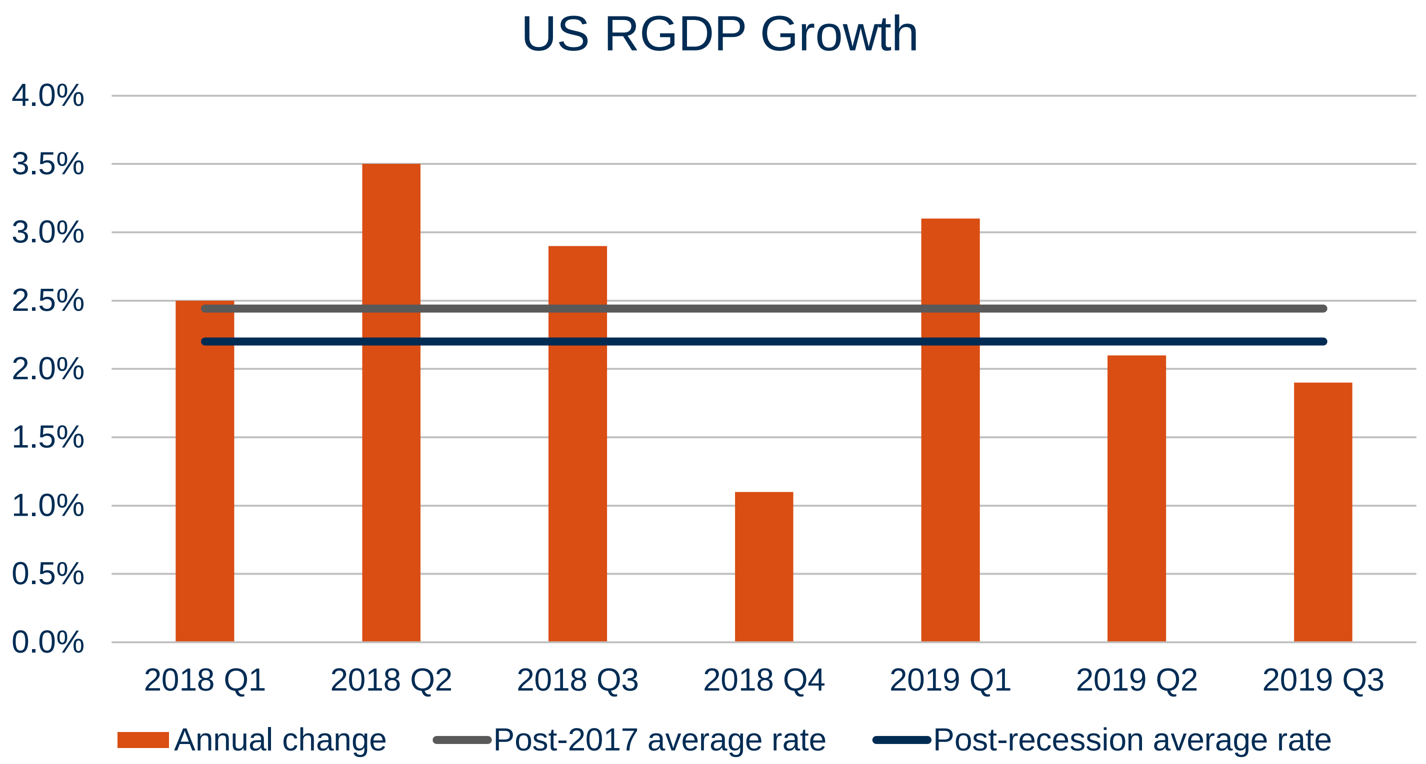
US Growth Has Lagged

- Typical recovery cycles see US Real Gross Domestic Product growth in excess of 3.0%



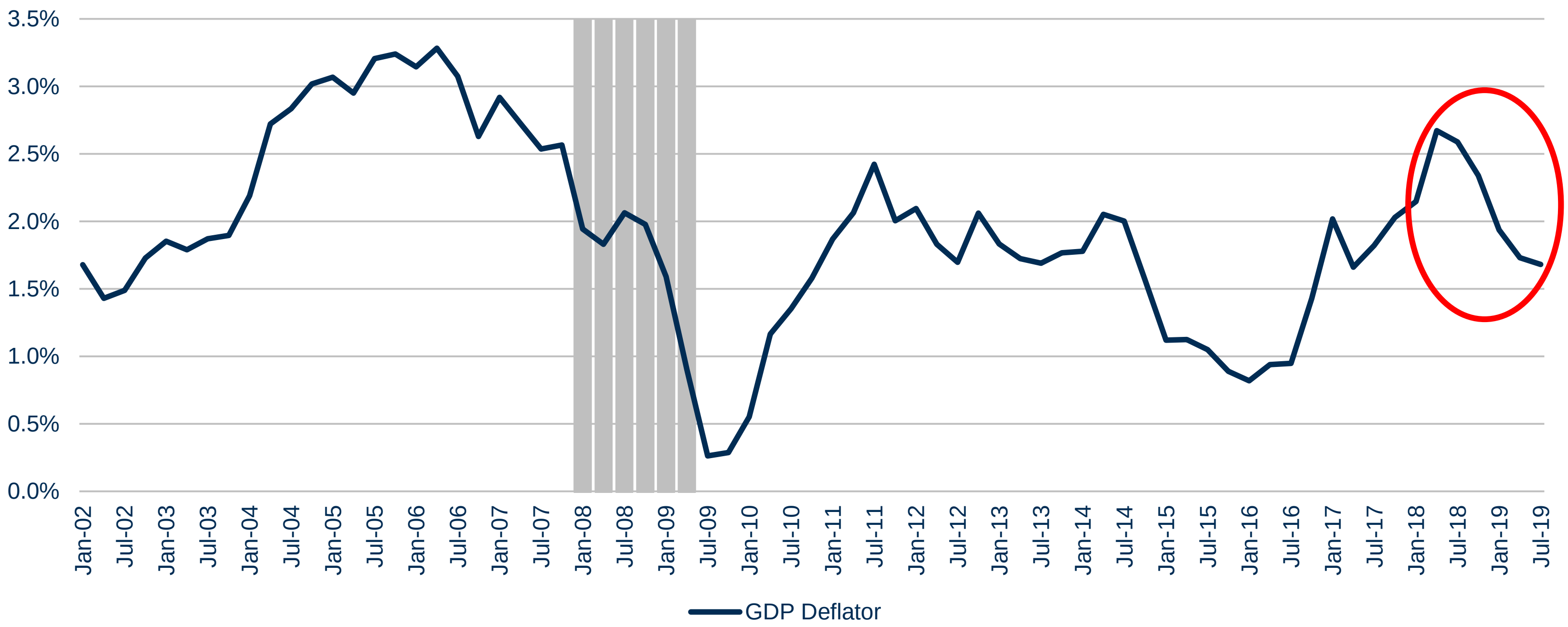
Growth Picked up in 2018

- Many states, including Arizona, benefited from both stronger national growth and the Tax Cuts & Jobs Act



Inflation is Moderating

- A trend which may help sustain the economy – historically, persistent inflation above 2.0% has preceded a slowing economy and eventually recession



Population Growth

- Arizona continues to be among the top states – beating both its Region and the Nation - for population increases since 2013

Geographic Area	ESTIMATE OF TOTAL STATE POPULATION (as of July 1, 2018)										
	2013	2014		2015		2016		2017		2018	
United States	316,057,727	318,386,421	0.7%	320,742,673	0.7%	323,071,342	0.7%	325,147,121	0.6%	327,167,434	0.6%
West	74,192,525	74,960,582	1.0%	75,788,405	1.1%	76,614,450	1.1%	77,319,986	0.9%	77,993,663	0.9%
Nevada	2,776,972	2,819,012	1.5%	2,868,666	1.8%	2,919,772	1.8%	2,972,405	1.8%	3,034,392	2.1%
Idaho	1,611,530	1,631,479	1.2%	1,651,523	1.2%	1,682,930	1.9%	1,718,904	2.1%	1,754,208	2.1%
Utah	2,897,927	2,937,399	1.4%	2,982,497	1.5%	3,042,613	2.0%	3,103,118	2.0%	3,161,105	1.9%
Arizona	**6,634,999**	**6,733,840**	**1.5%**	**6,833,596**	**1.5%**	**6,945,452**	**1.6%**	**7,048,876**	**1.5%**	**7,171,646**	**1.7%**
Florida	19,563,166	19,860,330	1.5%	20,224,249	1.8%	20,629,982	2.0%	20,976,812	1.7%	21,299,325	1.5%
Washington	6,962,906	7,052,439	1.3%	7,163,543	1.6%	7,294,680	1.8%	7,425,432	1.8%	7,535,591	1.5%
Colorado	5,270,482	5,351,218	1.5%	5,452,107	1.9%	5,540,921	1.6%	5,615,902	1.4%	5,695,564	1.4%
Texas	26,489,464	26,977,142	1.8%	27,486,814	1.9%	27,937,492	1.6%	28,322,717	1.4%	28,701,845	1.3%
South Carolina	4,764,153	4,823,793	1.3%	4,892,253	1.4%	4,958,235	1.3%	5,021,219	1.3%	5,084,127	1.3%
North Carolina	9,843,599	9,933,944	0.9%	10,033,079	1.0%	10,156,679	1.2%	10,270,800	1.1%	10,383,620	1.1%

Source: U.S. Census Bureau, Population Division

Release Date: December 2018

Net Migration Rates

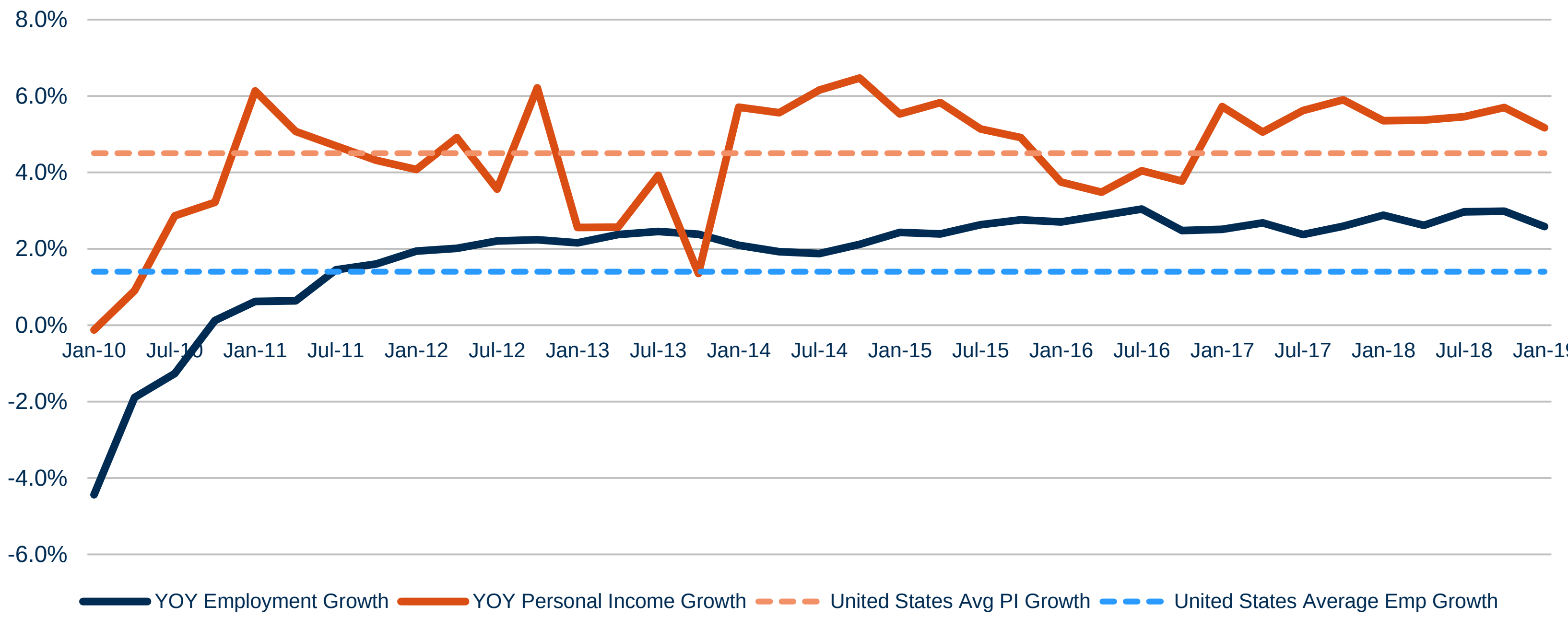
- Arizona continues to dominate national and regional migration trends – capturing nearly a *tenth* of total U.S. migration last year

Geographic Area	**ESTIMATE OF NET STATE MIGRATION (as of July 1, 2017)**										
	2013	**2014**		**2015**		**2016**		**2017**		**2018**	
United States	843,145	995,944	18.1%	1,150,528	15.5%	999,163	11.2%	1,111,283	11.2%	978,826	-11.9%
West Region	251,624	350,641	39.4%	401,257	14.4%	397,257	-9.3%	364,956	-8.1%	307,969	-15.6%
Arizona	**37,281**	**56,209**	**50.8%**	**63,278**	**12.6%**	**76,405**	**3.8%**	**79,316**	**3.8%**	**97,575**	**23.0%**
California	73,958	129,228	74.7%	103,503	-19.9%	33,530	-20.4%	26,672	-20.5%	-38,271	-243.5%
Colorado	44,857	51,003	13.7%	67,781	32.9%	60,773	-23.3%	46,626	-23.3%	51,500	10.5%
Idaho	6,142	9,389	52.9%	9,097	-3.1%	18,869	40.6%	26,525	40.6%	25,776	-2.8%
Montana	6,192	5,316	-14.1%	6,019	13.2%	7,422	20.7%	8,962	20.7%	6,876	-23.3%
Nevada	20,317	32,079	57.9%	37,115	15.7%	41,967	10.0%	46,184	10.0%	50,696	9.8%
New Mexico	-8,809	-11,482	30.3%	-9,721	n/a	-7,111	n/a	-4,666	-34.4%	-3,509	-24.8%
Oregon	16,590	29,532	78.0%	42,935	45.4%	56,972	-19.8%	45,687	-19.8%	34,996	-23.4%
Utah	9,920	4,230	-57.4%	15,744	272.2%	25,412	-11.1%	22,587	-11.1%	25,019	10.8%
Washington	38,411	51,896	35.1%	68,705	32.4%	91,981	-1.5%	90,563	-1.5%	77,106	-14.9%
Wyoming	2,941	-2187	-174.4%	-1,224	n/a	-3,823	n/a	-8,285	n/a	-3,089	n/a

