

## **Three Huge Tax Issues for Arizona Lawmakers**

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In this installment of SALT From My Saddle, Busby highlights three challenging tax issues that Arizona legislators will be asked to address during the 2019 legislative session. It could be difficult for lawmakers to understand and reach consensus on any one of these issues alone, he argues, so debating all three during the same session could make for a wild ride.

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When Arizona legislators return on January 14, they will address how to respond to the federal tax reform measures, whether to amend the state tax code to allow remote sales tax collections in the wake of *Wayfair*, and which, if any, digital goods and services should be subject to sales tax.

### Responding to Federal Tax Reform

Rather than respond to federal changes in their annual Internal Revenue Code conformity bill, Arizona lawmakers in 2018 pointed to the IRC provisions in effect on January 1, 2017, as the starting point for state individual and corporate income tax

liability for tax year 2018.<sup>1</sup> So unless the Legislature conforms the state's tax code to the IRC in effect on January 1, 2018, millions of Arizona taxpayers could be forced to calculate their 2018 state income tax liability using a radically different tax base than they use for their federal liability.

However, the Department of Revenue estimates that if the state conforms to the IRC in effect on January 1, 2018, without adjusting rates or the state's tax code in response to the federal changes, it could result in up to \$300 million in additional annual income tax revenue by fiscal year beginning July 1, 2019.<sup>2</sup> That would be roughly a 5 percent increase in Arizona income tax collections.<sup>3</sup>

Will lawmakers doom Arizona taxpayers to the complexity of radically different state income tax calculations? Will they ease those calculations with IRC conformity while exacting the largest tax increase in state history? Or will they come up with a revenue-neutral solution that simplifies taxpayers' calculations (even though no solution could be revenue neutral for every taxpayer)?<sup>4</sup> Stay tuned.

### Remote Sales Tax Collections

In the wake of the U.S. Supreme Court's *Wayfair*<sup>5</sup> decision, state and local lawmakers are faced with the prospect of collecting sales taxes from remote vendors. A 2017 study estimated that

<sup>1</sup>Laws 2018, Ch. 142.

<sup>2</sup>See Arizona Department of Revenue Office of Economic Research and Analysis, "Estimated Impact on State Revenues of Conformity to Provisions in the Tax Cuts and Jobs Act, and the Disaster Tax Relief and Airport and Airway Extension Act of 2017," Jan. 10, 2018.

<sup>3</sup>Based on the DOR's total collections for withholding, individual, and corporate income taxes according to its annual report for fiscal 2017.

<sup>4</sup>For more information and some ideas regarding this issue, see James G. Busby Jr., "Arizona Has Not Responded to Federal Tax Reform Measures," *State Tax Notes*, Oct. 22, 2018, p. 343.

<sup>5</sup>*South Dakota v. Wayfair Inc.*, 585 U.S. \_\_\_ (2018).

Arizona's share of these taxes may be between \$190 million and \$293 million annually.<sup>6</sup>

However, unlike South Dakota, which dramatically simplified its sales tax code to justify remote collection authority, Arizona has not adopted the Streamlined Sales and Use Tax Agreement or any of its features designed to reduce administrative and compliance costs for taxpayers. Worse, on top of the differences between each municipality and the state, the 91 Arizona municipalities with sales taxes can select from over 50 tax base differences.

The Council On State Taxation's April 2018 Scorecard on State Sales and Use Tax Administration best characterized the difference between the sales tax systems of South Dakota and Arizona when it graded South Dakota an "A" and Arizona a "D" on simplicity and transparency grounds.<sup>7</sup>

In short, if Arizona lawmakers want to simplify sales taxes like South Dakota did to collect sales taxes from remote vendors, they have a lot of work to do.<sup>8</sup>

### Which Digital Goods and Services Are Taxable?

Unlike most states, Arizona has no law specifying which digital goods and services are subject to sales tax.<sup>9</sup> Yet without statutory direction from the Legislature, states and localities have taken the position in confidential audit assessments and obscure private taxpayer rulings that digital goods and various digital services are subject to tax under the state's outdated tax code.<sup>10</sup>

In November an overwhelming majority (nearly two-thirds) of Arizona voters passed Proposition 126, which amended the Arizona Constitution to prohibit the state and its political subdivisions from

increasing or imposing new taxes on services not in effect on December 31, 2017.

With this new constitutional prohibition against the taxation of services in place, how will lawmakers and Gov. Doug Ducey (R) respond? Will they act in 2019 to specify which digital goods are taxable and, now that they are constrained by Proposition 126, that digital services are not? Or, will they continue to allow Arizona taxing authorities to run wild, forcing providers of digital goods and services into the untenable position of choosing to collect taxes from their customers that may not be lawfully due — thereby exposing them to potential class action lawsuits, or not collect taxes from their customers — thereby exposing them to potential audit assessments and legal fees to challenge the same?

### A Tax-Neutral Solution

Given the estimates cited earlier, if lawmakers conform the state's tax code to the IRC effective January 1, 2018, and simplify its sales tax code, Arizona's state, county, and municipal tax collections will soar by nearly \$600 million annually. However, Ducey and the Republican-controlled Legislature are not likely to raise taxes, especially given the two-thirds supermajority requirement<sup>11</sup> for passage of any legislation that would increase state tax revenue.

Rather, lawmakers may opt to level the playing field between in-state and remote vendors while enacting other important tax code changes that opponents previously argued would be too costly. For instance, the Legislature could specify which digital goods it wants to tax and clarify that digital services are not subject to tax, yet acknowledge that digital goods and services were not previously taxable under the state's antiquated tax code.<sup>12</sup> Likewise, the state could dramatically simplify how it taxes construction contractors by collecting taxes on building materials like most other states.<sup>13</sup> If Arizona is still collecting more net revenue after implementing these changes, one or more automatic triggers could kick in to reduce income tax rates for all taxpayers. ■

<sup>6</sup>U.S. Government Accountability Office Report to Congressional Requesters GAO-18-114, Nov. 2017, p. 48.

<sup>7</sup>Karl Frieden and Fred Nicely, *The Best and Worst of Sales Tax Administration*, COST, Apr. 2018.

<sup>8</sup>For more information regarding this issue, see Busby, "Arizona Is Not Prepared to Implement the *Wayfair* Decision," *State Tax Notes*, July 30, 2018, p. 485.

<sup>9</sup>In 2018, lawmakers were poised to address this issue, but ultimately failed. See Busby, "Arizona Intends to Clarify Taxation of Digital Goods and Services," *State Tax Notes*, Feb. 19, 2018, p. 711; and Busby, "Arizona Left Providers of Digital Goods and Services in a Pickle," *State Tax Notes*, June 4, 2018, p. 1003.

<sup>10</sup>See Busby, "Arizona's Tortured Method of Imposing Sales Tax on Services," *State Tax Notes*, Mar. 20, 2017, p. 1031.

<sup>11</sup>Arizona Constitution, Art. 9, section 22.

<sup>12</sup>See *supra* note 9, "Arizona Left Providers of Digital Goods and Services in a Pickle."

<sup>13</sup>See Busby, "Taxing Contractors Under Arizona's Sales Tax Reform Laws," *State Tax Notes*, June 1, 2015, p. 673.