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ARIZONA TAX RESEARCH ASSOCIATION

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Arizona's Highest Court Invalidates Pinal's Transportation Sales Tax

Following several years of litigation, the Arizona Supreme Court rendered Pinal County's transportation sales tax invalid. In its ruling, the Court determined that the statute that authorizes a county to levy a "variable rate" for transportation purposes does not permit the county to adopt the two -tiered rate structure proposed under Prop 417 and therefore the entire tax is illegal.

This litigation could have been avoided had Pinal County listened to the warnings from ATRA, the Goldwater Institute, and the Free Enterprise Club prior to the 2017 election.

The proponents of Prop 417 believed, at least initially, that they lacked the legal authority to levy a two-tiered tax rate under current law. During the 2017 legislative session, proponents attempted to amend the transportation sales tax statute to mimic the two-tiered sales tax rate structure that cities and towns are authorized to levy under the Model City Tax Code. ATRA and others strongly opposed the measure as it would have broken new ground by allowing the county sales tax base to differ from the state tax base, further complicating an already complicated sales tax system. Failure to move the bill through the House Rules Committee prompted the bill sponsor to request an opinion from Legislative Council, in which a staff attorney opined

Court Puts Final Nail in Prop 208

Maricopa County Superior Court Judge John Hannah issued his long awaited ruling in the legal challenge filed against Prop 208 which was passed by Arizona voters in November 2020. The Arizona Supreme Court declared Prop 208 unconstitutional in August of 2021 but remanded the case back to Superior Court to make a determination on whether the funds could be legally spent without the exemption from the K12 constitutional expenditure limit.

ATRA, along with the Arizona Chamber of Commerce, filed an amicus brief with the Arizona Supreme Court on March 22, 2021 arguing that the statutory exemption to the school district's constitutional expenditure limit was clearly unconstitutional (amicus authored by ATRA board member Otto Shill from Jennings, Strouss & Salmon). Following the Supreme Court's ruling in August of 2021, most observers expected a quick resolution to the issue on remand to Judge Hannah. Following failed attempts to expedite Judge Hannah's decision, he finally issued a ruling on March 11, 2022.

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that a two-tiered rate structure would be permissible under current law and that a statutory fix was not required after all.

In an op-ed to the Arizona Capitol Times in July 2017, ATRA warned that the county's reliance on the Legislative Council opinion was risky and officials should be concerned as to whether its position could withstand a court challenge. County officials received ample warning prior to the election that the proposed tax structure and other inconsistencies in the supporting election language may not be legal.

Immediately after Prop 417 was approved at the ballot, Goldwater filed litigation in Arizona Superior Court. In addition to questioning the legality of the two-tiered tax rate structure, Goldwater also questioned the legality of the inconsistent language between the county resolution, publicity pamphlet and the ballot question. James Busby of Cavanagh Law Firm authored an amicus brief on behalf of ATRA and The Free Enterprise Club that solely focused on the two-tiered tax rate structure.

After four years of litigation and collection of the tax, the Supreme Court provided a final ruling on March 8th in favor of taxpayers.

Acknowledging that the state and counties share the same TPT (sales tax) base in statute, the Court recognized that the sales tax is a levy on the gross volume of business activity and not on individual sales. And while the state and county rates vary among the different classifications, state statute does not contemplate a two-tiered tax structure.

The proponents argued that the undefined terms *modified* and *variable* in the transportation sales tax statute permitted the levy of a two-tiered rate. In interpreting their ordinary meaning, the court concluded that the Prop 417 two-tiered tax rate was neither *variable* nor *modified* since the rate is *fixed* and doesn't *vary* over time and there was not an existing rate that could be *modified* since this was a new tax. Furthermore, the Court cited *Ebasco* that "every interpretation shall be against exemptions from taxation statutes."