Source: U.S. Census Bureau, Population Division
Release Date: December 2018

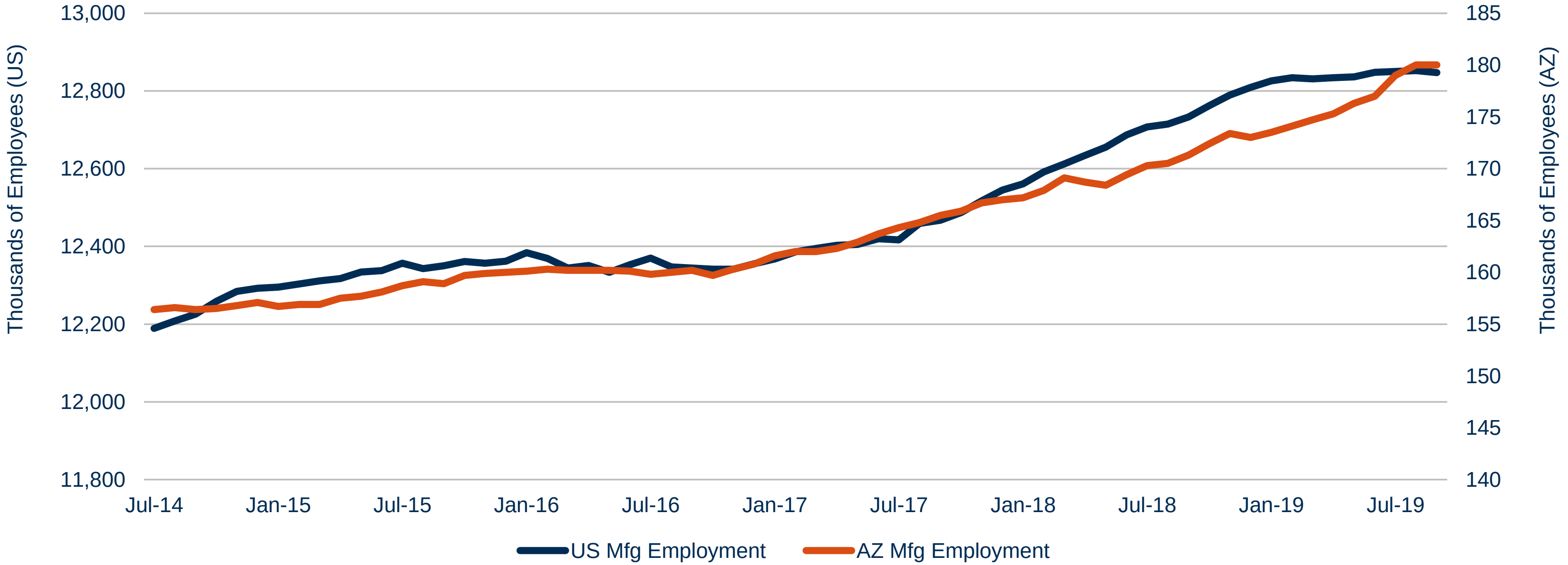
Consistent Growth in Arizona

- Overall employment and income growth remains near post-recession highs



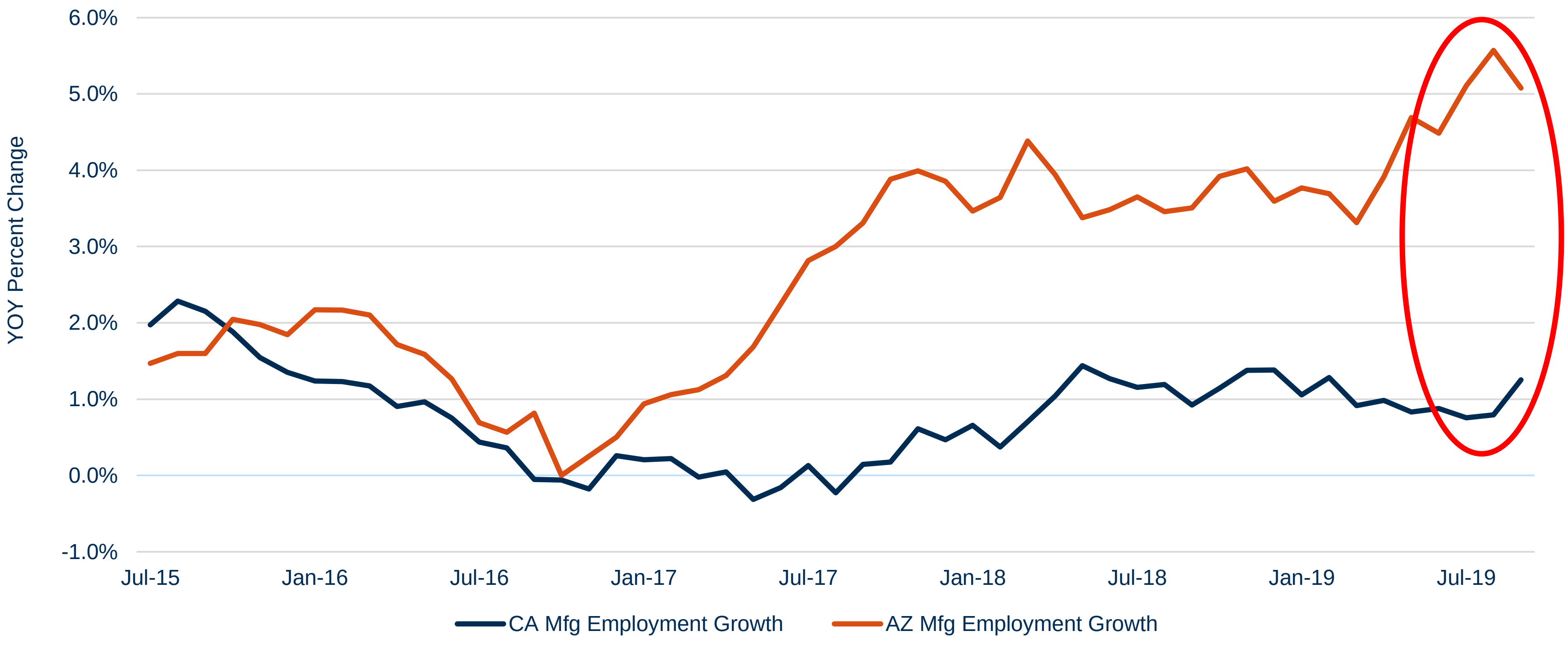
Strongest Manufacturing Job Growth in 30 Years

- Spurred by aggressive changes in federal regulatory and tax postures, coupled with growth-oriented State policies, Arizona has enjoyed a resurgence in manufacturing employment



Employment Gains Haven’t Been Distributed Evenly Among States

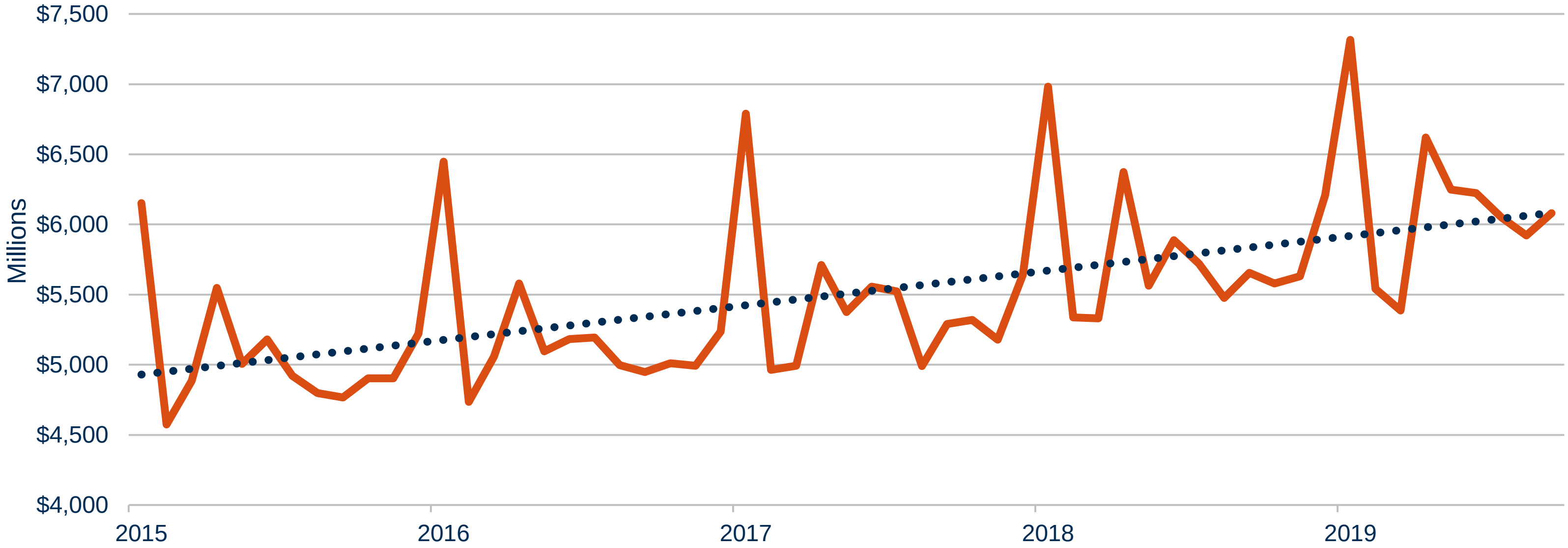
- This uneven pattern suggests the change is, in fact, driven by state policy differences



Retail Sales Activity

- Despite apparent variability in the chart, the TPT base is remarkably seasonal, and these trends are relatively consistent and easy to forecast – making the largest portion of the General Fund also the most reliable

Arizona Taxable Retail Sales



In Arizona, Sales Tax is Key Driver of Long-Run Revenue Trends

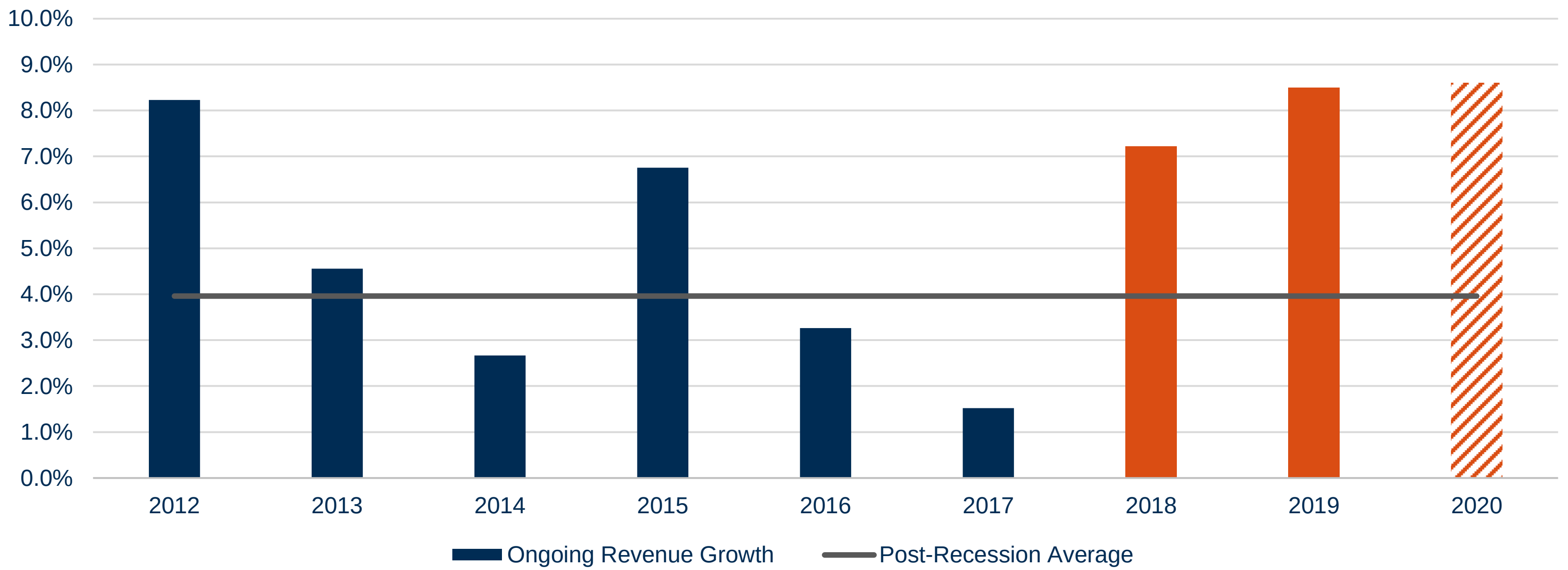
Major Ongoing Tax Sources As % of General Fund Revenue

Fiscal Year	Sales	Individual Income	Corporate Income	Other
2009	42.6%	29.1%	6.7%	21.6%
2010	37.7%	27.0%	4.6%	30.7%
2011	43.1%	35.8%	7.0%	14.1%
2012	42.6%	36.0%	7.5%	13.9%
2013	43.4%	39.0%	7.6%	10.0%
2014	44.2%	38.6%	6.4%	10.8%
2015	43.6%	39.1%	6.9%	10.4%
2016	42.6%	39.2%	5.4%	12.8%
2017	44.3%	40.6%	3.6%	11.5%
2018	45.0%	41.9%	3.0%	10.1%
2019	45.8%	45.0%	4.6%	4.6%
2020	**47.8%**	**44.1%**	**4.6%**	**3.5%**

- TPT is projected to become even more important with the implementation of the 2019 Tax Omnibus

Strong Recent Revenue Growth

- FY 2018 and 2019 posted some of the strongest revenue growth rates since before the Great Recession, far exceeding the post-recession average



Strong FY 2019 base growth supports FY 2020 enacted revenue targets

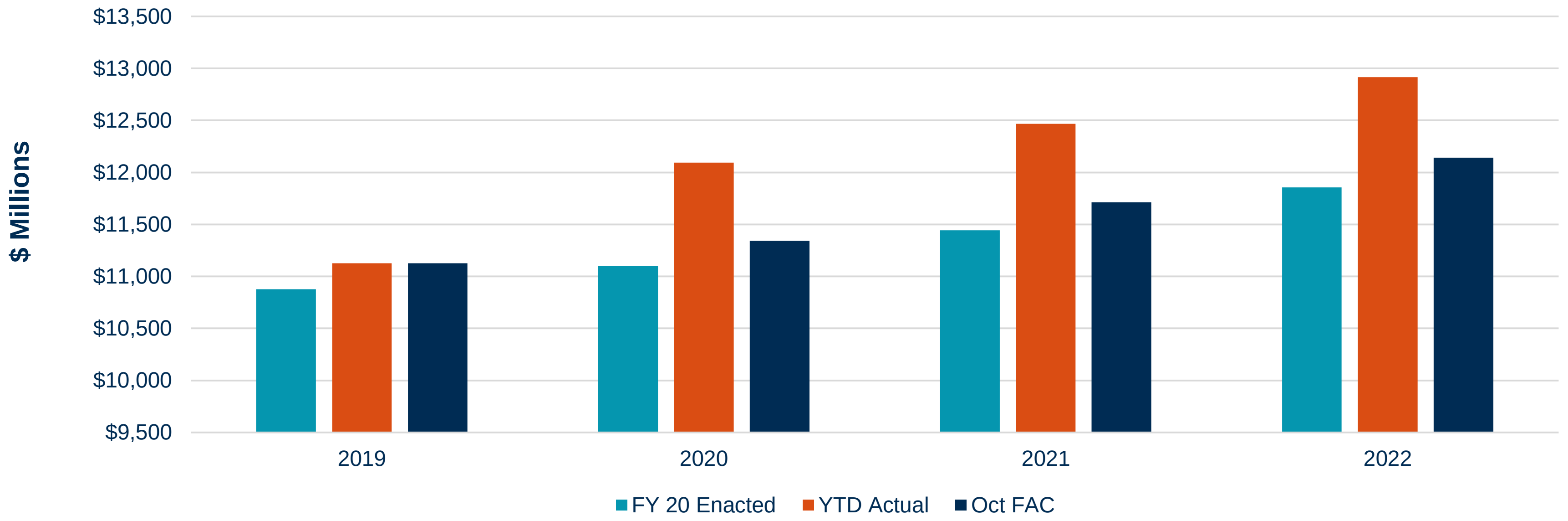
Current and Historical General Fund Revenue
$ in millions

