STATE OF ARIZONA

Joint Legislative Budget Committee

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October 3, 2016

The Honorable Doug Ducey
Governor
Office of the Governor
West Wing, State Capitol
1700 W. Washington, 9th Floor
Phoenix, AZ 85007

The Honorable Michele Reagan
Secretary of State
Secretary of State-Department of State
West Wing, State Capitol
1700 W. Washington, 7th Floor
Phoenix, AZ 85007

The Honorable Andy Biggs
President of the Senate
Senate Wing, Room 205
State Capitol
1700 W. Washington
Phoenix, AZ 85007

The Honorable David Gowan
Speaker of the House of Representatives
House Wing, Room 223
State Capitol
1700 W. Washington
Phoenix, AZ 85007

Dear Governor Ducey, Secretary Reagan, President Biggs and Speaker Gowan:

Laws 2013, Chapter 255, Section 28 requires the Joint Legislative Budget Committee Staff to report to you by September 30, 2016 on the fiscal impact of the legislation. Among other provisions, Chapter 255 shifted the classification of some Transaction Privilege Tax (TPT) transactions from the contracting to the retail category.

We have attached a copy of our report. If you have any questions, please let us know.

Sincerely,

Richard Stavneak

Richard Stavneak
Director

RS:lm
Attachment
xc: Lorenzo Romero, Director, OSPB

TPT Simplification Revenue Impact Report

This report responds to the requirement in Laws 2013, Chapter 255 for a Joint Legislative Budget Committee (JLBC) Staff analysis of the revenue impact of changes to the Transaction Privilege Tax (TPT) enacted under Chapter 255, commonly referred to as "TPT Simplification." Chapter 255 requires the analysis to include the estimated impact on revenues for the state, counties, and municipalities.

Brief Summary of TPT Simplification Legislation

Laws 2013, Chapter 255 made numerous changes intended to simplify the administration of TPT. The JLBC Staff has identified 6 provisions in the original legislation that may have a direct positive or negative impact on state and local government revenues, which are:

- Eliminate the contracting tax on Maintenance, Repair, Replacement or Alteration (MRRA) projects.
- Apply the retail TPT to MRRA for materials.
- Apply the use tax to MRRA materials.
- Eliminate the owner-builder sales tax.
- Eliminate the nonresident shipping retail tax exemption.
- Clarify sourcing statutes for remote sales.

Revenue Impact Analysis

Of the 6 fiscal impact provisions listed above, the Department of Revenue (DOR) was able to provide aggregate data at the state and county level based on industry classification for 3 of them. The other provisions, however, either lack available data or the aggregate data is not detailed enough to draw any inferences. Furthermore, the type of data needed to provide a revenue impact analysis at the municipal level does not exist for any of the provisions.

Because of the aforementioned data limitations, the JLBC Staff cannot determine the net revenue impact of the changes under TPT Simplification as a whole. If useful aggregate data exists for a particular provision, however, the JLBC Staff has attempted to provide an approximation or "ballpark estimate" of the revenue impact. These figures do not reflect precise estimates but were included in the analysis to convey a sense of the order of magnitude.

Adding together the impact of these particular "quantifiable" provisions would not yield a valid estimate of the legislation's overall impact. The remaining "unquantifiable" provisions could have a significantly greater impact than the quantifiable ones. *Table 1* provides a summary of the 6 provisions.

Table 1

Chapter 255 Fiscal Impact Provisions
($ Millions)

Description of Provision	**General Fund Revenue**	**County-Shared Revenue 1/**	**City-Shared Revenue 1/**	**Total State Sales Tax**	**County Excise Taxes 2/**
Eliminate Contracting Tax on MRRA Projects 3/	($49.0)	($4.6)	($2.8)	($56.4)	($8.0)
Apply Retail TPT to MRRA Materials 3/	$23.4	$5.2	$3.2	$31.8	$4.4
Apply Use Tax to MRRA Materials 3/	Small Gain	$0	$0	Small Gain	$0
Eliminate Builder-Owner Sales Tax	($4.3)	($0.4)	($0.3)	($5.0)	
Eliminate Nonresident Shipping Retail Exemptions			Unknown Gain		
Clarify Sourcing Statutes for Remote Sales	$0	$0	$0	$0	
TOTAL 4/	**Unknown**	**Unknown**	**Unknown**	**Unknown**	**Unknown**

1/ Represents the portion of state TPT tax collections shared with cities and counties.
2/ All sales subject to state TPT tax are also subject to various county excise taxes. Examples of such taxes are the general county excise tax, transportation or road tax, jail district tax and capital projects tax.
3/ Maintenance, repair, replacement or alteration (MRRA) of real property by contractors such as plumbers, electricians and HVAC technicians. Where a dollar value is listed, the JLBC Staff had some available data to develop an estimate. These amounts are not definitive, however, as the data was insufficient to capture all transactions.
4/ While some provisions can be roughly estimated, others cannot. As a result, adding only the provisions with an estimated impact would lead to a false conclusion concerning the bill's impact.

