Fiscal Note

BILL # SB 1366 **TITLE:** commerce authority; data centers

SPONSOR: Mesnard **STATUS:** Senate Engrossed

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REVISED

Description

The bill would expand the transaction privilege (TPT) and use tax exemption for data center equipment to include rented or leased equipment. Purchased equipment is already exempt. The bill also expands the definition of what software could be exempted from taxation. Currently, only "enabling" software is exempt; the bill would expand the exemption to all software and software maintenance that is used for the operation or benefit of a certified data center. Finally, the bill exempts data center equipment and property, as opposed to just equipment, from TPT and use tax. The bill would be retroactive to September 12, 2013. As with the current tax exemptions, the bill's expansions apply only to data centers certified by the Arizona Commerce Authority (ACA) as having met certain conditions.

Estimated Impact

The bill would result in an ongoing reduction of General Fund revenue collections to the extent that it exempts additional business expenses from TPT and use tax. Because the exemptions in the bill would be retroactive to September 12, 2013, the bill also has a one-time impact due to refund payments.

The JLBC Staff estimates that the revenue reductions as a result of the bill would be as follows. These estimates are speculative due to data constraints.

- A one-time General Fund revenue reduction of at least \$(4.0) million in FY 2020. This amount represents refunds that would be owed to companies that have been paying TPT and use tax on expenses that would now be exempt under SB 1366. The \$(4.0) million estimate is likely significantly understated and represents refund requests that have already been received by the Department of Revenue (DOR) from companies that believe all data center software should already be exempt from TPT and use tax under current law. The estimate does not include refunds that would be owed to taxpayers due to rented or leased equipment.
- An estimated ongoing reduction of General Fund collections of between \$(3.0) million and \$(8.5) million annually, beginning in FY 2020. Of these amounts, an estimated \$(1.2) million to \$(6.9) million is due to the exemption of all software expenses, while the remaining \$(1.8) million is due to the exemption of leased or rented data center equipment.

The JLBC Staff published its original fiscal note on February 22, 2019. The ongoing revenue loss in the original note has been revised to reflect additional information. While the original note estimated the ongoing revenue loss to be \$(8.5) million, we now estimate the impact at between \$(3.0) million and \$(8.7) million.

DOR and ACA have not responded to requests for the bill's fiscal impact.

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Table 1

SB 1366 Impact Summary
($ in M)

	Ongoing	**One-Time**
Lease/Rental Exemption	$(1.8)	1/
Software Definition Expansion	(1.2) - (6.9)	(4.0) 2/
Total	**$(3.0) - (8.7)**	**$(4.0)**

1/ There would likely be refunds associated with taxes paid by certified data centers on leased or rented equipment since 2013. The JLBC Staff lacks data to estimate these potential refunds.
2/ Reflects the minimum amount of refunds that would be issued as reported by DOR. Actual refunds would likely be higher.

Analysis

Background
Laws 2013, 1st Special Session, Chapter 9 provided tax relief for the owner, operator, or colocation tenants of certain data centers. Specifically, it exempted data center equipment purchases from retail TPT and use tax.

In order for a computer data center to qualify for the TPT exemption, they must first apply for certification through ACA. The certification process requires that a computer data center submit the anticipated investment with the data center to the ACA. In order to qualify for certification, the data center must then meet one of the following criteria:

1) The computer data center must make a minimum investment of $25 million, including land, buildings, modular units, and equipment over the next 5 years if located in a rural area.

2) The computer data center must make a minimum investment of $50 million, including land, buildings, modular units, and equipment over the next 5 years if located in an urban area.

3) The computer data center must make a minimum investment of $250 million including land, buildings, modular units, and equipment over the preceding 6 years prior to September 2013.

If a computer data center meets the above criteria, they may receive the tax incentives mentioned above for a period of up to 10 years. Under certain circumstances, the exemption period can be extended to 20 years. In addition, in order for a colocation tenant to qualify for the TPT exemption, the colocation tenant must occupy space at a certified data center for at least 2 years and use at least 500 kilowatts of electricity per month.

Currently, there are 18 certified data centers in the state.

State Revenue Loss
The bill would result in a reduction of General Fund revenues due to creating additional exemptions for multiple types of purchases, as described below.

Leased or Rented Equipment
Currently, only equipment purchased for use in a certified data center is exempt from taxation. The bill would expand the exemption to include equipment that is rented or leased. This would reduce General Fund revenues to the extent that businesses are currently renting and paying tax on equipment. In addition to an ongoing cost in FY 2020 and beyond, there would be a one-time cost associated with refund payments in FY 2020, since the bill would retroactively exempt rented and leased equipment going back to September 2013.