Tax Type	FY 2019 *Prelim Actual*	FY 2020 *Budgeted*	FY 2020 YTD Actual	10-Year Avg
Sales	$5,097	$5,365		
	6.5%	**5.6%**	**6.9%**	2.8%
Individual	$5,009	$4,961		
	10.2%	**0.3%**	**9.4%**	6.7%
Corporate	$514	$435		
	37.9%	**2.4%**	**10.6%**	(2.6)%
Ongoing GF	**$11,126**	**$11,101**		
	10.2%	**2.1%**	**8.6%**	**3.2%**

Source: Joint Legislative Budget Committee, FY 2020 Appropriations Report; JLBC Monthly Fiscal Highlights

’19 Revenues Beat Forecast by $248M or 2.3%

Year-over-year growth was 10.2%



- YTD, ongoing revenues are up more than 8.5% over prior year; unlikely to continue at this rate indefinitely
- Still, data suggests a strong year in 2020, and continued growth thereafter

’20 Summary with Baseline Spending

	$ in millions			
	FY 19	**FY 20**	**FY 21**	**FY 22**
Enacted Ending Balance	$764	$65	$43	$12
Enacted Structural Balance	766	310	139	27
Projected Oct. FAC Ending Balance	957	535	694*	173
Projected Oct. FAC Structural Balance	521	549	324	215
Enacted Baseline Spending Changes		1,189	(380)	441

** JLBC assumes this amount is spent as part of the FY 2020 budget process*

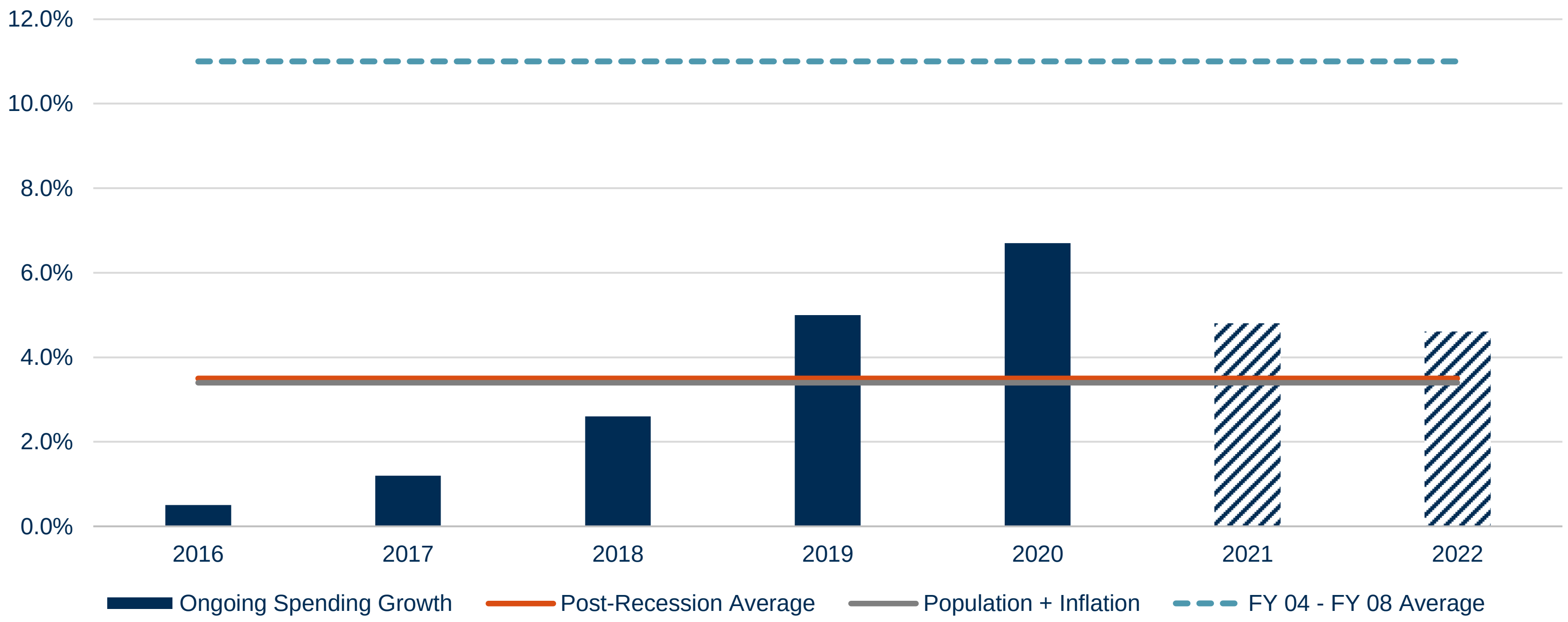
General Fund Spending

"We're making good on our promises to invest in the things that matter like K-12 and higher education, public safety, health care and rural infrastructure – all while preparing our state for the unexpected and inevitable."

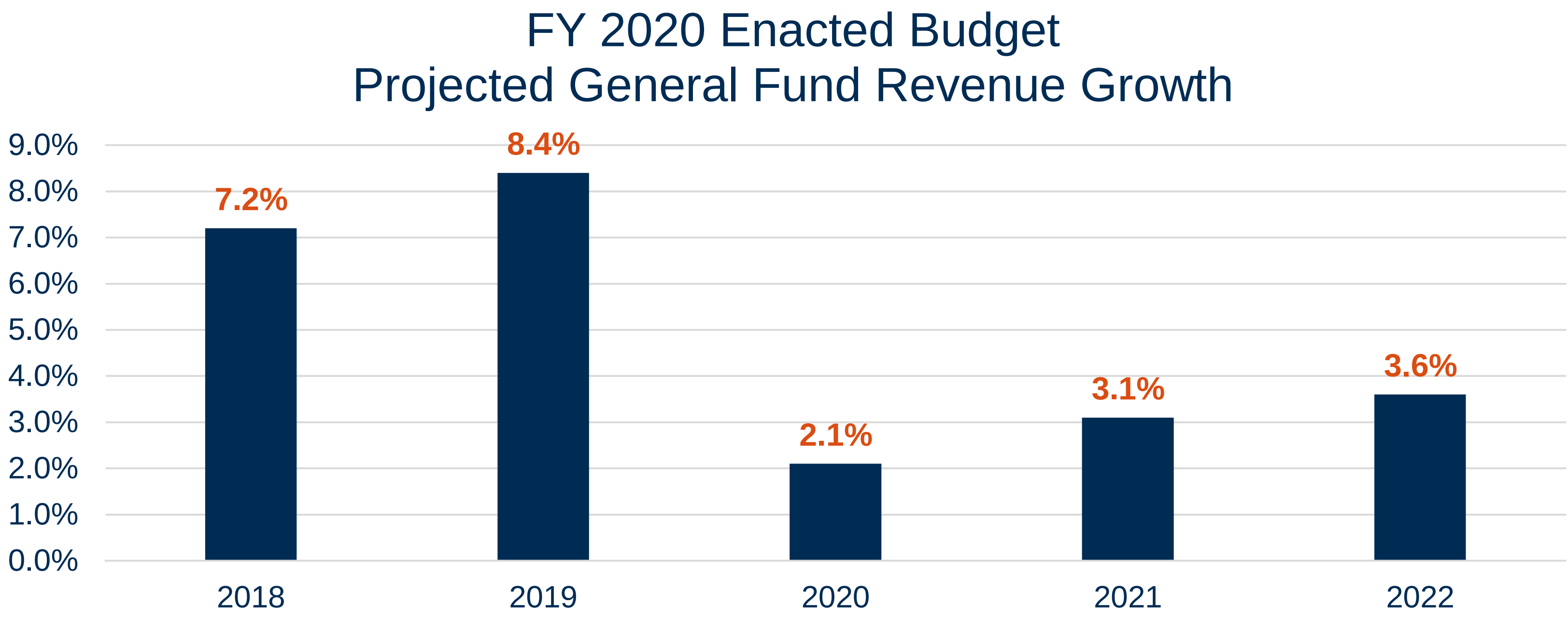
- Governor Doug Ducey

Avoiding the Mistakes of the Past

- Despite a recent acceleration in spending, the Governor is committed to keeping spending growth in line with benchmarks like Population + Inflation



Both the FY 2020 Executive & Enacted Budget Reflected Slowing Revenue Growth After FY 2019



- The Executive anticipates maintaining this conservative approach during the FY 2021 budget development cycle

FY 2020 Budget At-A-Glance

$1.4B
FY 2020
JLBC Starting Projected Cash Balance

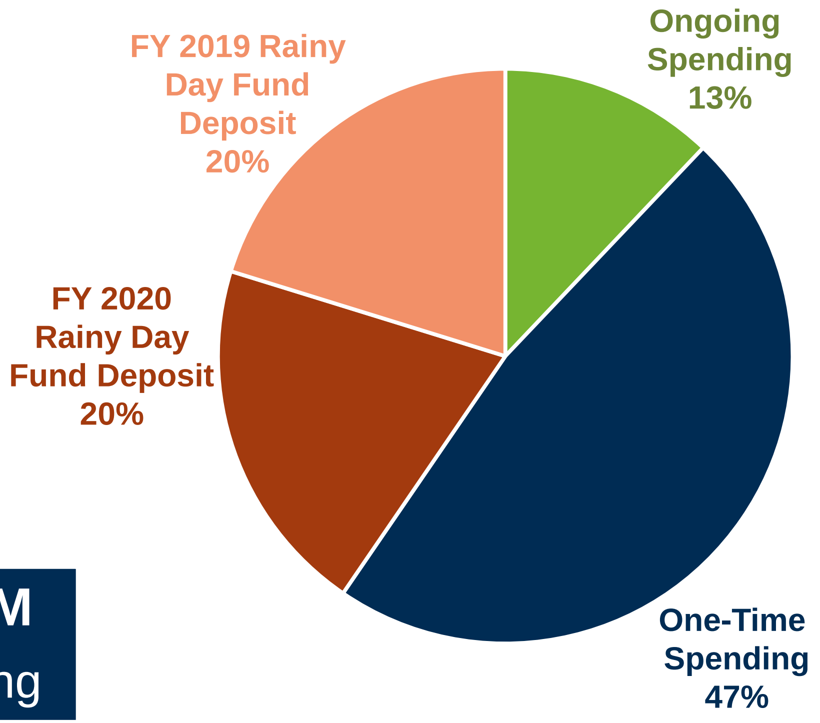
$271M
FY 2019 Rainy Day Fund Deposit

$798M
Budget Agreement

$271M
FY 2020 Rainy Day Fund Deposit

$636M
One-Time

$162M
Ongoing



Balancing Fiscal Prudence and Program Needs

Agencies submitted 405 funding issues, with a net GF cost of ~$501 million

- IT projects
- Ag lab equipment
- Building renewal funding
- K-12: New school construction and building renewal
- Adult education waitlist
- Increased regulatory staff
- Adoption subsidy caseload
- Prisons (locks, fire, HVAC)
- Public safety communications
- Medicaid caseload and inflation
- Adult probation growth
- University funding
- Election funding

Education

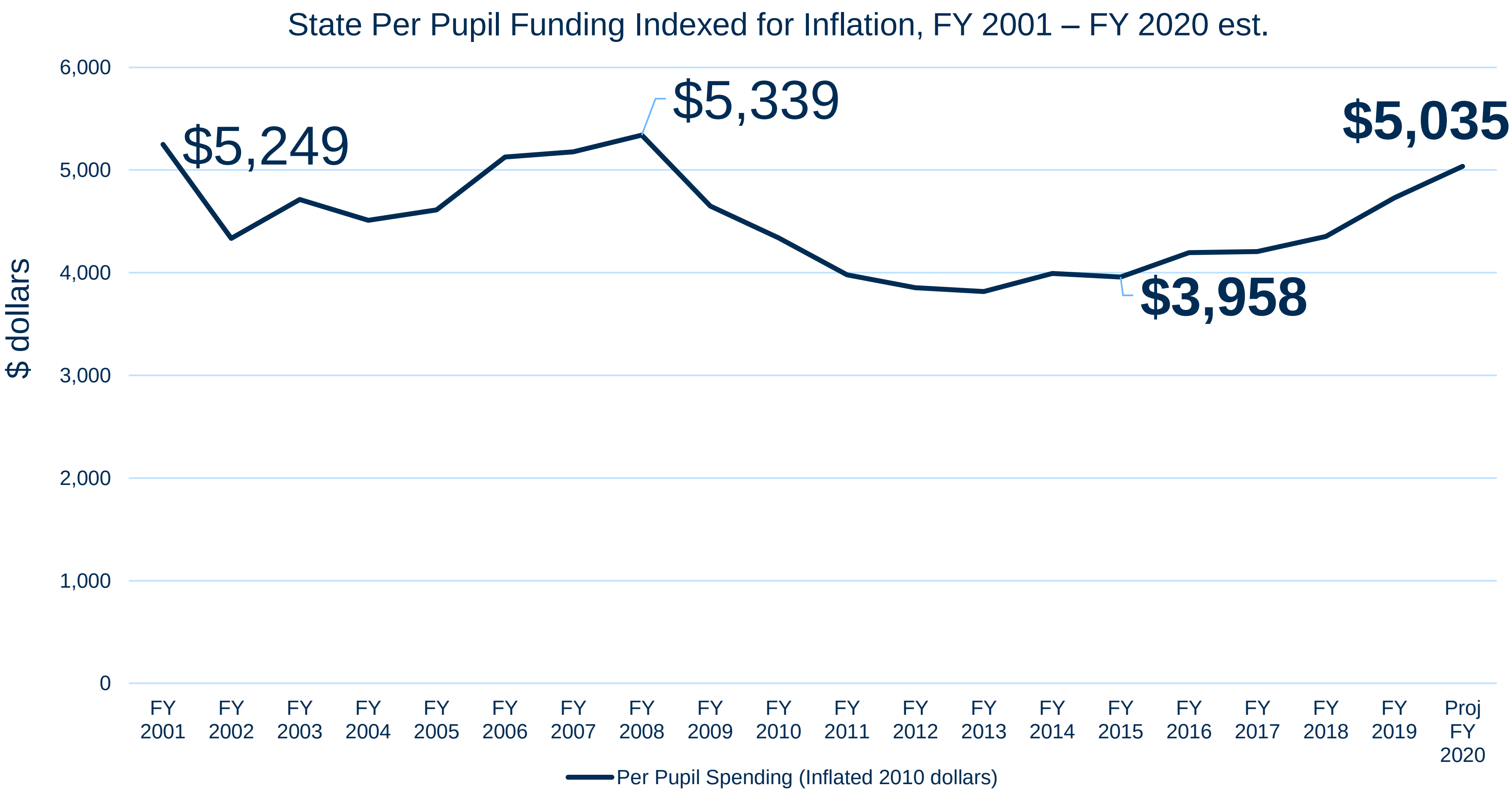
- FY 2019 investments to increase teacher pay, improve school capital, and otherwise roll back Recession-era cuts have enjoyed widespread public support
- These investments have been accomplished within the General Fund budget without new tax increases, unfunded mandates, or Voter Protection