Below follows a detailed discussion of each of the 6 provisions.

Eliminate Contracting Tax on Maintenance, Repair, Replacement or Alteration (MRRA) Projects

Effective January 1, 2015, the gross income derived from maintenance, repair, replacement or alteration (MRRA) of real property is exempt from prime contracting TPT when such activities are performed directly for the property owner. MRRA activities are often provided by specialty trade contractors, such as plumbers, electricians, and heating, ventilation and air conditioning (HVAC) technicians. This category can include up to $750,000 in remodeling projects for commercial property. For residential property, remodeling costs up to 25% of the property's full cash value qualify under the MRRA category. All other modifications to real property (i.e., non-MRRA projects) remain taxable under the prime contracting classification. Under the prime contracting classification, the tax is levied on 65% of the value of the contract.

DOR provides monthly taxable sales data for several contracting categories, including residential construction, nonresidential construction, and specialty trade contracting. From February 2015 through January 2016, the first 12 months of collection data under TPT Simplification, DOR reports that taxable sales from specialty trade contracting activities decreased by (36.1)% compared to the same period in the prior year. In dollar terms, this was a statewide reduction of $(1.46) billion in taxable sales subject to the contracting tax. Of that amount, the reduction was $(914) million in Maricopa County, $(253) million in Pima County and the remaining $(282) million in all other counties. DOR did not release county-specific data for the state's 13 rural counties. Moreover, taxable sales data for trade contracting is not compiled at the municipal level.

While statewide taxable activity for specialty trade contracting declined by (36.1)%, taxable activity for all other contracting categories combined decreased by (8.2)%. The JLBC Staff cannot determine from available data what the decline in specialty trade contracting activity would have been absent TPT Simplification. As a result, this analysis assumes that the statewide decline in specialty trade contracting would have equaled the decline in all other contracting categories combined, or (8.2)%. Thus, any decline in specialty trade contracting taxable activity greater than (8.2)% was attributed to TPT Simplification. Under this methodology, that amount equates to (27.9)%, or $(1.13) billion. Due to the data limitations, however, this estimate is not definitive.

The $(1.13) billion reduction in taxable contracting activity translates into a state sales tax reduction of $(56.4) million, of which $(49.0) million was incurred by the General Fund. Under the statutory TPT distribution formula, 86.9% of state prime contracting tax revenue is retained by the General Fund, whereas 8.1% and 5.0%, respectively, is allocated to counties and cities.

In terms of counties, the state-shared revenue loss was $(4.6) million. This amount included $(2.9) million for Maricopa County, $(0.7) million for Pima County, and a combined $(1.0) million for all other counties. In terms of cities and towns, the total reduction in state-shared revenue was an estimated $(2.8) million.

All sales subject to state TPT are also subject to various county excise taxes, such as a general sales tax or a transportation tax. The combined tax rates vary by county. As a result of the reduction in taxable contracting activity, the JLBC Staff estimates that total county excise taxes were reduced by an estimated $(8.0) million.

Apply Retail TPT to MRRA Materials

Prior to Laws 2013, Chapter 255, MRRA contractors had a retail TPT exemption since their materials were taxed as part of the overall contracting tax. To obtain the exemption, the TPT-licensed contractor provided a TPT Exemption Certificate to the retailer. Beginning in January 2015, this retail exemption no longer applies to contractors that perform MRRA projects. The exemption, however, continues to apply to materials purchased to be incorporated into non-MRRA projects.

A TPT-licensed contractor that purchases materials with an exemption certificate and later incorporates the materials into a MRRA project is required to pay retail TPT on that purchase. Since DOR tracks and reports sales tax collected from such MRRA activities on a monthly basis, the JLBC Staff has incorporated that dataset into this analysis. According to DOR, a total of $123.9 million in statewide MRRA taxable sales by TPT-licensed contractors occurred during the first 12 months under TPT Simplification. Of this amount, $84.2 million was for sales occurring in Maricopa County, $12.3 million in Pima County, and $27.4 million combined in the other 13 counties. The amount collected from retail tax paid on MRRA materials is likely underreported, however, as compliance with this requirement is difficult to enforce.

