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Jane Dee Hull
Secretary of State

CHAPTER 31

SENATE BILL 1238

AN ACT

AMENDING SECTION 12-348.01, ARIZONA REVISED STATUTES, AS AMENDED BY LAWS 1995, CHAPTER 251, SECTION 1; REPEALING SECTION 12-348.01, ARIZONA REVISED STATUTES, AS AMENDED BY LAWS 1995, CHAPTER 189, SECTION 1; AMENDING SECTIONS 42-104, 42-139.13, 43-1021, 43-1028, 43-1029 AND 43-1130.01, ARIZONA REVISED STATUTES; RELATING TO TAXATION.

Be it enacted by the Legislature of the State of Arizona:

Section 1. Section 12-348.01, Arizona Revised Statutes, as amended by Laws 1995, chapter 251, section 1, is amended to read:

12-348.01. <u>Award of costs and fees against a department in administrative hearings; exceptions; definitions</u>

A. EXCEPT AS PROVIDED IN SECTION 42-139.14, SUBSECTION G, a hearing officer shall award fees and other costs to any prevailing party in a contested case brought pursuant to any state administrative hearing authority. For purposes of this subsection, a person is considered to be a prevailing party only if both:

1. The agency's position was not substantially justified.

2. The person prevails as to the most significant issue or set of issues unless the reason that the person prevailed is due to an intervening change in the law.

B. Reimbursement under this section may be denied if during the course of the proceeding the party unduly and unreasonably protracted the final resolution of the matter.

C. A party that seeks an award of fees or other costs shall apply to the hearing officer, within thirty days after the final decision or order, providing:

1. Evidence of the party's eligibility for the award.
2. The amount sought.
3. An itemized statement from the attorneys and experts stating:
(a) The actual time spent representing the party.
(b) The rate at which the fees were computed.

D. The award of reasonable attorney's fees pursuant to subsection A need not equal or relate to the attorney's fees actually paid or contracted, but an award may not exceed the amount paid or agreed to be paid.

E. A decision of a hearing officer under this section is subject to judicial review under chapter 7, article 6 of this title. If fees and other costs were denied by the hearing officer because the party was not the prevailing party but the party prevails on appeal, the court may award fees and other costs for the proceedings before the hearing officer if the court finds that fees and other costs should have been awarded under subsection A.

F. The department shall pay the fees and ~~monies~~ COSTS awarded pursuant to this section from any monies appropriated to the department and available for that purpose, or from other operating costs of the department. If the department fails or refuses to pay the award within thirty days after the demand, and if no further review or appeals of the award are pending, the person may file a claim for the award with the department of administration which shall pay the claim within thirty days in the same manner as an uninsured property loss under title 41, chapter 3.1, article 1, except that the department shall be responsible for the total amount awarded and shall pay it from operating monies. If the department had appropriated monies available for paying the award at the time it failed or refused to pay, the legislature shall reduce the department's operating appropriation for the following fiscal year by the amount of the award and appropriate that amount to the department of administration as reimbursement for the loss.

G. This section does not apply to:

1. Any grievance and appeal procedure pursuant to title 36, chapter 29.
2. Any appeal procedure pursuant to title 41, chapter 4, article 6.
3. Any administrative appeal filed by an inmate in an Arizona state prison.

H. As used in this section:

1. "Department" includes a state agency, department, board or commission, and the universities.
2. "Party" includes an individual, partnership, corporation, association and public or private organization.

Sec. 2. Repeal

Section 12-348.01, Arizona Revised Statutes, as amended by Laws 1995, chapter 189, section 1, is repealed.

Sec. 3. Section 42-104, Arizona Revised Statutes, is amended to read:

42-104. General powers and duties of the department; res judicata; remedies; enforcement; special collections account

A. The department shall administer and enforce the provisions of this title, title 43 and other laws assigned to it and has all the powers and duties prescribed by law for such purposes. In all proceedings prescribed by law the department may act on behalf of this state. In addition, the department shall:

1. Formulate policies, plans and programs to effectuate the missions and purposes of the department.

2. Employ and remove personnel subject to the provisions of title 41, chapter 4, articles 5 and 6, determine the conditions of employment and prescribe the duties and powers of administrative, professional, technical, secretarial, clerical and other personnel as may be necessary in the performance of its duties, and contract for the services of outside advisors, consultants and aid as may be reasonably necessary.

3. Make contracts and incur obligations within the general scope of its activities and operations subject to the availability of its funds.

4. Contract with or assist other departments, agencies or institutions of the state, local, Indian tribal and federal governments in the furtherance of its purposes, objectives and programs.