In 2013, Jones Lang LaSalle, a commercial real estate services and investment management firm, completed a financial analysis of the 2013 legislation which created the original data center tax incentive program. This analysis estimated that

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on average, a data center required an initial investment of $200 per square foot. Based on this, the JLBC Staff has extrapolated that investment in current data centers totals. There are currently 18 certified data centers with an average of 280,000 square feet. Based on this information, we estimate that existing data centers required total initial investment of just over $1 billion. This investment would be spread out over 3 years (or $333 million per year).

There is a lack of definitive information on the extent to which data center equipment is leased instead of purchased. Based on discussions with industry representatives, the estimated percent of rented equipment has ranged between "minimal" and 25%. In our 2016 fiscal note on similar legislation (HB 2584), we assumed that 25% of equipment was rented or leased. We have chosen to continue that assumption in this year's analysis as well. Under that assumption, total lease payments for initial data center investment would be $84 million per year.

The Jones Lang LaSalle study estimated that data centers replace 60% of their initial equipment investment every 3 years. Under this assumption, ongoing annual lease payments are estimated to be $50 million. Based on the state's TPT distribution formula, exempting these annual expenditures would result in a General Fund revenue loss of $(1.8) million annually.

In addition to this ongoing cost, there may be a one-time revenue loss associated with refund payments. Because the bill is retroactive to 2013, companies that have previously paid TPT on leased or rented equipment would be eligible for a refund from DOR. The JLBC Staff lacks information to estimate this refund amount.

Software
Under current law, businesses are exempt from paying TPT or use tax on "enabling software". DOR has interpreted this to include software required for the operation of the data center, which does not include certain types of "application software".

Existing data centers have challenged DOR's interpretation of current statute, contending that all software expenditures should currently be tax exempt. An initial ruling by the Office of Administrative Hearings sided with DOR's interpretation. If all software expenditures were exempted, as is the case under SB 1366, DOR would be required to issue refunds to data centers for taxes paid going back to September 2013. DOR has indicated that, at a minimum, these refunds would be at least $(4.0) million. This figure represents existing refund requests from companies that have challenged DOR's interpretation of current statute. The actual amount of refunds may be higher, as DOR would be required to refund TPT and use tax paid on all newly eligible software, regardless of whether a certified data center had previously filed a refund request.

In addition to refunds for taxes already paid on software, there would be an ongoing cost as the result of future software spending.

An analysis by the City of Phoenix projected that the bill's software exemption would reduce the city's revenues by at least $(2.9) million per year. The city produced this estimate by reviewing 2,041 software transactions that they believe would become exempt from TPT under the bill. The city analysis assumed that there were 51 co-location tenants for each of the 12 certified data centers in the city, and that each would owe $(4,700) less per year in city TPT under the bill.

Industry representatives believe that the City of Phoenix estimate is overstated due to different assumptions about the number of certified co-location tenants per data center.

The JLBC Staff has used both industry and City of Phoenix assumptions to create an estimated annual state General Fund impact of between $(1.2) million and $(6.9) million. The low end of the range assumes that there is an average of 12 certified tenants per 9 co-location data centers in the state, and that an additional 9 enterprise-level data center with only 1 company makes software purchases equivalent to 6 certified co-location tenants. The high end of the range uses the same assumptions as the city.

The JLBC Staff, however, lacks the necessary information to validate the methodology used by both the industry and City of Phoenix's analysis, so this estimate is speculative.

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Local Government Impact

Counties
To the extent that SB 1366 reduces state revenues collections, it would also reduce county revenue collections. Under the statutory distribution formula for retail sales, counties receive 16.2% of total state TPT collections from such sales.

In addition, the bill would also affect the county excise taxes imposed on retail sales. All 15 counties in the state levy some type of county tax. Although these taxes are collected by the state, they are all distributed to the counties except for the 0.5% transportation excise tax imposed in both Maricopa and Pima Counties. These excise taxes are directly allocated to the Maricopa Association of Governments (MAG) or Pima Association of Governments (PAG) rather than Maricopa or Pima County governments.

Cities
Cities currently receive 10.0% of total state TPT collections from retail sales. These city revenue distributions would be reduced under the bill. The exemptions under the bill would also reduce municipal TPT collections.

As stated in the analysis section (above), the City of Phoenix estimates that the bill would reduce its annual municipal TPT revenues by $(2.9) million annually. Under the JLBC Staff's alternative set of assumptions (described above), this impact would be reduced to $(509,200).

In addition to the ongoing revenue loss, cities would also be required to issue refunds to companies that have been paying taxes on software and equipment that is exempt under SB 1366. While they were unable to provide a dollar figure of existing refund requests, the City of Phoenix has indicated that they have received requests from companies that believe certain software expenses should be exempt under current law.

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