

## **Arizona Constitutional Amendment Prohibits New Taxes on Services**

by James G. Busby Jr.

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In this installment of SALT From My Saddle, Busby explains how Proposition 126, an initiative that amended the Arizona Constitution to prohibit the state and its political subdivisions from increasing or imposing new taxes on services, may affect legislation enacted in 2018 and the state's ongoing efforts to clarify which digital goods and services are subject to tax.

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On November 6 Arizona voters overwhelmingly approved Proposition 126, which amended the state's constitution to prohibit the state and its political subdivisions from imposing or increasing any "sales tax, transaction privilege tax, luxury tax, excise tax, use tax, or any other transaction-based tax, fee, stamp requirement, or assessment on the

privilege to engage in, or the gross receipts of sales or gross income derived from, any service performed in Arizona that was not in effect on December 31, 2017."<sup>1</sup>

Proposition 126 was promoted by a political action committee organized and funded primarily by the Arizona Board of Realtors, because Realtors were concerned that lawmakers may expand Arizona's tax base in a way that would tax their services.

### Potential Impact on Education Funding

Although probably an unintended consequence, Proposition 126 may affect legislation passed this year that extended for 20 years a tax used to fund educational programs. This 0.6 percent sales and use tax was scheduled to expire on June 30, 2021.<sup>2</sup> To the extent that this tax applies to services that are taxable in Arizona, Proposition 126 may prevent authorities from collecting it on proceeds from services including but not limited to telecommunications, pipeline operations, and construction contracting.

### Potential Impact on Online Lodging Marketplaces

Although probably also unintended, Proposition 126 may affect the measure the Arizona Legislature passed this year that would require all online lodging marketplaces to register with the DOR to collect all applicable state and local taxes beginning in 2019.<sup>3</sup>

<sup>1</sup> Proposition 126 (Ariz. 2018).

<sup>2</sup> Laws 2018, Ch. 74, section 11.

<sup>3</sup> Laws 2018, Ch. 189.

It is debatable because the legal incidence of this tax is on property owners and the tax took effect in 2017,<sup>4</sup> however, Proposition 126 may prevent taxing authorities from implementing this measure, which would require online lodging marketplaces to collect and report the tax for property owners.<sup>5</sup> However, under the legislation that took effect in 2017, online lodging marketplaces may continue to voluntarily collect and remit all state and local taxes levied on online lodging operators for the convenience of property owners.<sup>6</sup>

### Potential Impact on Digital Goods and Services Legislation

Unlike most states, Arizona has not enacted legislation to specify which digital goods and services, if any, are subject to sales tax. During its 2018 legislative session, the state House of Representatives approved a bill that would have taxed sales of specified digital goods.<sup>7</sup> While the Senate was considering the bill, some suggested that to secure enough votes in the Senate and get Gov. Doug Ducey (R) to sign the bill, it should be amended so that some digital services would be taxable.

However, now that Proposition 126 is in place, providers of digital services probably would challenge any attempt by state or local taxing authorities to impose tax on their services. These include software as a service, platform as a service, infrastructure as a service, application service providers, hosting services, data storage management, data processing and information services, streaming services, digital authentication services, and any other cloud-based or other remotely accessed computing services.

### How Will Arizona Lawmakers and Ducey Respond?

The tally on Proposition 126 was not even close — nearly two-thirds of the state's voters objected to the taxation of services.<sup>8</sup> Yet without statutory direction from the legislature, SALT authorities in Arizona have taken the position in confidential audit assessments and obscure private taxpayer rulings that digital goods and a variety of digital services are subject to tax under the state's outdated tax code.<sup>9</sup>

So the question is, how will Arizona lawmakers and Ducey respond to the voters' mandate? Will they act during the 2019 legislative session 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 between collecting from their customers taxes that may not be lawfully due, thereby exposing them to potential class action lawsuits, or not collecting taxes from their customers, thereby exposing them to potential audit assessments and legal fees to challenge the same?<sup>10</sup> ■

<sup>4</sup>Laws 2016, Ch. 208.

<sup>5</sup>If Proposition 126 does not prevent Arizona taxing authorities from implementing this measure, the fact that most online lodging marketplaces probably do not have nexus in Arizona may prevent them from doing so.

<sup>6</sup>Laws 2016, Ch. 208.

<sup>7</sup>H.B. 2479 (2018). For more information regarding Arizona's efforts to clarify which digital goods and services are subject to tax, see James G. Busby Jr., "Arizona Is Reexamining the Taxation of Digital Goods and Services," *State Tax Notes*, Sept. 4, 2017, p. 967; and Busby, "Arizona Left Providers of Digital Goods and Services in a Pickle," *State Tax Notes*, June 4, 2018, p. 1003.

<sup>8</sup>Ballotpedia.org, Arizona Proposition 126, Prohibit New or Increased Taxes on Services Initiative (2018).

<sup>9</sup>See Busby, "Arizona's Tortured Method of Imposing Sales Tax on Services," *State Tax Notes*, Mar. 20, 2017, p. 1031.

<sup>10</sup>For more information about this quandary, see Busby, "Pickle," *supra* note 7.