5. Accept grants, matching funds and direct payments from public or private agencies for the conduct of programs which are consistent with the overall purposes and objectives of the department.

6. Provide information and advice within the scope of its duties subject to the laws on confidentiality of information and departmental rules adopted pursuant to such laws.

7. Advise with and make recommendations to the governor and the legislature on all matters concerning its objectives.

8. Have an official seal which shall be judicially noticed.

9. Provide an integrated, coordinated and uniform system of tax administration and revenue collection for the state.

10. In each year in which there is a regularly scheduled general election, mail voter registration forms to individual income taxpayers. The department shall consult and cooperate with the secretary of state to develop a mailing list for voter registration forms that is designed to mail those forms to persons who have not registered to vote. The department shall mail these forms no later than one hundred eighty days before the date of the general election.

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B. The department may:

1. With the approval of the attorney general:

(a) Abate any balance owed by a taxpayer if the balance is uncollectible. Related liens, if any, may also be released.

(b) Abate all or part of the unpaid portion of any tax if the director determines that the administration and collection costs involved would exceed the amount of the tax.

2. Offer publications relating to the administration of state taxes for sale at a price equal to the pro rata cost of publication and distribution. Monies received from the sale of publications shall be placed in a revenue publications revolving fund. Monies in the fund:

(a) Shall be used to meet publication and distribution expenses.

(b) Are exempt from the provisions of section 35-190 relating to lapsing of appropriations.

3. Enter into contingent fee contracts to collect delinquent state taxes, penalties and interest due under title 43 and chapter 8, article 1 of this title, consistent with the requirements of section 42-108. No contract may be entered into for the collection of delinquent state taxes which exceed five hundred dollars for an individual resident, Arizona corporation or partnership.

C. In the determination of any issue of law or fact under this title or title 43, neither the department, nor any officer or agency having any administrative duties under this title or title 43, nor any court is bound by the determination of any other executive officer or administrative agency of this state. In the determination of any case arising under this title or title 43, the rule of res judicata is applicable only if the liability involved is for the same year OR PERIOD as was involved in another case previously determined under this title or title 43.

D. The remedies of this state provided for in this title and title 43 are cumulative, and no action taken by the department constitutes an election by this state to pursue any remedy to the exclusion of any other remedy provided by law.

E. The attorney general shall prosecute in the name of this state all actions necessary to enforce this title and title 43. The attorney general may defend all actions brought against this state or an officer or agency of this state arising under this title and title 43. The attorney general may delegate the prosecuting authority to any county attorney for prosecution in that county.

F. A special collections account is established in the state general fund. All monies collected pursuant to contracts authorized by subsection B, paragraph 3 of this section shall be deposited in the special collections account. The department shall pay from the account all fees and court costs provided for in the contracts authorized under subsection B, paragraph 3 of this section. The department shall allocate the remainder of the amounts

collected under subsection B, paragraph 3 of this section to the state or the political subdivision in the proportion that the monies would have been distributed pursuant to chapter 8 of this title or title 43, chapter 2, article 3, respectively.

Sec. 4. Section 42-139.13, Arizona Revised Statutes, is amended to read:

42-139.13. Department responsibilities; decision deadlines; definition

A. The department shall attempt to issue a decision from the hearing officer within ninety days after the date of a formal hearing or after the last post-hearing brief is ~~submitted~~ DUE, whichever is later. If the department expects the decision to be delayed, the department shall notify the taxpayer or his designated representative of the proposed issue date.

B. The department shall attempt to issue a decision by the director on any pending appeal to the director within ninety days after the last brief is ~~submitted~~ DUE. If the department expects the decision to be delayed, the department shall notify the taxpayer or his designated representative of the proposed issue date.

C. The department shall provide a written document to each new transaction privilege tax licensee that provides information regarding the collection, reporting and payment of taxes in the appropriate tax classification.

D. For purposes of this section "designated representative" means an individual who has been authorized in writing to represent another person before the department of revenue.

Sec. 5. Section 43-1021, Arizona Revised Statutes, is amended to read:

43-1021. Additions to Arizona gross income

In computing Arizona adjusted gross income, the following amounts shall be added to Arizona gross income:

1. A beneficiary's share of trust or estate income includible under section 43-1344.

2. A beneficiary's share of trust or estate deductions allowable under the internal revenue code.

3. An amount equal to the "ordinary income portion" of a lump sum distribution that was excluded from federal adjusted gross income pursuant to section 402(e) of the internal revenue code.

4. The amount of interest income received on obligations of any state, territory or possession of the United States, or any political subdivision thereof, located outside the state of Arizona.