K-12 Spending

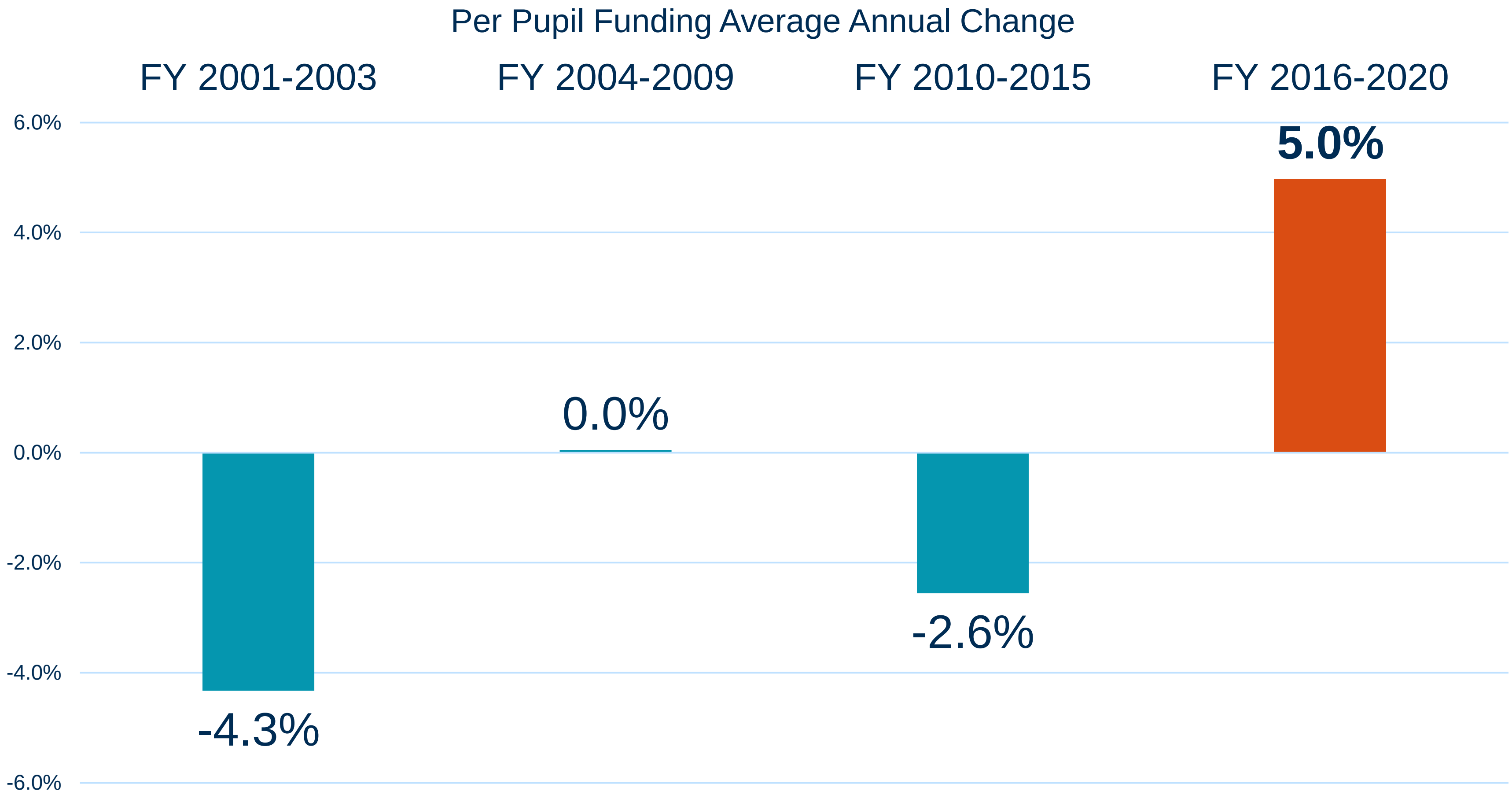
	FY 2015	FY 2020	
Teacher Salaries[1]	Ranked 40th	Ranked 16th	✓
Flexible School Capital Funding (Additional Assistance)	$254.6 million in formula funding suspensions	Fully restored formula funding by FY 2023	✓
Proposition 301	Revenue source expires FY 2021	Revenue source extended FY 2041	✓
New School Construction Funding	After capacity is reached	A year before capacity is reached	✓
Basic State Aid Funding Mechanism	Prior Year Funding	Current Year Funding	✓

1. Arizona Tax Research Association estimate and adjusted for cost of living (http://www.arizonatax.org/sites/default/files/press_release/teacher_pay_update.pdf)

State Per-Pupil Funding Up 27% since FY 2015
Longest growth streak since 2000

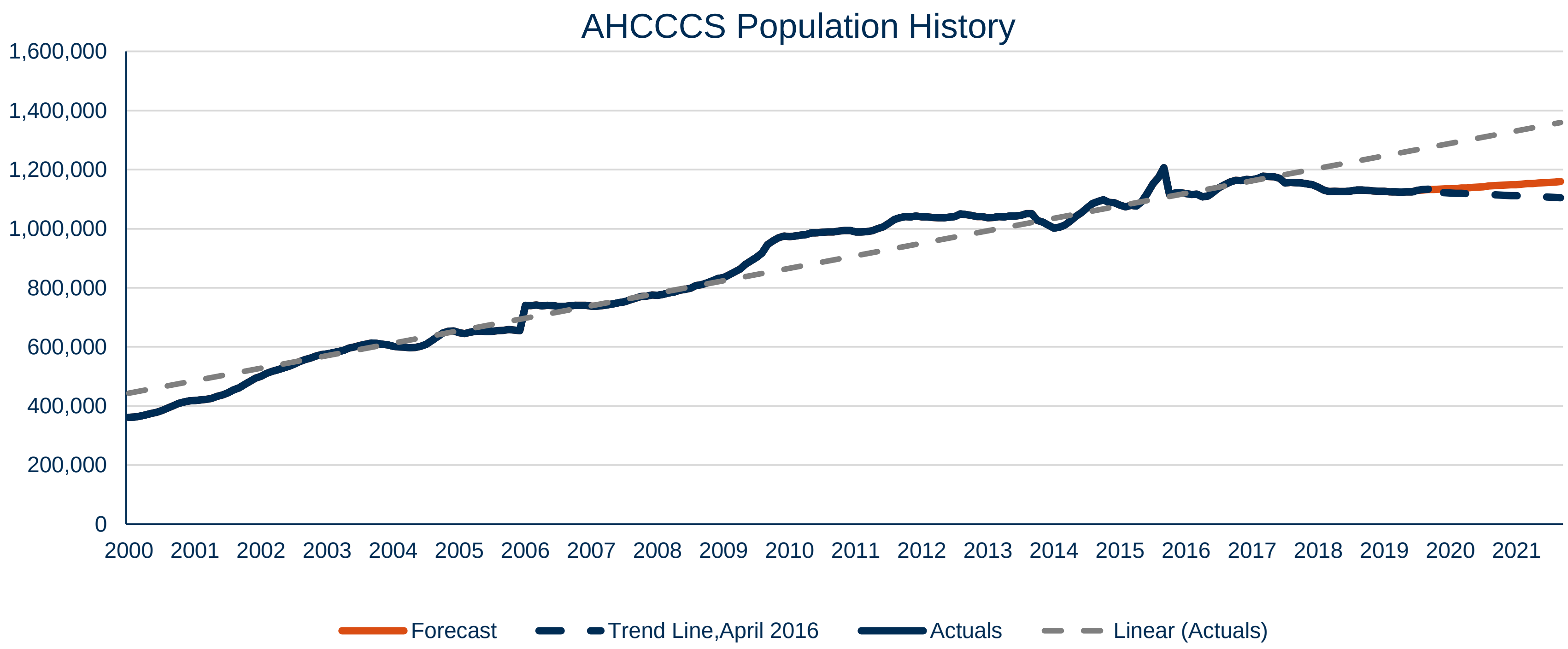


State per pupil funding has grown faster in the last five years

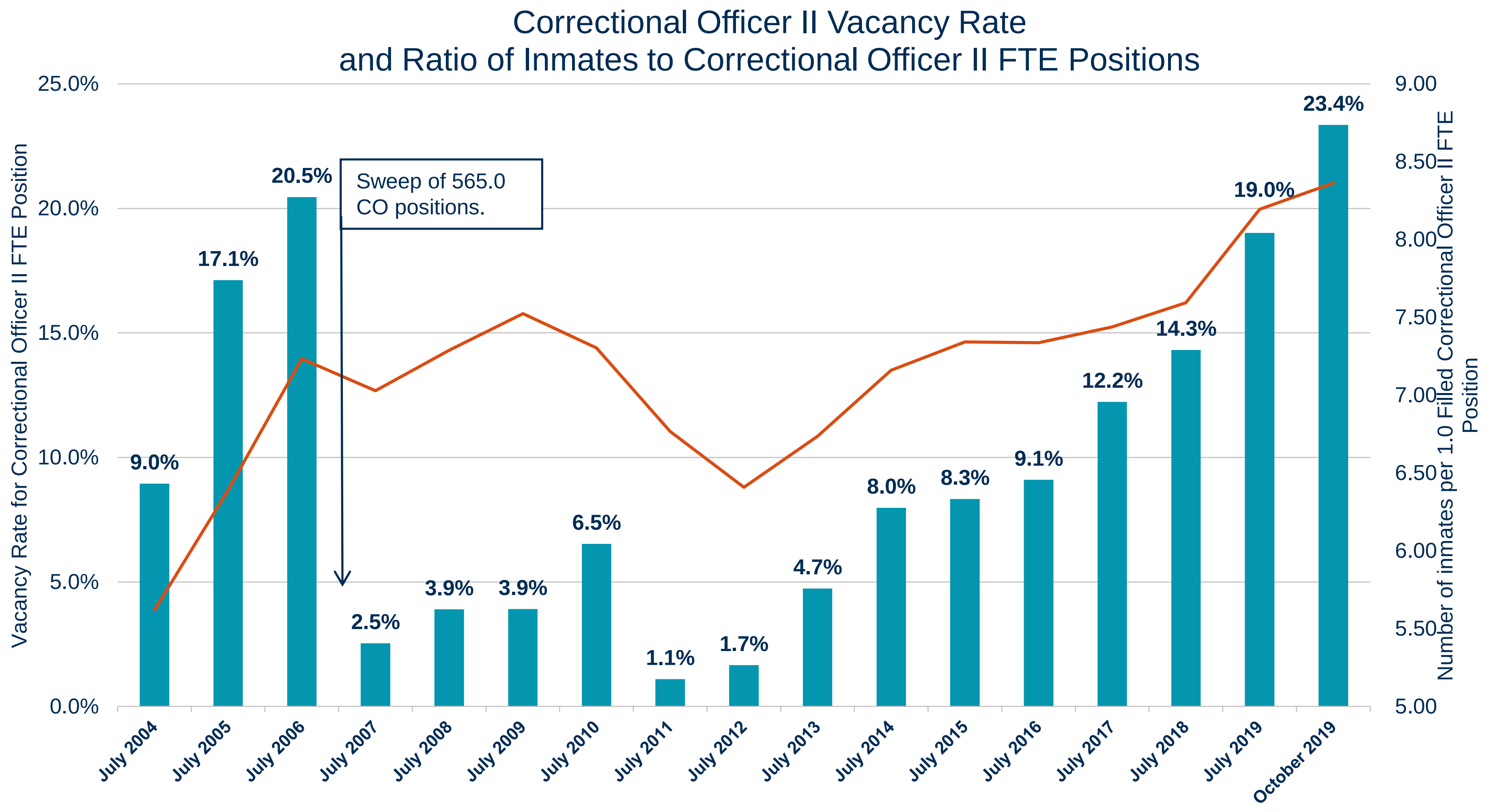


Caseloads - Medicaid

- Slower than trend caseload growth indicates both a strong Arizona economy, and reduced forward fiscal pressure on the State



Correctional Officer Vacancy Rates Continue to Rise



Transportation & Infrastructure

- **Preventive Maintenance**
  - At $51 million, the FY 2020 budget will spend the most money in a given year on roadway preventative maintenance in State history

- **One-Time Transportation Funding**
  - The FY 2020 budget included $95.3 million General Fund ($225.3 million total funds) for expansion and modernization of vital State roads & highways, such as the I-17 corridor

Key Takeaways

- Arizona's economy is strong and steadily growing
- General Fund revenues beat expectations in '19 and are projected to do so again in '20
- While the State's balance sheet is stronger than it has been in years, fiscal restraint is necessary to prevent the excesses of the mid-2000s
- K-12 and public safety remain top priorities of the Governor
- Arizona's "job and economic growth forecasts over the next five years are among the best in the U.S."[1]

[1] Forbes Magazine, *Best States For Business* (https://www.forbes.com/places/az/)

Q&A

"With a budget surplus and booming economy, we aren't going on a spending spree. We've learned from the mistakes of the past and, this time, we're preparing for Arizona's future."