Unfortunately, the Court wasn't swayed by Goldwater's argument that the inconsistent language in the county Resolution which stated that the tax only apply to the retail classification was legally deficient. First, the Court ruled that any Resolution-based procedural challenge must be brought before an election is held. It further stated that even if the Court could allow for such a challenge, the fact that the county only provided a partial description did not render the Resolution invalid. In fact, the Court rationalized that the publicity pamphlet that included all business classifications when describing the tax provided the requisite notice.

As taxpayers await the final judgment, the Arizona Department of Revenue is in the process of determining how exactly to refund the approximately $80 million in sales tax collections to taxpayers.

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2022 Legislative Update

Rolling near the 80th day of session, state lawmakers continue to work on crafting a state budget as they wrap up their regular committee hearings. As is the case every session, ATRA has been closely tracking all legislation related to tax and public finance. The following are a few key legislative measures that ATRA has either been advocating in support of or actively opposing.

HB2749 TPT; prime contracting; exemption; alterations (Cobb)

Arizona's prime contracting tax is generally regarded as the most complex and inefficient area of Arizona's transaction privilege tax (TPT) system. For years, it was the most audited and litigated of all the TPT classifications and the complexities of the system has resulted in a high level of noncompliance.

Unlike most other states that tax materials at retail, Arizona's prime contracting tax system requires contractors to purchase materials tax-free at retail with the use of exemption certificates, and instead, pay taxes on 65% of the gross proceeds of the contract upon completion of the project. A study commissioned by the Arizona Department of Revenue in 2019 reflected a noncompliance rate as high as 19%, resulting in a loss in tax revenues of nearly $1 billion between 2010 and 2016 (*See ATRA FEB/MARCH 2019 Newsletter*).

Some improvements were made to the system as a result of then Governor Brewer's 2012 TPT Simplification Task Force which carved out activities involving *maintenance, repair*, *replacement*, and *alteration* (within certain thresholds), now known as MRRA. Rather than paying tax on 65% of the contract under the prime contracting class, all contracts involving MRRA activity are subject to tax on materials at retail.

While the intent of MRRA was to simplify tax compliance for contractors, confusion remains as to which activities are considered an *alteration* to property (subject to the prime contracting tax if the contract amount exceeds 25% of a residential property's full cash value) or if the activity is considered *replacement* (subject to

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Arizona taxpayers can now breathe a sigh of relief as the long battle opposing the 3.5% income tax surcharge is over. The surcharge would have increased Arizona's top marginal rate 78% on earnings over $250,000 on single filers and $500,000 on married filing joint and was estimated to raise roughly $830 million. Many of the impacted taxpayers would have been Arizona small businesses that pay taxes as pass through entities on the individual income tax.

ATRA participated in an unsuccessful statewide campaign opposing Prop 208 arguing the surcharge would do considerable damage to an effective tax that generated roughly $5 billion for the state general fund. The surcharge would crush Arizona's reputation as an attractive destination for small businesses. Moreover, strong economic growth has been a successful path to fund school spending increases, including a 20% teacher pay raise. Prop 208 was awful public policy that shifted a mandatory obligation on only 2% of the income tax filers while not generating meaningful new funding.

the retail tax under MRRA).

According to guidance provided by the Arizona Department of Revenue, a residential contract to remodel a kitchen that includes the *replacement* of existing flooring and appliances is considered MRRA. However, if the homeowner chooses to add a kitchen island, the entire contract is then considered an *alteration* and would be subject to the prime contracting tax if it breaches the 25% threshold. Another scenario included in the Department's guidance was whether adding or replacing wiring and conduit in a home remodel contract would be considered taxable under prime contracting or MRRA. As the MRRA legislation was being crafted, it was never contemplated that the Department would need access to a home to determine whether or not a kitchen island or wiring and conduit was added or replaced in order to determine how the contract should be taxed.