5. Annuity income received during the taxable year to the extent that the sum of the proceeds received from such annuity in all taxable years prior to and including the current taxable year exceeds the total consideration and premiums paid by the taxpayer. This paragraph applies only to those

annuities with respect to which the first payment was received prior to December 31, 1978.

6. The excess of a partner's share of partnership taxable income required to be included under chapter 14, article 2 of this title over the income required to be reported under section 702(a)(8) of the internal revenue code.

7. The excess of a partner's share of partnership losses determined pursuant to section 702(a)(8) of the internal revenue code over the losses allowable under chapter 14, article 2 of this title.

8. The amount by which the adjusted basis of property described in this paragraph and computed pursuant to the internal revenue code exceeds the adjusted basis of such property computed pursuant to this title and the income tax act of 1954, as amended. This paragraph shall apply to all property which is held for the production of income and which is sold or otherwise disposed of during the taxable year, except depreciable property used in a trade or business.

9. The amount of depreciation or amortization of costs of any capital investment that is deducted pursuant to section 167 or 179 of the internal revenue code by a qualified defense contractor with respect to which an election is made to amortize pursuant to section 43-1024.

10. The amount of gain from the sale or other disposition of a capital investment which a qualified defense contractor has elected to amortize pursuant to section 43-1024.

11. The amount of depreciation or amortization of costs of child care facilities deducted pursuant to section 167 or 188 of the internal revenue code for which a credit is taken under section 43-1075, subsection A, paragraph 1.

12. Amounts withdrawn from the state retirement system, the corrections officer retirement plan, the public safety personnel retirement system, the elected officials' retirement plan or a county or city retirement plan by an employee upon termination of employment before retirement to the extent they were deducted in arriving at Arizona taxable income in any year.

13. That portion of the net ~~operation~~ OPERATING loss included in federal adjusted gross income which has already been taken as a net operating loss for Arizona purposes.

14. Any nonitemized amount deducted pursuant to section 170 of the internal revenue code representing contributions to an educational institution which denies admission, enrollment or board and room accommodations on the basis of race, color or ethnic background except those institutions primarily established for the education of American Indians.

15. The amount of depreciation or amortization of costs of recycling equipment deducted pursuant to the internal revenue code for which an election is made pursuant to section 43-1076.

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16. The amount paid as taxes on property in this state with respect to which a credit is claimed under section 43-1078.

17. Amounts withdrawn by the taxpayer during the taxable year from an individual medical savings account established in the taxpayer's name pursuant to:

(a) Section 43-1028, subsection F.

(b) Section 43-1028, subsection G and not transferred to a new trustee within sixty days after the withdrawal.

18. Any amount of agricultural water conservation expenses that were deducted pursuant to the internal revenue code for which a credit is claimed under section 43-1084.

19. The amount by which the depreciation or amortization computed under the internal revenue code with respect to property for which a credit was taken under section 43-1080 exceeds the amount of depreciation or amortization computed pursuant to the internal revenue code on the Arizona adjusted basis of the property.

20. The amount by which the adjusted basis computed under the internal revenue code with respect to property for which a credit was claimed under section 43-1080 and which is sold or otherwise disposed of during the taxable year exceeds the adjusted basis of the property computed under section 43-1080.

21. The amount by which the depreciation or amortization computed under the internal revenue code with respect to property for which a credit was taken under section 43-1081 exceeds the amount of depreciation or amortization computed pursuant to the internal revenue code on the Arizona adjusted basis of the property.

22. The amount by which the adjusted basis computed under the internal revenue code with respect to property for which a credit was claimed under section 43-1081 and which is sold or otherwise disposed of during the taxable year exceeds the adjusted basis of the property computed under section 43-1081.

23. The deduction referred to in section 1341(a)(4) of the internal revenue code for restoration of a substantial amount held under a claim of right.

24. The amount by which a net operating loss carryover or capital loss carryover allowable pursuant to section 1341(b)(5) of the internal revenue code exceeds the net operating loss carryover or capital loss carryover allowable pursuant to section 43-1029, subsection F.