- Governor Doug Ducey

TAX LITIGATION UPDATE

Pat Derdenger, Lewis Roca Rothgerber & Christie

Otto Shill, Jennings, Strouss & Salmon

Overview

- Sales Tax Cases
  - Digital Goods & Services
  - *Phoenix v. Orbitz*
  - *Carter Oil v. ADOR*
  - *Vangilder v. Pinal County*
- Property Tax Cases
  - *Engleborn v. City of Phoenix*
  - *State of AZ v. ABOR*

Digital Goods and Services

- Absence of clear laws or rules on digital products
- Litigation testing state's position that (nearly) all subject to TPT
  - Response to audit claims for back taxes & penalties
  - Requests from taxpayers for refunds
- At least 4 major taxpayers have filed suit
- All challenging ADOR position that:
  - Remotely accessed software is tangible personal property (TPP)
  - Remotely accessed software is a rental of TPP

DGS Litigation Summary

Taxpayer	Product	Category	Litigation	Filed	Status
Netflix	Video Streaming	Streaming	Assessment/ Refund Claim	June 2018	Superior Court rejected motion to dismiss; awaits 2020 trial
ADP	HR, Payroll, etc.	SaaS	Refund Claim	May 2018	Superior Court rejected motion to dismiss; awaits 2020 trial
GoDaddy	Web hosting & securing	Web hosting	Assessment	Feb 2019	Awaits Superior Court ruling on motion to dismiss
NuOrder Technologies	Web API, food orders	SaaS	Class-Action/ Refund Claim	Nov 2018	Referred to a mandatory settlement conference

Relevant Case Law

- Remotely accessed software is not tangible personal property (TPP)
  - *State v. Jones:* Jukebox usage is a retail transaction because music is TPP
  - Plaintiffs: *Jones* wrongly decided and AZ Supremes must re-analyze
- Plaintiffs: Even if this software is TPP, these services are not rentals
  - *State v. Peck:* Coin-op laundry is taxable because user has exclusive use & control
  - *Energy Squared v. ADOR*: Tanning salons are not rentals because user does not have exclusive control of machine
  - *Jones v. ADOR:* Billboards aren't rentals because user doesn't have exclusive use or exclusive control

Phoenix v. Orbitz

- Supreme Court decision in favor of CoP
- Online Travel Company (OTC) fees are subject to city TPT
  - Under MCTC, OTCs are "persons" because they are a "broker" of a hotel; therefore are in the business of hoteling
  - Owe city TPT on gross proceeds of all amounts, OTC fees not exempt
- Court made clear *all* travel agents are subject to TPT if they're booking services (as opposed to negotiating prices for customer)
- Taxpayer victory: Model Code & A.R.S. bars taxation under a new policy, procedure, or interpretation under a city has both adopted the change and provided impacted taxpayers with notice of that change

Section V of *Orbitz* Ruling

"MCTC § 542(b) provides that if a city "adopts a new interpretation or application of any [MCTC] provision . . . or determines that any provision applies to a new or additional category or type of business and the change in interpretation or application is not due to a change in the law," then the city "shall not assess any tax, penalty or interest retroactively based on the change in interpretation or application." (¶ 35)

- Phoenix position appeared to be a new *application* and SC said a lower court must decide when taxpayers were properly notified
- Created a "formal and clear notification" test
  - Adds teeth to previous rulings with similar calls for taxpayer awareness/transparency
  - *APS v San Luis* (2017), *Duham v. State Tax Comm* (1947), *State Tax Com v. Staggs* (1959)
- Strongly suggests ADOR Private Letter Rulings would be insufficient

Carter Oil v. ADOR

- Whether dyed diesel fuel qualifies as machinery & equipment in mining; and thereby exempt from retail TPT
- *ADOR v Capitol Castings* (2004) created 4-part test
  - 1/4: Is the M&E part of a "integrated synchronized system"?
  - Found that silica sand was "equipment"
- State law does not exempt "expendable materials" however a statutory exemption exists "regardless of the cost or the useful life of the property" (*Chevron*)
  - *Chevron v. ADOR (2015): oils* & greases are exempt equipment
  - *Empire Southwest v. ADOR:* truck delivering diesel fuel to exempt machinery is also exempt equipment
- ADOR is appealing Tax Court ruling

Vangilder v. Pinal County

- Tax court ruled Pinal transportation TPT was illegal
- Prop 417 only applied to retail sales
  - "…failed to include 'each person' engaging in a taxable business"
- Tax Court did not rule on "variable/modified" $10K challenge
  - Tax was excluded on proceeds over $10,000 for single item
  - County tax base is a statutory tax base
  - ADOR argued the $10K "base division" is inconsistent with state law
- Court of Appeals hearing was Sept 2019
- Taxes on all classifications have been collected despite lawsuit on order of Pinal County and held in escrow

Englehorn v. City of Phoenix

- Lawsuit challenging legality of GPLET property tax incentives
  - Derby Roosevelt Row micro apartments to receive GPLET
  - 8 year property tax abatement + 17 years of excise taxes instead of higher property taxes
- Tax Court allowed 3 challenges to proceed, dismissed 3
  - Gift Clause, Conveyance to Evade Taxation, Arbitrary & Capricious Blight Designation

State of AZ v. ABOR

- AZ AG challenging ASU/ABOR ground lease for an Omni Hotel
  - Design of lease shields commercial development from property taxation
  - State own land is not taxable
  - Private improvements on them *are* taxable; but not if ASU takes title
- GPLET doesn't apply because it's only for cities, counties, special districts
- Superior Court dismissed most challenges
  - "Short of selling the fee interest outright to a non-exempt party, nothing the Board does with the land can affect its exemption."
- Allowed a constitutional "gift clause" violation to proceed
- Vehicle for *McFate* challenge at Supreme Court
  - Does AG need specific legislative authority to sue a state agency?
  - Who enforces state law if AG cannot?

Major Tax Issues

- 2019 Recap
- Property Tax: Assessment ratio reform?
- Sales: Wayfair issues & Digital update
- Income: Conformity recap & future issues

Arizona's Classification System

Class	Description	Assessment Ratio
1	Commercial, Industrial, Utilities & Mines	**18%**
2	Agricultural & Vacant Land	**15%**
3	Owner-occupied Residential	**10%**
4	Rental Residential	**10%**
5	Railroad, Private Car, Airline Flight	**14%**
6	Residential Historic, Enterprise & Foreign Trade Zones	**5%**
7	Commercial Historic	**1%**
8	Rental Residential Historic	**1%**
9	Possessory Interests, leased property to certain nonprofits	**1%**

Including Arizona, only 16 states assess business property at a higher ratio than residential.

Assessment Ratio History

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Class 1	25%	24.5%	24%	23%	22%	21%	20%	20%	19.5%	19%	18.5%	18%
Class 2	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	16%	15%
Class 3	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Class 4	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Class 5	21%	22%	21%	20%	18%	17%	15%	15%	15%	15%	15%	15%
Class 6	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
Class 7	25%	24.5%	24%	23%	22%	21%	20%	20%	19.5%	19%	18.5%	18%
Class 8	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Class 9	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%

Note: Assessment ratios remain the same since tax year 2016.

Assessment Ratio Equity

- Considerable success:
  - 2005 Legislation: 10-year phase down in class one assessment ratio to 20%, combined with property tax reductions & increased homeowner rebate
  - 2007 Legislation: accelerated reduction to six years-assessment ratio reduced to 20% by 2011
  - 2011 Legislation: reduced the assessment ratio on class one from 20% to 18% in half-percent increments beginning in 2013, coupled with increased homeowner rebate

2018 Effective Tax Rates (ETRs)

Class	Total Taxable Full Cash Value	Percent of Total	Total Yield	Percent of Total	Effective Rate
1	138,013,477,255	21.00%	2,630,270,421	35.62%	1.91%
2	26,347,136,096	4.01%	347,567,592	4.71%	1.32%
3	325,896,375,478	49.59%	2,819,142,347	38.18%	0.87%
4	158,515,317,080	24.12%	1,503,258,898	20.36%	0.95%
5	2,386,963,698	0.36%	37,855,143	0.51%	1.59%
6	5,379,965,599	0.82%	40,171,831	0.54%	0.75%
7	59,044,881	0.01%	746,934	0.01%	1.27%
8	21,588,701	0.00%	238,544	0.00%	1.10%
9	559,323,190	0.09%	4,339,363	0.06%	0.78%
Total	**657,179,191,978**	**100.00%**	**7,383,591,073**	**100.00%**	**1.12%**

Assessment Ratio Tax Shifts

2018 Effective Tax Rates

Class	Type	Total Levies	Effective Rate	Assessment Ratio Tax Shift
1	Business, industrial, telecomm, utility, mines	2,630,270,421	1.91%	$ (828,621,033)
2	Agricultural, vacant land, golf courses, nonprofits	347,567,592	1.32%	$ (70,989,424)
3	Owner occupied residential	2,819,142,347	0.87%	$ 569,379,927
4	Rental residential; nonprofit residential	1,503,258,898	0.95%	$ 272,914,792
5	Railroads & flight property	37,855,143	1.59%	$ (2,142,189)
6	Historic prop; FTZ; enviro tech; (more)	40,171,831	0.75%	$ 43,822,008
7	Comm historic property	746,934	1.27%	$ 279,723
8	Rental residential historic property	238,544	1.10%	$ 240,188
9	Possessory interests; leased churches	4,339,363	0.78%	$ 24,085,429
Total		7,383,591,073	1.12%	

Tax shifts resulting from Assessment Ratios are measurable & substantial

Before/After Ratio Changes

Class	Type	2005 Effective Rate	2018 Effective Rate	Percentage Change in ETR
1	Business, industrial, telecomm, utility, mines	2.66%	1.91%	-28%
2	Agricultural, vacant land, golf courses, nonprofits	1.53%	1.32%	-14%
3	Owner occupied residential	0.96%	0.87%	-10%
4	Rental residential; nonprofit residential	1.13%	0.95%	-16%
5	Railroads & flight property	2.30%	1.59%	-31%
6	Historic prop; FTZ; enviro tech; (more)	0.57%	0.75%	30%
7	Comm historic property	1.78%	1.27%	-29%
8	Rental residential historic property	0.85%	1.10%	30%
9	Possessory interests; leased churches	0.07%	0.78%	963%
Total		1.37%	1.12%	-18%

Reductions in Class 1 Assessment Ratio did not increase ETRs elsewhere

National Rankings

Total State & Local Property Taxes

Property Tax Collections-State & Local FY 2015				
	Per Capita		Per $1,000 of Income	
State	**Amount**	**Rank**	**Amount**	**Rank**
ARIZONA	**$1,036.43**	**35**	**$27.17**	**34**
U.S. Average	***$1,518.41***		***$32.55***	

Minnesota 50-State Property Tax Comparison Study

Phx El/Phx Union/City of Phx ($15.6494/$17.5067)

Residential Property Taxes
Payable 2018
$300,000 Land and Building

Rank	State	NET TAX	ETR
25	Arizona	$3,817	1.272%
	U.S. Average	*$4,386*	*1.462%*

Industrial Property Taxes
Payable 2018
$25,000,000 Land & Building
$12,500,000 Machinery & Equipment
$10,000,000 Inventories $2,500,000 Fixtures

Rank	State	NET TAX	ETR
6	Arizona	$1,127,592	2.255%
	U.S. Average	*$727,085*	*1.454%*

Statewide Average Tax Rate ($10.83/$12.62)

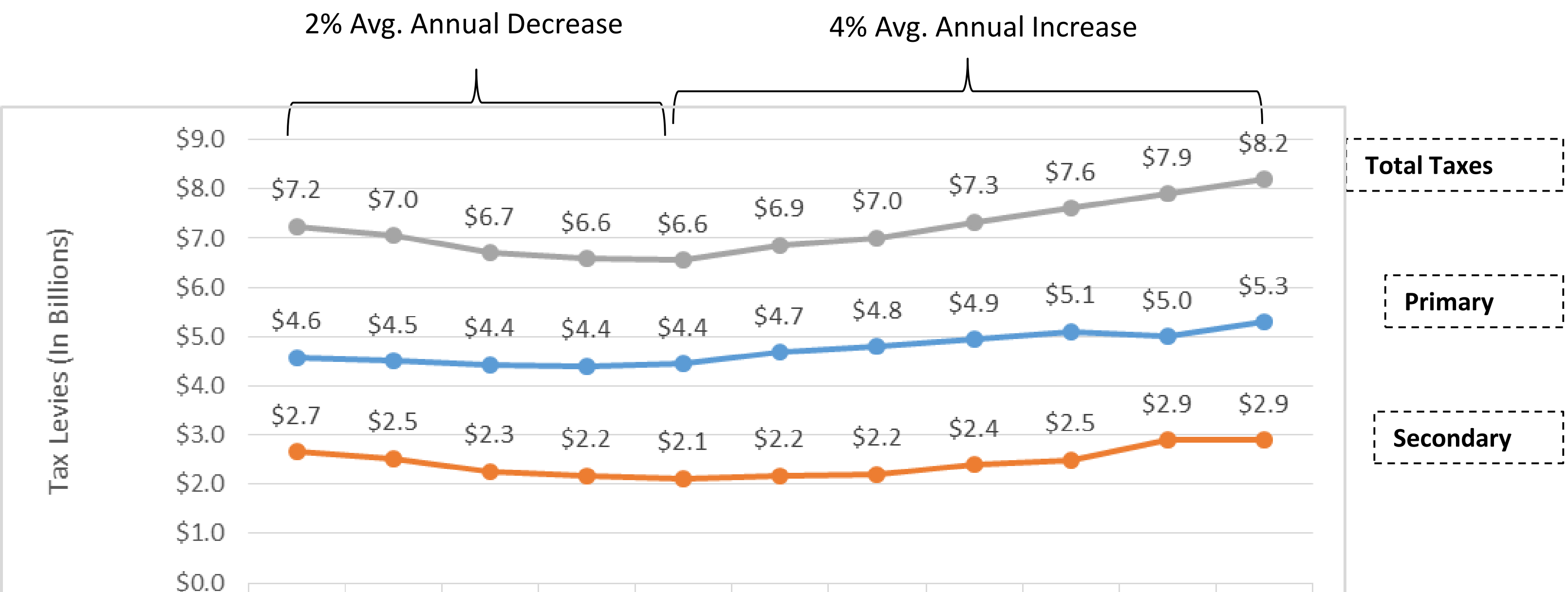
Residential Property Taxes
Payable 2018
$300,000 Land and Building

Rank	State	NET TAX	ETR
36	Arizona	$3,249	1.083%
	U.S. Average	*$4,386*	*1.462%*

Industrial Property Taxes
Payable 2018
$25,000,000 Land & Building
$12,500,000 Machinery & Equipment
$10,000,000 Inventories $2,500,000 Fixtures

Rank	State	NET TAX	ETR
22	Arizona	$788,603	1.577%
	U.S. Average	*$727,085*	*1.454%*

10-Year Property Tax Levies



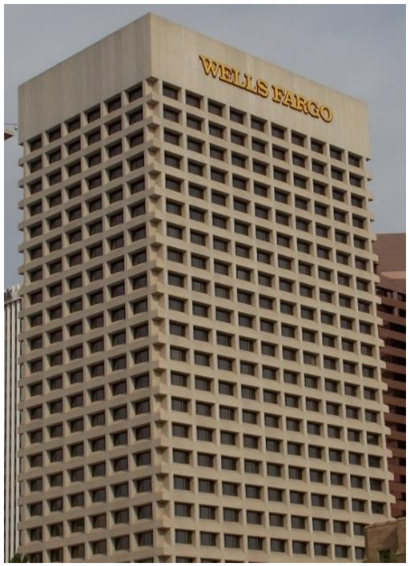
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Primary	$4.6	$4.5	$4.4	$4.4	$4.4	$4.7	$4.8	$4.9	$5.1	$5.0	$5.3
Secondary	$2.7	$2.5	$2.3	$2.2	$2.1	$2.2	$2.2	$2.4	$2.5	$2.9	$2.9
Total	$7.2	$7.0	$6.7	$6.6	$6.6	$6.9	$7.0	$7.3	$7.6	$7.9	$8.2

Tax Year

Statewide Average Tax Rates

	Tax Year 2019	
	Primary	Secondary
School districts	3.81	2.26
Counties	1.92	0.49
State	0.50	0.00
Cities & Towns	0.55	0.56
Community Colleges	1.26	0.13
Special Districts	0.00	0.93
Statewide Average	**8.05**	**4.37**
Total	**12.41**	

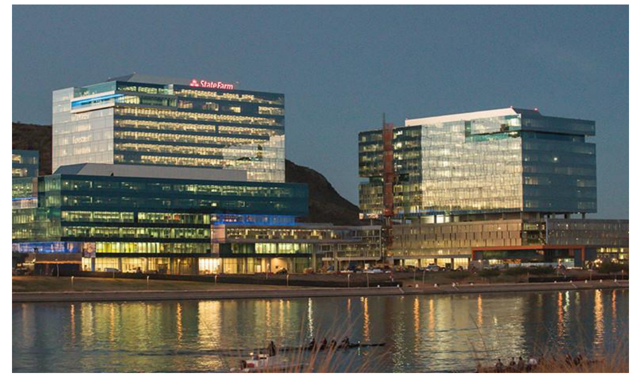
Policy Choice: Reform vs. Targeted Tax Breaks
GPLET & University Leasing



Wells Fargo
$1M in 2016

Collier/BofA
GPLET

MARINA HEIGHTS/TEMPE



SKYSONG/SCOTTSDALE

New Statewide Property Tax Would Be Damaging

- Would reverse previous reforms that reduced the effective tax rates on business property

- Increase 1% cap costs that impact state general fund

Quick Recap: What Happened w/Wayfair?