Last year, President Fann sponsored legislation under SB1721 on behalf of the Arizona League of Cities and Towns to eliminate MRRA, and instead, would have created dollar thresholds of $100,000 for residential contracts and $1 million for commercial contracts to remain taxable at retail. Although the $100,000 threshold on residential contracts made some sense, ATRA opposed the bill since placing a threshold on all commercial MRRA contracts, specifically maintenance, repair, and replacement activities, would have resulted in a significant tax increase on businesses since those activities aren't currently subject to any threshold amounts to remain taxable under MRRA.

To avoid catching residential property owners and contractors unaware, HB2749 greatly simplifies this area in law by specifying that only residential contracts that add square footage are subject to the prime contracting tax. All other contracts, such as those to simply remodel a home without expanding the square footage, would remain taxable under MRRA.

The sensible reforms under HB2749 will improve and further simplify this complicated area in law. HB2749 passed with bipartisan support in the House and awaits a hearing in Senate Appropriations.

HB2124 common school districts; tuition; elimination (Udall)

Arizona taxpayers, parents and students, depending on their residence can find themselves in significantly different school districts. In addition to differences in taxation, these school districts can also have an impact on the legal status of students seeking the district school of their choice.

This had long been a particular challenge for students and parents living in what the Arizona law refers to as common school districts. These are K through 8 elementary districts that are not included in 9 through 12 union districts. Historically, the high school students in these common school districts have attended a neighboring high school through a process where the common school district paid tuition to the attending district based on the per pupil cost of the attending union or unified district.

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In recent years, ATRA research, along with Arizona County School Superintendents, discovered a myriad of differences that were being employed by both common and attending districts to finance the tuition of these high school students.

HB2124, sponsored by House Education Chair Michelle Udall, changes and simplifies the financing of high school students from common school districts. Beginning in fiscal year 2024, common school districts will no longer pay tuition for their high school students attending a neighboring high school. Rather, the attending union or unified district will simply count that student in the same manner they currently count all other students attending the district. The common district, in lieu of paying tuition to the attending district, will budget for the costs of educating their high school students based on the average countywide per pupil cost from the preceding fiscal year as calculated by the county school superintendent.

The revenues generated by each district for the costs of their high school district students are added to the county aid for equalization assistance to assist in the costs of state aid for all districts in the county.

HB2124 cleared the Arizona House 59-0 and the Senate Education Committee 7-0.

SB1708 motion picture production; tax credits (Gowan)

SB1708 establishes $150 million in annual refundable income tax credits for the motion picture industry.

The bill outlines criteria for companies to qualify, and if qualified, the tax credits are based on a percentage of each company's level of spending. The tax credits are first used to offset the production company's tax liability, *if any*. In the event the production company has no tax liability, the Department of Revenue must refund any excess amount to the company within 180 days after completion.

ATRA is strongly opposed to the refundable tax credits under SB1708 for two reasons. First, refundable tax credits are the "first draw" on state revenues. These credits appropriate state funds ahead of funding for schools, health care, and prisons and are not really credits at all. A refundable "credit" is not a credit against tax liability. In fact, the venture may not have even been profitable.

Second, ATRA believes these refundable tax credits are unconstitutional under the Arizona Constitution. In fact, the Goldwater Institute released a Gift Clause Analysis in response to the refundable tax credits under SB1708. In describing how the Gift Clause prohibits the disproportionate gift of public resources to private enterprises, Goldwater reinforced that "government may only give public resources to a private entity in exchange for direct, obligatory consideration, and that consideration must not be disproportionate to the cost to the public." Under SB1708, the company is only required to satisfy the location requirements for production and filming and any other benefits associated with production activities are "indirect" benefits, and therefore, would not be considered as offsets to the public benefit received by the private entity. Because SB1708 provides significant refundable tax credits to companies without receiving a direct benefit in return, the tax credit scheme under SB1708 would likely be in violation of the Arizona Constitution's Gift Clause.

SB1708 passed the Senate by a vote of 21-7 and awaits a hearing in House Appropriations.