If a contractor did not maintain their TPT license, they no longer are required to file a TPT return to DOR. Therefore, a sale of materials to such contractor is the same as the sale to any other consumer. As a result, the retail TPT paid on materials purchased by non-TPT licensed contractors remains unknown. To gauge the possible impact of this provision, the JLBC Staff analyzed aggregate taxable sales data for businesses that sell building materials, lumber, construction materials, hardware, plumbing and heating equipment. Non-TPT licensed contractors are likely to make many of their purchases from such stores.

According to data provided by DOR, taxable sales from these building material and related stores increased by 21.9%, or $818.4 million, during the first 12 months under TPT Simplification compared to the prior 12-month period. The JLBC Staff estimates that of the $818.4 million in increased sales, $567.6 million occurred in Maricopa County, $132.9 million in Pima County and $117.9 million in the other 13 counties combined. The $818.4 million increase for this category far exceeded any prior year, including the “housing boom” years of 2005 and 2006. Taxable sales for all other retail categories combined increased by 8.2% over the same period.

Similar to the prime contracting provision discussed above, this analysis assumes that absent TPT Simplification taxable sales for building materials would have increased at the same rate as all other retail categories combined, or 8.2%. Thus, only the "excess growth" of 13.7% was attributed to TPT Simplification. In dollar terms, the 13.7% net increase translates into an increase in taxable sales of $511.3 million. Again, these estimates are not definitive given the shortcoming of the methodology.

The JLBC Staff estimates that the $635.2 million combined increase in taxable sales ($123.9 million in MRRA sales plus $511.3 million in other sales) generated total state tax collections of $31.8 million. Of this amount, $23.4 million was retained by the General Fund, whereas the remaining $8.4 million was distributed as follows: $3.3 million to Maricopa County, $0.7 million to Pima County, $1.2 million to all other counties combined, and $3.2 million to cities and towns.

The statutory distribution formula is different for retail TPT than for prime contracting TPT. For retail TPT, 73.8% of state tax revenue is distributed to the General Fund, 16.2% to counties and 10.0% to municipalities.

As a result of the increase in taxable retail sales (owing to the elimination of the retail exemption), the JLBC Staff estimates that total county excise taxes were increased by an estimated $4.4 million.

Apply Use Tax to MRRA Materials

The use tax is imposed on items purchased in another state and brought into Arizona for storage, use, or consumption, and for which no tax (or tax at a lesser rate) has been paid in the other state. Unlike state TPT, the state use tax is not shared with counties and cities. Generally, counties do not impose their own separate use tax.

Prior to Laws 2013, Chapter 255, all materials purchased by a TPT-licensed contractor from a vendor located outside Arizona for incorporation into a taxable prime contracting activity were exempted from the use tax. However, effective January 1, 2015, this use tax exemption applies to only non-MRRA projects. Materials purchased from another state to be used in MRRA projects in Arizona are now subject to the use tax.

The impact of eliminating this use tax exemption cannot be determined from available taxable sales data. While DOR reports on the amount of use tax paid by businesses in the construction industry, this information is not separated by industry type, such as residential or nonresidential construction or specialty trade contracting. Instead, the reported data is for the Arizona construction industry as a whole.

After analyzing this dataset, the JLBC Staff determined that there was no distinguishable pattern (such as a clear increase in use tax payments) during the first 12 months of TPT Simplification. The JLBC Staff has received some anecdotal information, however, which suggests that out-of-state purchases are far more common for large construction companies than for the small specialty trade contracting firms most likely involved in MRRA projects. For this reason, the elimination of this exemption may not have generated much additional revenue for the state.

Eliminate Owner-Builder Sales Tax

Laws 2013, Chapter 255 eliminated the owner-builder sales tax, beginning January 1, 2015. An owner-builder refers to the owner of real property who makes improvements to the property. The tax was imposed on owners who sold their property within 24 months after the improvement. The tax was applied to the sales price of materials purchased for incorporation into the real property improvement.

The impact of repealing this provision cannot be determined, as owner-builder sales transactions are no longer reported to DOR. Based on historical data, the loss could range from a low of $(1.0) million to a high of $(9.0) million in terms of state sales tax collections. Historical owner-builder sales tax data is not available at the county level.

Historically, collections from this TPT category tended to vary significantly from one year to the next. This analysis assumes that the state TPT loss was $(5.0) million, which represents the midpoint between the lower and upper bound referenced above. Under the owner-builder classification, 86.9% of state TPT was retained by the General Fund. Counties and cities received 8.1% and 5.0%, respectively, in state-shared revenue. Therefore, the elimination of the owner-builder tax resulted in an estimated General Fund loss $(4.3) million. In terms of state-shared revenue, counties and cities lost $(0.4) million and $(0.3) million, respectively.