- SCOTUS ruled in *S.D. v. Wayfair* June '18
- Overruled 26 yr *Quill* standard
- Theme was: technology will help businesses manage other states' systems
- Court applauded simplicity of S. Dakota's model: warned that other states may create undue burdens
- SCOTUS essentially blessed South Dakota's model as complying with a *substantial* nexus requirement but did not create a new legal standard: ergo each state gets to test their system

ATRA's Recommendation

- ATRA historical position: Internet should not be a tax free zone for **tangible personal property** sold online
- ATRA Wayfair principals:
  1. AZ **needs a law** to tax remote sellers. ATRA will oppose attempts to simply establish economic nexus through ADOR rule/policy ✓ **HB2757**
  2. AZ's law should be **fair and administrable** to sellers, purchasers, and state government ✓ **Uniform retail statewide base; requirements on ADOR to assist taxpayers**
  3. AZ's law should be consistent with the SCOTUS decision and **avoid litigation** to the greatest extent possible ✓ **Some simplification; small biz exemption; no retroactivity**
  4. The increased tax collections should be clearly **acknowledged** by state and local governments ✓ **Projected State GF revenues leveraged for income tax reform**

What Happened?

- ATRA pushed for a Study Committee
  - Leg declined, wanted to move
- Most states rush to tax
  - remote sellers
  - marketplace facilitators
- Estimated $33B on the table
- AZ estimate:
  - $200M-$300M in new state, county, local revenues (GAO)
  - $85M to state GF (JLBC)

What did AZ do?

- HB2757 created economic nexus & marketplace facilitator (MF) laws
- Phased in small business exemption: $100K in sales = *economic* nexus
- Delayed to Oct 1, 2019 for both MF and remote sellers
- Preempted all cities on retail base, first time in state history
- Cities will no longer be able to independently change their retail base
  - Instead of unique base at 91 cities + state, there is 1 uniform tax base (with a few exceptions)
  - Applies to all sales, not just remote sellers

What SCOTUS liked about South Dakota *in Wayfair*	New Arizona law in HB2757
✓ No retroactive tax collection on remote sellers	✓ No retroactive tax collection on remote sellers
✓ Small business exemption	✓ Small business exemption: 100K in sales
✓ Membership in Streamlined Sales & Use Agreement	✗ AZ not a member of SSUTA
✓ Uniform base for state and localities	✓ Uniform retail base*
✓ State level administration of all sales/use tax	✓ AZ passed state level admin in 2013
✓ Rate simplification	✗ Cities have varying rates between classes
✓ No caps or thresholds	✗ Cities maintain tiered/blended rates
✓ Free software provided for sellers for admin	
✓ Simplified administration & standardized rules	

Wayfair/City Retail Preemption

- Preempts cities & towns on Retail base, with toggles to levy tax on:
  - **Food** for home consumption, **textbooks**, sales of **fine art sold at auction** or gallery
  - **Motor vehicle to a nonresident** of this state if resident state doesn't allow a corresponding use tax exemption, a special 90-day nonresident registration permit was secured, or an enrolled member of an Indian tribe who resides on the reservation, except if the vehicle is received on the reservation
  - Cities may exempt **fine art** sold by the original artist
  - 4 **agricultural** related issues, 3 of which expire in two years

Good News

- Arizona did this fairly methodically, used lessons from other states
- Executive & Leg leadership demanded good policy
- Fairness for brick and mortar businesses (tax equity)
- Secured a major reform with localities on retail uniformity
- State gave GF *Wayfair* money back to taxpayers

Bad News: Struggle for Small Businesses

- Compliance with remote seller laws is chaotic at best
  - Federal intervention could help create standards, alleviate compliance burdens
  - Congress seems highly unlikely to address issue; every state has its own agenda
- Driving enormous compliance expenses, time burdens, add'l staff requirements
  - Options are: pay to comply, hide, or join a marketplace facilitator, leave market
  - DORs nationwide are reacting rapidly & aggressively to boost collections
  - Small taxpayers receiving threatening letters, demands for back taxes, allegations of unpaid taxes
- Notion that software solves these challenges was incomplete
  - APIs for purchasing platforms are not working seamlessly
  - Free software is completely unreliable; purchased software has bugs; businesses must QC each sale

Digital Goods & Services

- ATRA & the business community's effort to create clarity in this area failed in the 2018 & 2019 session
  - Message received: policy leaders didn't want something that would be described by ADOR & spending lobby as a tax cut
  - Some policymakers want to tax digital services like cloud storage, SaaS, IaaS
  - Some policymakers thought it went too far: ie, didn't like the proposal to make all streaming content taxable
- Without a legislative fix, it will be left to courts
- Prop 126 complicates: no new service taxes after 1/1/18
- Prop 108 implications: 2/3 vote requirement to increase taxes

Income Tax Conformity

- No law governing tax base for 2018 taxes; ADOR had assumed conformity
  - ATRA warned AZ needed a law in 2018; at latest a law in early 2019
  - Looming crisis
- Governor Vetoed first effort
  - Bill shaved tax rates slightly to give back revenue increased from tax year 2018 due to base expansion in Tax Cuts & Jobs Act
  - Governor wanted to use 2018 revenues, negotiate on future years
- HB2757 arrived late in session, combined Wayfair with Conformity
  - Used 2018 revenues from base expansion to pay off recession-era debt
  - Debt payoff created $24M in ongoing budget capacity
  - Net result of HB2757 was a revenue impact of ($24M)

Tax Omnibus Details

New Brackets

Single or Married Filing Separately		Married Couple or Head of Household	
Taxable Income	**Tax**	**Taxable Income**	**Tax**
$0-$26,500	2.59% of taxable income	$0-$53,000	2.59% of taxable income
$26,501-$53,000	$686, plus 3.34% of the amount over $26,500	$53,001 - $106,000	$1,373, plus 3.34% of the amount over $53,000
$53,001-$159,000	$1,571, plus 4.17% of the amount over $53,000	$106,001- $318,000	$3,143, plus 4.17% of the amount over $106,000
$159,001 and over	$5991, plus 4.50% of the amount over $159,000	$318,001 and over	$11,983, plus 4.50% of the amount over $318,000

Old Married Filing Joint Brackets

$0-$20K: 2.59%
$20K-$50K: 2.88%
$50K-100K: 3.36%
$100K-300K: 4.24%
$300 on up: 4.54%

Tax Omnibus Proposal Ongoing Impact

	Impact
Revenue Additions	
Conformity	$217
Wayfair	85
Eliminate Personal/Dependent Exemptions	354
Eliminate Lottery Winning Subtraction	0.1
Total, Additional Revenue	**$656**
Revenue Subtractions	
Increase Standard Deduction	(404)
Dependent Tax Credit	(144)
Bracket/Rate Reduction	(108)
25% Charitable Deduction	(24)
Total, Reduced Revenue	**($680)**
Net Ongoing Impact	**($24)**

Source: JLBC

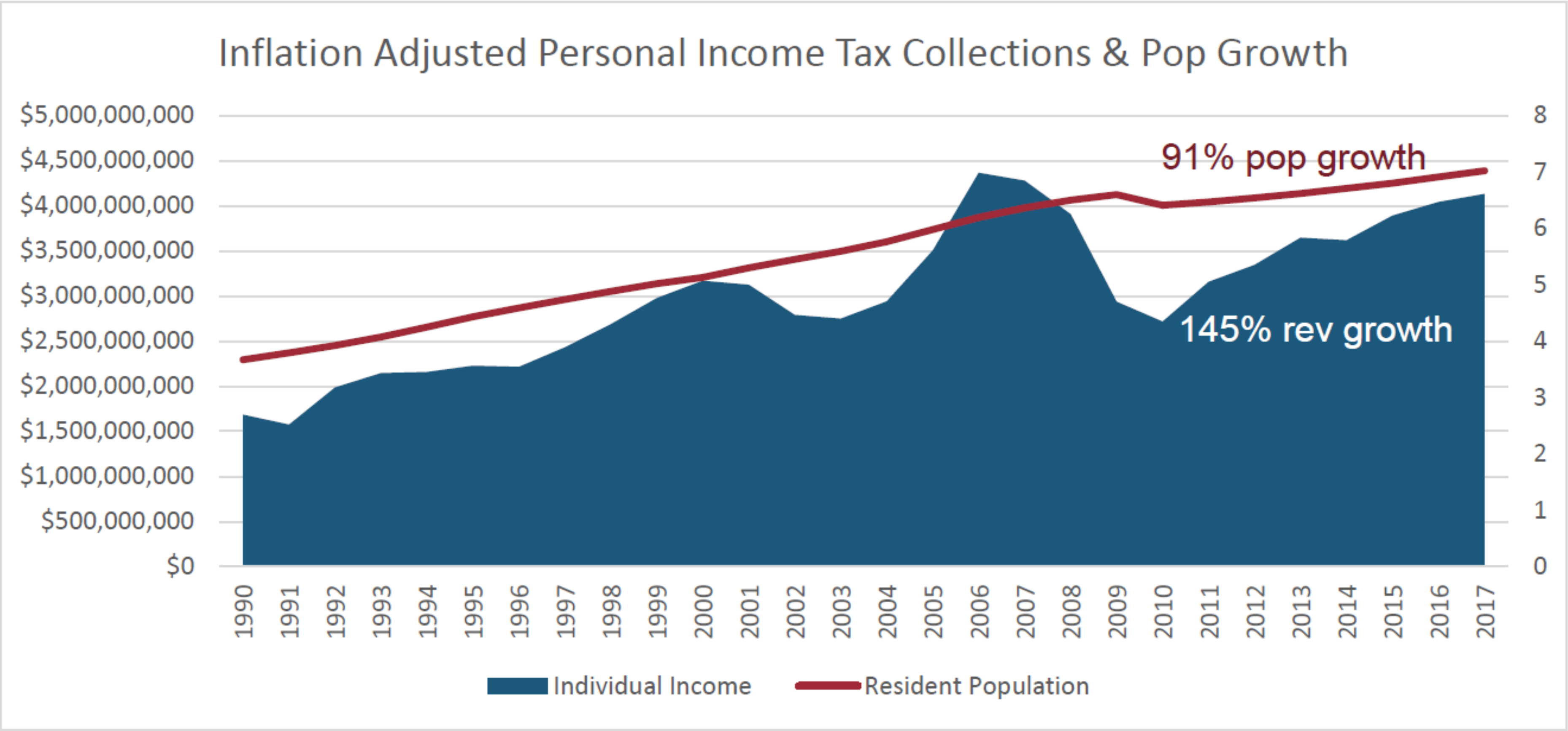
Tax Omnibus Highlights

- Conformed AZ to new federal tax law changes (TJCA)
- Reduced personal income tax rates slightly
- Reduced tax brackets from 5 to 4
- Matched federal standard deduction ($12K/$24K)
  - Far fewer Arizonans will itemize
  - Eliminated personal/dependent exemptions
  - Created a dependent tax credit

Hiking the Income Tax

- Continued calls for Income Tax Hikes
  - Usually on higher incomes
  - Sometimes combined with other tax increases
- Worth recalling AZ used to have uncompetitive income tax rates
  - Had a top marginal rate of 7% through early 90's
  - Collected $400 less per capita in real dollars than today (all state and local taxes)
- AZ personal income tax revenue growth outpaced population and inflation between 1991-2017 by 60%
- At low rates, AZ income taxes produce 1/3 of state revenues
- AZ system charges essentially zero for low incomes, small amounts on middle earners and modest rates on higher incomes

AZ Income Taxes Over Time



AZ Continues to be a Destination State

- AZ went from < 500 millionaire filers to 6,500 from ’91-’17
  - Includes persons and businesses filing under IIT
  - Went from paying $101M in ‘91 to $700M in ‘17 (in 2017 dollars)
- Wealthy nonresident filers have flocked to AZ (paid $100M in ‘17)
- Tax hike on upper brackets will change migrant calculus
- Study: estimated 10% of high income migrants won’t migrate here + 10% existing high income filers would leave if top bracket grows 100%.
- Doubling top bracket would give AZ the largest gap between highest and lowest tax brackets, which is an improper balance of tax burden

Single Revenue Sources to fix Problems

- Restricted dollars from a single source make spending tricky
- Admins would first have to wait to see what $ was available
  - Payouts would largely have to be in form of a bonus
  - Would not raise base pay of teachers, other employees
- Top bracket income tax is very volatile
  - Cratered 32% during the recession
    - Capital gains drop dramatically
    - Business income suffers
  - Next recession would be a huge hit to fund beneficiary

Comparing Taxes Collected to Personal Income?