Sec. 6. Section 43-1028, Arizona Revised Statutes, is amended to read:

43-1028. <u>Individual medical savings accounts; definitions</u>

A. For taxable years beginning from and after December 31, 1994, a resident may establish an individual medical savings account. An individual medical savings account is a trust created or organized to pay eligible medical expenses. The account holder may subtract the amount of deposits to

1 an individual medical savings account during the taxable year in computing
2 Arizona adjusted gross income under section 43-1022.
3 B. On agreement between an employer and employee an employer may
4 either:
5 1. Contribute to the employee's individual medical savings account.
6 Employer contributions to an employee's account are not considered to be
7 income to the employee until they are withdrawn from the account.
8 2. Make or continue to make contributions toward the employee's
9 medical coverage.
10 3. Contribute a combination of monies to the employee's individual
11 medical savings account and medical coverage.
12 C. In each taxable year, total deposits made to the account from
13 either the account holder or the account holder's employer shall not exceed
14 the following:
15 1. For the 1995 taxable year, either:
16 (a) Two thousand dollars for the account holder.
17 (b) Two thousand dollars for the account holder plus one thousand
18 dollars for each of the account holder's dependents up to a maximum of two
19 dependents.
20 2. For subsequent taxable years, the department shall adjust the
21 maximum amounts prescribed by paragraph 1 of this subsection according to the
22 annual change in the GDP price deflator, as defined in section 41-563.
23 D. For the 1995 taxable year, no taxpayer is eligible to subtract from
24 Arizona gross income deposits to individual medical savings accounts totaling
25 more than four thousand dollars with respect to the taxpayer's household.
26 For subsequent taxable years, the department shall adjust this maximum amount
27 according to the annual change in the GDP price deflator as defined in
28 section 41-563.
29 E. The individual medical savings account shall be established as a
30 trust under the laws of this state and placed with a trustee. At the time
31 the medical savings account is established the trustee shall notify the
32 account holder of potential federal income tax liability that may be
33 associated with the account. The trustee shall use the monies in an
34 individual medical savings account solely to pay medical expenses of the
35 account holder and the holder's spouse and dependents that are not otherwise
36 covered under the holder's existing medical coverage. After submitting
37 appropriate documentation to the trustee, the holder may also be reimbursed
38 by the trustee out of available account monies for eligible medical expenses
39 paid directly by the holder during the taxable year.
40 F. The account holder may withdraw monies from the individual medical
41 savings account for purposes other than those expenses allowed pursuant to
42 subsection E of this section on the last business day of a calendar year
43 without incurring a withdrawal penalty. Money withdrawn pursuant to this
44 subsection is considered income for the purposes of computing Arizona

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adjusted gross income. If an account holder withdraws money at any other time for purposes other than those expenses allowed pursuant to subsection E of this section or as provided by subsection G of this section, all of the following apply:

1. The amount of the withdrawal is considered income for the purpose of computing Arizona adjusted gross income.

2. The account holder shall pay a penalty, equal to ten per cent of the amount of the withdrawal, to the department at the same time as the account holder files the income tax return under this title for the taxable year. The state treasurer shall credit penalty monies to the state general fund.

G. If an account holder withdraws all or part of the monies from an individual medical savings account and does not deposit the amount withdrawn in another individual medical savings account, the amount that is not deposited is considered to be a withdrawal for purposes of subsection F of this section, except that:

1. If an interest in an individual medical savings account is transferred or distributed to the account holder's spouse or former spouse under the terms of a legal separation or dissolution of marriage and the spouse or former spouse fails to deposit the full amount in another individual medical savings account within sixty days, the amount that is not deposited is considered to be income to the spouse or former spouse for the purpose of computing Arizona gross income but is not subject to a penalty under subsection F, paragraph 2 of this section.

2. If, pursuant to a written request by a former employee to the current trustee to retain the monies in the current individual medical savings account, the current trustee fails or refuses to retain the former employee's individual medical savings account, the trustee shall mail a check ON THE DATE THE REQUEST IS RECEIVED for the full amount of the balance in the individual medical savings account ~~on that date~~ to the former employee's last known address. The amount of the check is considered to be income TO THE FORMER EMPLOYEE for the purpose of computing Arizona gross income but is not subject to a penalty under subsection F, paragraph 2 of this section. The written request from the former employee to the current trustee must be made within sixty days of the final date of employment.

H. On the death of the account holder, the trustee shall distribute the principal and accumulated interest of the individual medical savings account to the estate of the account holder.

I. The trustee of an individual medical savings account shall make such reports regarding the account to the department and the account holder with respect to contributions, income earned during the taxable year, distributions and such other matters as the department may require by rule. The report shall be:

1. Filed with the department at the time and in the manner prescribed by the department.

2. Furnished to the account holder in the manner prescribed by the department on or before January 31 of the calendar year following the calendar year to which the report relates.

J. For purposes of this section:

1. "Account holder" means an individual on whose behalf an individual medical savings account is established.

2. "Eligible medical expense" means expenses paid by or on behalf of an account holder for medical care that is described in section 213(d) of the internal revenue code.

