

Update on Arizona's Three Huge Tax Issues

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Reprinted from *State Tax Notes*, April 29, 2019, p. 419

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In this edition of SALT From My Saddle, Busby summarizes the status of three major tax issues troubling Arizona's legislators.

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As predicted,¹ this session, Arizona lawmakers are debating how to respond to the federal tax reform measures that took effect for tax year 2018, whether to amend the state tax code to allow remote sales tax collections in the wake of *Wayfair*, and the sales taxation of digital goods and services.

Arizona's Response to Federal Tax Reform

In 2018, in its annual Internal Revenue Code conformity bill, rather than respond to federal tax changes, Arizona's Legislature established the IRC — in effect as of January 1, 2017 — as the starting point for state individual and corporate

¹ See James G. Busby Jr. "Three Huge Tax Issues for Arizona Lawmakers," *State Tax Notes*, Dec. 10, 2018, p. 959.

income tax liability for tax year 2018.² Then, in January, the Department of Revenue released forms and began accepting income tax returns for tax year 2018 as if the Legislature had conformed to the IRC in effect on January 1, 2018. This may result in up to \$300 million in additional income tax revenue annually³ — a roughly 5 percent increase in overall income tax collections.⁴

On January 31, 2019, Arizona's Republican-majority Legislature transmitted S.B. 1143 to Gov. Doug Ducey (R), which, for tax year 2018, would have retroactively conformed Arizona's tax code to the IRC as of January 1, 2018, but reduced rates slightly to offset the effects of the broader federal tax base. However, Ducey vetoed S.B. 1143 the next day, emphasizing that any bill with a fiscal impact should be considered as part of the state's budget discussions and reiterating his desire to bolster the state's rainy day fund.⁵

So, incredibly, when Arizona's April 15 income tax filing deadline passed, state law required taxpayers to calculate and remit income taxes for tax year 2018 based on IRC provisions in effect on January 1, 2017, yet the DOR created forms and accepted income tax returns for tax year 2018 as if the state had conformed to the IRC as of January 1, 2018.

Response to *Wayfair*

A 2017 study estimated that Arizona's share of sales taxes from remote vendors may be

² Laws 2018, Ch. 142.

³ See 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).

⁴ Based on the DOR's total collections for withholding, individual, and corporate income taxes according to its annual report for fiscal 2017.

⁵ Veto Letter from Gov. Douglas A. Ducey to Sen. Karen Fann, "Re: Senate Bill 1143 conformity; Internal Revenue Code; rates" (Feb. 1, 2019).

between \$190 million and \$293 million annually.⁶ Accordingly, following the U.S. Supreme Court decision in *Wayfair*,⁷ lawmakers are examining their options.

S.B. 1155 would have created a study committee to examine underlying legal hurdles, as well as best practices around the country, and issue a report by the end of the year detailing what the state should do to begin lawfully and efficiently collecting taxes from remote vendors. However, S.B. 1155 failed in the Senate.

H.B. 2702 would impose economic nexus thresholds and require both individual remote sellers and marketplace facilitators who cross such thresholds to begin paying sales tax on their proceeds from transactions with Arizona customers. However, Arizona has not adopted the Streamlined Sales and Use Tax Agreement or any of its features that were designed to reduce administrative and compliance costs for taxpayers. It permits its 91 municipalities that impose sales taxes to select from more than 50 tax base differences in addition to differences between each municipality and the state; and it imposes burdensome sourcing rules on out-of-state sellers. Thus, H.B. 2702 was held in the House Rules Committee over concerns that remote sellers may challenge remote sales tax collection as unduly burdening interstate commerce.⁸

Interested parties are working on a strike-everything amendment that may address some of these concerns and impose economic nexus thresholds requiring both individual remote sellers and marketplace facilitators who cross those thresholds to begin paying sales tax on their proceeds from transactions with Arizona customers.

The Taxation of Digital Goods and Services

Unlike most states, Arizona has not enacted legislation specifying which digital goods and services, if any, are subject to sales tax.⁹ Yet, without statutory direction, state and local taxing authorities have taken the position in confidential audit assessments and obscure private taxpayer rulings that digital goods and a variety of digital services are taxable under the state's outdated tax code.¹⁰

Last year, a bill was introduced that would have clarified which digital goods and services are taxable,¹¹ but it failed.¹² This year, lawmakers are weighing S.B. 1460, which provides that prewritten software and some digital goods would be subject to state and local sales and use taxes going forward, but clarifies that — consistent with a recent amendment to Arizona's constitution¹³ — digital services are not taxable.¹⁴

Supporters are having a tough time securing enough votes to pass S.B. 1460 because opponents argue it would reduce revenues because taxing authorities are already attempting to collect taxes on virtually all digital goods and services under existing law.

A Possible Grand Bargain?

Given the estimates cited above, if lawmakers conform the state's tax code to the IRC in effect on January 1, 2018, and simplify its sales tax code to permit tax collection from remote vendors, Arizona's total state, county, and municipal tax collections could soar by nearly \$600 million annually. However, Arizona's Republican-dominated Legislature and Republican governor are unlikely to enact

⁹ In 2018 lawmakers were poised to address this issue but, in the end, they failed. See Busby, "Arizona Intends to Clarify Taxation of Digital Goods and Services," *State Tax Notes*, Feb. 18, 2019, P. 711; and Busby, "Arizona Left Providers of Digital Goods and Services in a Pickle," *State Tax Notes*, June 4, 2018, p. 1003.

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

¹¹ See Busby, "Digital Goods," *supra* note 9.

¹² See Busby, "Pickle," *supra* note 9.

¹³ See Busby, "Arizona Constitutional Amendment Prohibits New Taxes on Services," *State Tax Notes*, Nov. 26, 2018, p. 781.

¹⁴ See Busby, "Proposed Arizona Legislation Addresses Digital Goods and Services," *State Tax Notes*, Feb. 25, 2019, p. 683.

⁶ U.S. GAO Report to Congressional Requesters, GAO-18-114, 48 (Nov. 2017).

⁷ 585 U.S. ___ (2018), 138 S. Ct. 2018 (2018).

⁸ See Busby, "Arizona Is Not Prepared to Implement the *Wayfair* Decision," *State Tax Notes*, July 30, 2018, p. 485.

legislation simply to raise taxes, especially given the state's constitutional provision¹⁵ requiring that legislation creating a net revenue increase through certain tax changes pass by a two-thirds vote.

Instead, lawmakers may opt to level the playing field between local and remote vendors but, at the same time, enact other important tax code changes that opponents argued would cost the state too much money. For instance, the Legislature could specify which digital goods to tax going forward and clarify that digital services are not subject to tax, while acknowledging that digital goods and services were not subject to tax in the past.¹⁶ After implementing these changes, if the state is still collecting more money on a net basis, one or more automatic triggers could kick in to reduce income tax rates for all taxpayers. ■

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¹⁵ Arizona Const. art. 9, section 22.

¹⁶ See Busby, "Pickle," *supra* note 9.