- Groups making the argument taxation is low from this perspective
  - Comparing revenues collected against personal income
  - Implying government should grow evenly with the economy or wealth in AZ
- If Gov't is supposed to protect, enable, & fuel, why should size of government grow with the total wealth in the economy?
- It's true that State GF collections over personal incomes are down
  - Presently: 3.3%, down from 4.9% in 1994
  - Ignores growth in non-appropriated such as P301 & local govt spending
  - Only personal income taxes will track growth in personal incomes
  - Rise in personal income won't necessarily increase property/sales taxes
  - People tend to buy more services as wealth increase, some of which aren't taxable
- Better question: does gov't have enough to provide services?
- Better measure: spending adjusted for services provided & inflation

Arizona Tax Research Institute 2019 Outlook Conference

November 14, 2019

Nikki Dobay
Council On State Taxation Sr. Tax Counsel

Rapid Enactment of *Wayfair* Legislation

South Dakota v. Wayfair, 138 S.Ct. 2080 (2018)

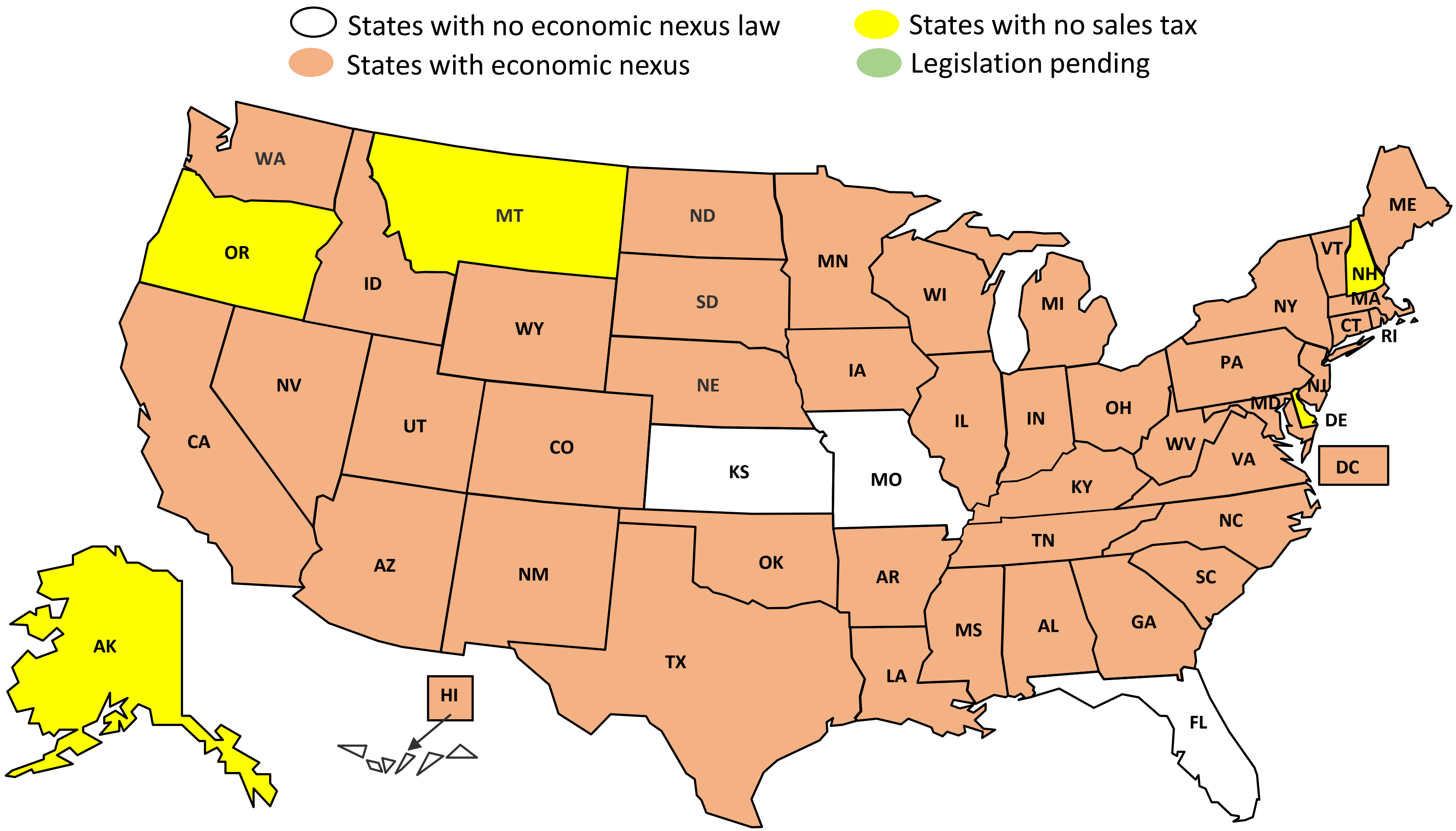
The U.S. Supreme Court issued its decision in *Wayfair* on June 21, 2018, overturning *Quill* and its "physical presence" nexus standard.

- New test for sales and use tax nexus is "economic or virtual" presence.

Case was remanded (ultimately settled) to address whether South Dakota's S.B. 106 was unduly burdensome and/or discriminatory against interstate commence, however, the Supreme Court's majority noted:

- The law did not impose the tax retroactively
- It provided a small business exception
  - ➓$100,000 or 200 transaction yearly threshold
- South Dakota was a member of the Streamlined Sales and Use Tax Agreement

Sales Tax States with Economic Nexus Law



Primary Source: https://www.avalara.com/content/dam/avalara/public/documents/pdf/avalara_2019-sales_tax_changes_mid-year_update.pdf, Updated September 2019

State Reactions—Adoption of South Dakota-Style Thresholds*

Unless otherwise noted, states adopt South Dakota style threshold of $100,000/200
State "doing business" statute applies to the extent allowed under the US Constitution

AL – 10/1/2018 -- $250K plus an activity in Ala. Code § 40-23-68(b)	**ID** – 6/1/2019 -- $100K	**MO** – S.B. 189/H.B. 701/H.B. 548**	**RI**[3] – 8/17/2017
AR – 7/1/2019	**IL** – 10/1/2018	**MS** – 9/1/2018 -- $250K plus systematic solicitation	**SC** – 11/1/2018 -- $100,000 (includes marketplace sales)
AZ – 9/30/2019 -- $100K[1]	**IN** – 10/1/2018	**NC** – 11/1/2018	**SD** – 11/1/2018
CA – 4/1/2019 -- $500K	**IA** – 1/1/2019; 7/1/2019 --$100K	**ND** – 10/1/2018; 1/1/2019 --$100K	**TN** – 10/1/2019 --$500K
CO[2] – 6/1/2019 -- $100K	**KS** – 10/1/2019 – no threshold	**NE** – 1/1/2019	**TX** – 10/1/2019 -- $500K
CT – 12/1/2018 -- $250K & 200 ($100K/200 beg. 7/1/2019)	**KY** – 10/1/2018	**NJ** – 11/1/2018	**UT** – 1/1/2019
DC – 1/1/2019	**LA** – 7/1/2020	**NM** – 7/1/2019 -- $100K	**VA** – 7/1/2019
FL – S.B. 1112** S.B. 126 prefiled	**MA** – 10/1/2019 -- $100K	**NV** – 10/1/2018	**VT** – 7/1/2018
GA – 1/1/2019 -- $250K/200 (collect or report); ($100K/200 beg. Jan. 1, 2020)	**MD** – 10/1/18	**NY** – 6/21/2018 -- $500K & 100	**WA**[4] – 10/1/2018
HI – 7/1/2018	**ME** – 7/1/18	**OH** – 8/1/2019	**WI** – 10/1/2018
	MI – 10/1/2018	**OK** – 07/01/2018 -- $10K (collect/notice); 11/1/2019 -- $100K	**WV** – 1/1/2019
	MN – 10/1/2018 -- $100K in 10 transactions/100 transactions ($100K/200 beg. 10/1/2019)	**PA** – 4/1/2018 -- $10K (collect/notice); 07/1/2019 -- $100K	**WY** – 2/1/2019

[1] The threshold is $200,000 for 2019, $150,000 for 2020, and $100,000 beginning in 2021 and beyond.
[2] Effective December 1, 2018 with grace period until May 31, 2019 for collection requirement (not for notice requirement); threshold from December 1, 2018 to April 13, 2019 was $100K/200.
[3] Collection/notice requirements until June 30, 2019; collection requirement after July 1, 2019.
[4] Collection required for $100K/200 threshold effective October 1, 2018; 200 transaction threshold eliminated effective March 14, 2019.

State Reactions—Simplification

Alabama Simplified Sellers Use Tax Program

- Provides for an elective 8% flat rate for all sales into the state

Colorado HB 1240

- Provides for destination-based sourcing.

Idaho

- Remote seller nexus law does not impose requirement to collect local sales tax

Louisiana

- Newly-created Sales and Use Tax Commission for Remote Sellers will serve as single, state-level tax administrator for remote sellers

Texas HB 2153

- Allows marketplace sellers to collect using a single local tax rate of 1.75 percent, effective October 1, 2019

Streamlined Sales Tax

Although no additional states have joined the Streamlined Sales and Use Tax Agreement since *Wayfair*, Connecticut, Illinois, New Mexico and Pennsylvania have recently authorized use of Certified Service Providers.

The SST Governing Board is working to adopt policies to encourage non-SST states to use its centralized registration and simplified electronic return system.

Other Reactions

Eliminating Transaction Threshold

- **California** (A.B. 147 enacted): From \$100K/200 to \$500K
- **Iowa** (S.F. 631/H.F. 779 proposed): From \$100K/200 to \$100K

Payment Processors Must Collect and Remit

- **Massachusetts** (Governor's proposed budget) (real time collection)
- **Missouri** (H.B. 648 proposed)

Expanding Nexus for Other Taxes

- **Hawaii** (S.B. 495 enrolled to Governor): Creates an income tax economic nexus threshold of \$100K/200.
- **Utah** (S.B. 28 enacted): Expands Utah's corporate income tax "doing business" definition to include "selling or performing a service" in the state and "earning income from the use of intangible property" subject to certain limitations.

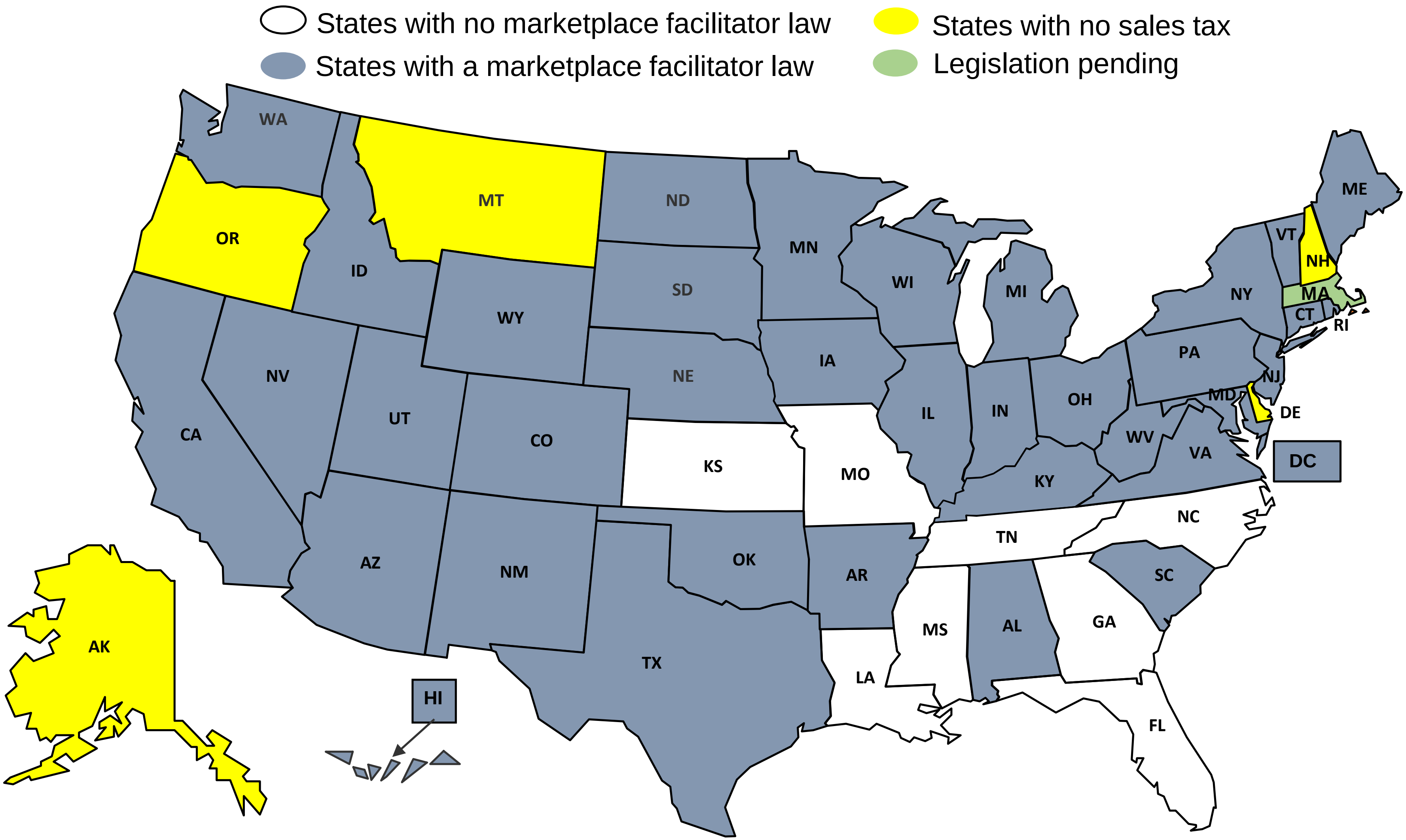
Watch Out for Localities

- **Arizona** (H.B. 2702 proposed): Allows locality to levy transaction privilege, sales, use, franchise or other similar tax or fee on a person that is not a marketplace seller, and that is engaging or continuing in business in Arizona.
- **California** (A.B. 147 enacted): Sellers are required to collect local use taxes once the seller exceeds \$500K of sales into the state.

Who Should Collect the Tax?

- Sales taxes are typically collected by the seller, just as personal income taxes are withheld and reported by an employer—to put the administrative burden on the party most able to bear it (the seller or employer versus the customer or employee).
- But what about when a marketplace facilitator is involved in the transaction?
- Is this similar to a sale for resale—where the final seller collects the tax?

Marketplace Facilitator Laws



Issues Identified by MTC Work Group

- Definition of marketplace facilitator/provider
- Who is the retailer?
- Remote seller, Marketplace seller, marketplace facilitator/ provider recordkeeping, audit exposure and liability protection
- Marketplace seller-marketplace facilitator/provider information requirements
- Collection responsibility determination
- Marketplace seller economic nexus threshold calculation
- Remote seller sales/use tax economic nexus threshold issues
- Certification requirement
- Information sharing
- Taxability determination
- Return simplification
- Foreign sellers
- Local sales/use taxes

Addressing the Issues – Need for Uniformity

NCSL Work Group Draft Model Legislation –

Overview of Topics

Remote Seller Nexus Thresholds

- Dollars
- Transactions
- Application to other taxes

Marketplace Laws

- Definitions
- Exclusions & waivers
- Liability & Liability Relief
- Reporting tax
- Lawsuit protection
- Miscellaneous Provisions

NCSL Model Language – Nexus Threshold

- If a [seller], the [seller] makes sales of tangible personal property [and/or other property or services subject to sales or use tax in the State] for delivery into this state exceeding [100,000] dollars.

- If a [marketplace facilitator], the [marketplace facilitator] makes or facilitates the sale of tangible personal property [and/or other property or services subject to sales tax in the State], on its own behalf or on behalf of one or more marketplace sellers, for delivery into this State exceeding [100,000] dollars.

What about other taxes?

- Focus has been on sales/use tax collection but what about other taxes
  - Telecom fees such as 911 charges
  - Environmental fees such as paint/oil
  - Tire fees
- Should marketplace seller be liable for other taxes/fees, or should the facilitator be liable?
- Should the model address this?
- Income taxes – are thresholds needed?

What about other taxes?

- The communications companies recommended requiring marketplaces to collect other transactions taxes and fees in addition to sales and use tax.

- To date, no state has implemented marketplace collection of other taxes and fees, although Washington State has adopted a statute which would require such collection in 2020.