Eliminate Nonresident Shipping Retail Tax Exemptions

Prior to January 1, 2015, a sale to a nonresident of tangible personal property delivered to a location outside Arizona was exempt from retail TPT. Also, a sale of tangible personal property delivered to a destination outside the United States was exempt from retail TPT. The exemptions applied to in-person purchases by the out-of-state resident.

Laws 2013, Chapter 255 eliminated the nonresident shipping retail TPT exemptions for all tangible personal property except motor vehicles. Thus, prior to January 1, 2015, if an out-of-state visitor went into an art gallery in Arizona and purchased a painting, and then asked the gallery to ship the painting to their residence located in another state, the sale was exempt from state TPT. Beginning January 1, 2015, the same transaction was subject to retail TPT. (Laws 2016, Chapter 368, however, restored the nonresident shipping retail exemption for fine art, beginning September 1, 2016.)

According to DOR, the nonresident shipping exemptions reduced taxable sales by an estimated $(1) billion in FY 2015, the last year for which tax expenditure data has been released. Based on this estimate, state sales tax collections were reduced by $(49.4) million in FY 2015.

This figure is difficult to interpret for several reasons. First, the exemptions were eliminated, beginning in the second half of FY 2015. This means that a portion of the estimate above reflects the 6-month period prior to elimination of the exemptions. Second, Chapter 255 retained the nonresident shipping exemption for motor vehicles, which is also reflected in the estimate. Since the Tax Expenditure Report neither includes monthly estimates nor delineates between motor vehicles and non-motor vehicles exemption amounts, the JLBC Staff cannot provide the type of analysis used for the other provisions in Chapter 255.

The elimination of the nonresident shipping exemption is likely to have induced out-of-state buyers to adjust their practices in order to avoid paying the new tax imposed after December 31, 2014. As an example of such behavioral change, an out-of-state business that previously sent a representative to Arizona in order to purchase equipment or machinery to be shipped to the company's home state would no longer have the incentive to do so (since such transaction would now be subject to TPT). Instead, the company could place an order online or over the phone and ask the Arizona business to ship the order to its location outside the state since such transaction would not be subject to tax in Arizona. This example assumes that the Arizona seller does not have a physical presence ("nexus"), such as an office or a warehouse, in the buyer's state.

Since there is a strong incentive under TPT Simplification for an out-of-state company to make their purchases by means of electronic commerce, it is not clear to what extent the elimination of the nonresident shipping exemption has resulted in net new revenue for the state and the counties, if any. Cities and towns are not affected by this provision, however, since they did not provide the exemptions prior to January 1, 2015.

Clarify Sourcing Statutes for Remote Sales

Laws 2013, Chapter 255 added new statutory language that was intended to clarify the sourcing of sales for taxation purposes, beginning January 1, 2015. "Sales tax sourcing" refers to the tax rate that a vendor should apply to a given purchase. Depending on sourcing statutes, the tax rate is based on either the seller's or the buyer's geographic location. For out-of-state or remote sellers, Chapter 255 clarified that sales should be sourced to the buyer's location in Arizona. As an example, under Arizona sourcing statutes, an online purchase made by a consumer in Arizona from a retailer in California is taxed at the Arizona rate, and the sales tax collected is remitted to Arizona.

At the time of enactment, DOR estimated that the provision would generate $25 million in state tax collections, of which $18.4 million would be retained by the General Fund. However, no details were provided by DOR at that time as to how that estimate was determined, including which remote vendors would be affected.

DOR now says that the provision was not intended to be a "revenue generator," as originally indicated. Instead, the language was included to comply with the sourcing requirements for out-of-state purchases included in the federal Marketplace Fairness Act (MFA). The federal

legislation, which was introduced in 2013 but never enacted, intended to grant states the authority to collect sales tax from remote sellers, such as online and catalogue retailers.
To evaluate the impact of this provision, the JLBC Staff analyzed taxable sales data for a subset of retailers classified as non-store retailers. This refers to the selling of goods and services outside the confines of a regular retail facility, such as a shop or a store. Examples of non-store retailing are online shopping and catalogue sales. The analysis of sales activity for non-store retailers during the first 12 months under TPT Simplification did not reveal any discernable patterns, such as a spike in taxable sales from non-store retail establishments. Based on this dataset, the JLBC Staff could not find any evidence that this provision resulted in any net new revenue for the state, counties and municipalities.