NCSL Model Language – Marketplace Facilitator Definition

- "Marketplace facilitator" means a person, including any affiliate of the person, that:
  - Contracts or otherwise agrees with marketplace sellers to facilitate for consideration, regardless of whether deducted as fees from the trans-action, the sale of the marketplace seller's products through a physical or electronic marketplace operated, owned, or otherwise controlled by the person; and,
  - Either directly or indirectly through contracts, agreements or other arrangements with third parties, collects the payment from the purchaser and transmits all or part of the payment to the marketplace seller.

NCSL Model Language – Exclusions

- Substantially all sellers registered
  - Discretionary waiver where marketplace facilitator can show substantially all sellers are already registered and collecting tax
- Large Seller Waiver
  - Allows marketplace facilitator and certain large marketplace seller to contractually agree to have marketplace seller collect
    - Applies only to very large taxpayers doing business everywhere
- Ads, Payment Processors & CFTCs
- Hotel/Lodging Vendors
  - Potentially others as well

Marketplace Facilitator Exclusions Issues

- Should more or less flexibility be given for the exclusions to the state tax/revenue departments?
- Are any of the exclusions problematic?
- What about food deliveries? Car rentals?
- What documentation is needed for facilitator/seller to claim an exclusion?
- Audit concerns?
- Will exclusions be timely granted/provided?

NCSL Model Language – Marketplace Facilitator Liability & Liability Relief

- If the marketplace facilitator is required to collect the tax, then
  - The marketplace facilitator should have the same rights and duties as a seller
  - The Department should only audit and assess the marketplace facilitator
- Liability relief (for the tax) where:
  - A marketplace facilitator can receive liability relief where the marketplace facilitator can show the error was due to incorrect or insufficient information given to the marketplace facilitator by the marketplace seller
  - A marketplace facilitator can proof the tax was paid by the marketplace seller
- Relief of penalty and interest waiver for reasonable cause—by rule

Marketplace Facilitator Tax Reporting - Issues

- Should there be two options for facilitators?
- Should marketplace sellers also have to do some reporting?
- How are those sales tracked/noted as subject to collection by marketplace facilitators?

Marketplace Facilitator Lawsuit Protection - Issues

- Is it needed?
- Should it include marketplace sellers? All sellers?
- States that allow tax false claims acts, should that also be addressed?

COST’s 2020 Legislative Initiatives to Improve State Tax Administration

COST's 2020 Legislative Initiatives to Improve State Tax Administration

- **Ensuring State return due dates are at least one month after the federal deadline**
  - Worked with AICPA and TEI in getting penalty relief for late filing in 2018 and 2019
- **RAR Improvements, including partnership audit adjustments**
  - Working with 'interested parties' to encourage states to enact MTC Model Statute

Extending State Corporate Income Tax Filing Deadlines to At Least One Month After the October 15 Federal Extended Filing Deadline

- In at least 22 states, Corporate taxpayers face simultaneous federal and state extended return deadlines on October 15.
- For the past two years COST, AICPA, and TEI have asked tax administrators in these states to provide penalty relief for late return filing if returns are filed within one month of the federal due date.
- While we appreciate the states' willingness to cooperate with such ad-hoc efforts to alleviate the administrative burden imposed by the coinciding deadlines, a permanent fix to this recurring issue is both preferable and possible through state legislation by changing state extended filing deadlines to automatically fall at least one month after the federal extended deadline.
- We hope to work closely with tax administrators, our members, and in-state partners to address this issue.

Improving the Process for Taxpayers to Report Federal Audit Changes and Addressing New Federal Partnership Audit Procedure

- In 2003, the Multistate Tax Commission (MTC) first issued model legislation for states to uniformly address the reporting of federal adjustments (*e.g.,* after an IRS audit) to a state. Unfortunately, there was no initiative at that time to push states to adopt the MTC's model.
- The MTC recently issued a new model, developed in conjunction with COST, the AICPA, and other groups, which addresses changes in how the IRS will audit and assess many large partnerships (*i.e.*, over 100 partners).
- Importantly, the new MTC model also addresses the reporting of federal adjustments for all taxpayers, not just for the new federal partnership audit regime.
- All states with corporate or individual income taxes can improve their processes for taxpayers to report federal audit changes by adopting the new MTC model.

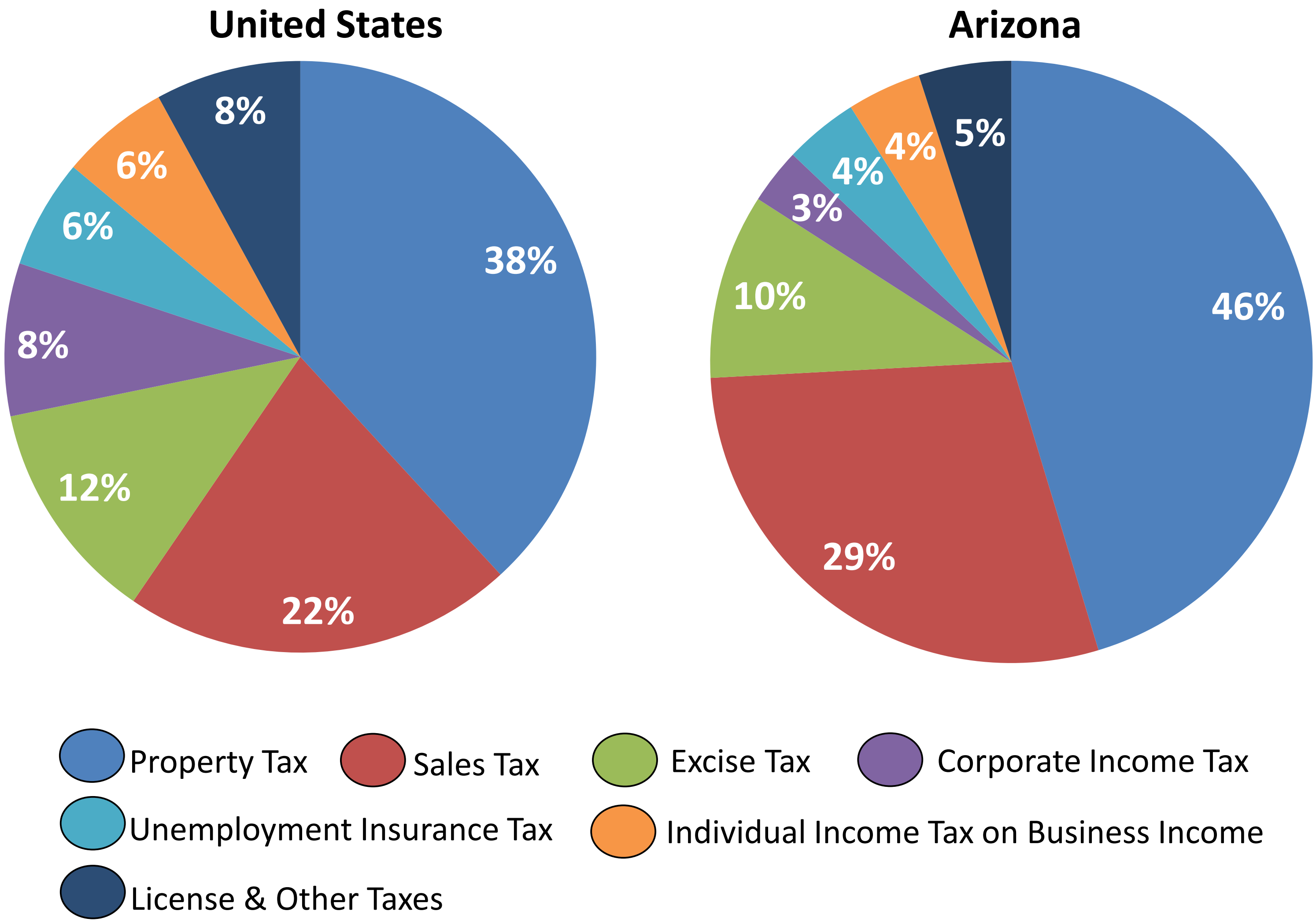
COST Business Tax Burdens Study

How Much Do Businesses Pay?

- Businesses paid more than $781 Billion in U.S. state and local taxes in FY 18, an increase of 6.1% from FY 17
- State business taxes increased by 7.1% and local business taxes grew by 5.1%
- In FY18, business tax revenue accounted for approximately 43.5% of all state and local tax revenue.
- Remarkably, the business share of SALT nationally has been within approximately **1% of 45% since FY 2003**
- Moreover, C Corporations on average pay about three-fifths more in income tax than pass through businesses
- **Severance taxes increased from $8.9 billion in FY2017 to $12.7 billion in FY2018, an increase of nearly 42.2%**.

Sources:
Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2018, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation, October 2019
COST/PWC Study, Corporate and Pass-Through Business State Income Tax Burdens, October 2017

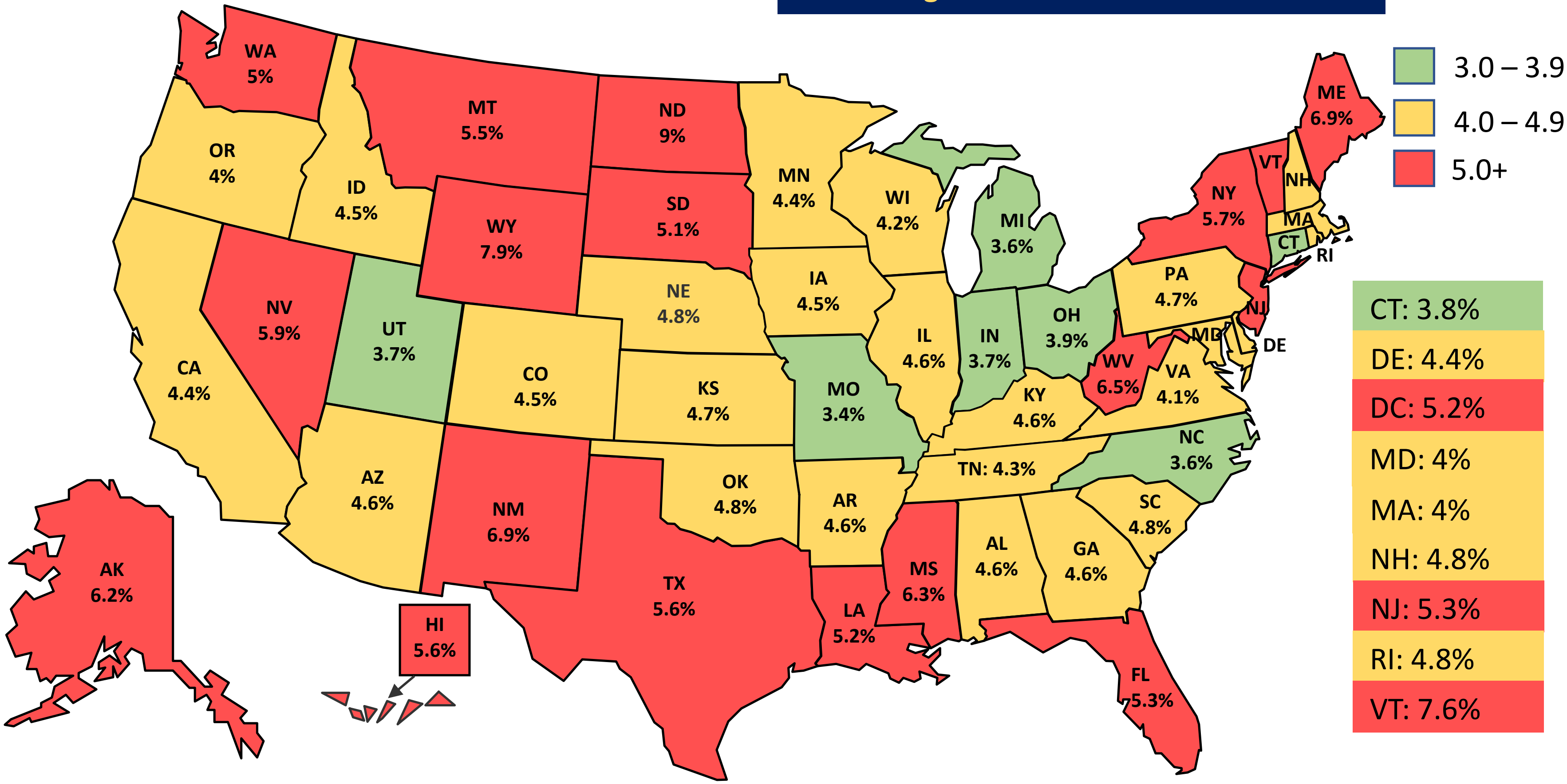
OVERALL STATE AND LOCAL TAX REVENUE



Source: Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2018, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation, October 2019

The Total Effective Business Tax Rate (TEBTR) Imposed on Business Activity by State and Local Governments (based on state GDP)

The average TEBTR across all states is 4.7%



Source: Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2018, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (October 2019)

Other Developments

California Split Roll Initiative

- 2020 California ballot initiatives that would remove Prop 13 protections for most commercial property
  - IP 17-0055
    - Qualified in 2018 for 2020 ballot
  - IP 19-0008
    - Filed August 13, 2019
    - 997,113 signatures required prior to April 21, 2020 to qualify for 2020 ballot

Oregon Corporate Activity Tax (OR CAT)—Legislation

- Oregon HB 3427 (signed May 16, 2019) created a modified gross receipts tax on all business entities with “taxable commercial activity” in excess of $1 million beginning on or after January 1, 2020
- Oregon HB 2164 (signed July 23, 2019) made technical corrections to several provisions of the tax created in HB 3427
- Effective date for both bills was September 29, 2019

Oregon CAT Overview

Starting point: “Commercial Activity” sourced to Oregon

Subtraction: 35% of the greater of COGS or labor costs--apportioned

Tax base: “Taxable Commercial Activity”

“Taxable Commercial Activity” and Rate

- Means “commercial activity” sourced to the state less the allowable subtraction
- Tax is equal to 0.57 percent of “taxable commercial activity” in excess of $1 million plus $250

Note: found in HB 3427 § 65

Portland, Oregon Retail Gross Receipts Tax

- Gross Receipts Tax on Retail Sales: Effective for tax years beginning on or after 1/1/2019, Portland imposes a 1% “surcharge on gross revenues from sales within the City, unless otherwise exempted,” on “Large Retailers”

  - Large Retailer is a “business” that:
    - Is subject to the Portland Business License Tax
    - Annual gross revenue from retail sales that exceeded $1 billion
    - Annual gross revenue from retail sales within Portland of $500,000 or more
  - Large Retailer excludes:
    - Any manufacturer or other business that is not engaged in retail sales within Portland
    - Utilities, federal or state cooperatives and credit unions

  - “Retail sale” is a sale to a consumer for use or consumption, not for resale, and includes services

Wyoming Corporate Income Tax Proposal on Large Retailers

- Started as H.B. 220 (died during the session)
- LSO-0073—National Corporate Tax Recapture Act
  - Would impose a corporate income tax at a rate of 7% on certain large taxpayers with more than 100 shareholders
    - NAICs codes removed
  - Current draft attempts to address some of technical raised during the legislative session and interim period, but continues to include significant drafting flaws
    - Includes COP and market-based sourcing provisions
    - Questionable filing group provisions
    - NOL provisions confusing at best, but likely fundamentally flawed

Questions?