3. "Household" means the taxpayer, the spouse and those persons that the taxpayer claims as dependents pursuant to this chapter.

4. "Trustee" means:

(a) A financial institution that is authorized to conduct business in this state as a fiduciary.

(b) An insurance company that is authorized to conduct insurance business in this state.

(c) An employer if the employer has a self-insured health plan that meets the requirements of the employee retirement and income security act of 1974 (P.L. 93-406; 88 Stat. 829).

Sec. 7. Section 43-1029, Arizona Revised Statutes, is amended to read:

43-1029. <u>Restoration of a substantial amount held under claim of right; computation of tax</u>

A. This section applies if:

1. An item of income was included in gross income for a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to the item.

2. A deduction would be allowable under the internal revenue code or this title for the taxable year, without application of section 1341(b)(3) of the internal revenue code or section 43-1021, paragraph ~~11~~ 23, because after the close of the prior taxable year or years it was established that the taxpayer did not have an unrestricted right to all or part of the item.

3. The amount of the deduction exceeds three thousand dollars.

B. If all of the conditions in subsection A of this section apply, the tax imposed by this chapter for the taxable year is an amount equal to the tax for the taxable year computed without the deduction, minus the decrease in tax under this chapter for the prior taxable year or years that would result solely from excluding the item or portion of the item from gross income for the prior taxable year or years.

C. If the decrease in tax exceeds the tax imposed by this chapter for the taxable year, computed without the deduction, the excess is considered to be a payment of tax on the last day prescribed by law for the payment of

tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment for the taxable year.

D. Subsection B of this section does not apply to any deduction that is allowable with respect to an item that was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer, or other property of a kind that would properly have been included in the inventory of the taxpayer on hand at the close of the prior taxable year, or property that is held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This subsection does not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility that is listed in section 7701(a)(33)(A) through (H) of the internal revenue code, if the refunds or repayments are:

1. Required to be made by the government, political subdivision, agency or instrumentality referred to in that section.

2. Required to be made by an order of a court.

3. Made in settlement of litigation or under threat or imminence of litigation.

E. If the exclusion under subsection B of this section results in:

1. A net operating loss for the prior taxable year or years for purposes of computing the decrease in tax for the prior year or years under subsection B of this section:

(a) The loss shall be:

(i) Carried over under this chapter to the same extent and in the same manner as was provided under prior law for taxable years beginning on or before December 31, 1989.

(ii) Carried back and carried over to the same extent and in the same manner as provided under section 172 of the internal revenue code for taxable years beginning from and after December 31, 1989.

(b) No carryover beyond the taxable year may be taken into account.

2. A capital loss for the prior taxable year or years, for purposes of computing the decrease in tax for the prior taxable year or years under subsection B of this section:

(a) The loss shall be carried back and carried over to the same extent and in the same manner as is provided under section 1212 of the internal revenue code.

(b) No carryover beyond the taxable year may be taken into account.

F. In computing Arizona taxable income for taxable years subsequent to the current taxable year, the net operating loss or capital loss determined in subsection E of this section shall be taken into account to the same extent and in the same manner as a net operating loss or capital loss sustained for prior taxable years.

Sec. 8. Section 43-1130.01, Arizona Revised Statutes, is amended to read:

43-1130.01. Restoration of a substantial amount held under claim of right; computation of tax

A. This section applies if:

1. An item of income was included in gross income for a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to the item.

2. A deduction would be allowable under the internal revenue code or this title for the taxable year, without application of section 1341(b)(3) of the internal revenue code or section ~~43-1021~~ 43-1121, paragraph ~~11~~ 20, because after the close of the prior taxable year or years it was established that the taxpayer did not have an unrestricted right to all or part of the item.

3. The amount of the deduction exceeds three thousand dollars.

B. If all of the conditions in subsection A of this section apply, the tax imposed by this chapter for the taxable year is an amount equal to the tax for the taxable year computed without the deduction, minus the decrease in tax under this chapter for the prior taxable year or years that would result solely from excluding the item or portion of the item from gross income for the prior taxable year or years.

C. If the decrease in tax exceeds the tax imposed by this chapter for the taxable year, computed without the deduction, the excess is considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment for the taxable year.

D. Subsection B of this section does not apply to any deduction that is allowable with respect to an item that was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer, or other property of a kind that would properly have been included in the inventory of the taxpayer on hand at the close of the prior taxable year, or property that is held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This subsection does not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility that is listed in section 7701(a)(33)(A) through (H) of the internal revenue code, if the refunds or repayments are:

1. Required to be made by the government, political subdivision, agency or instrumentality referred to in that section.

2. Required to be made by an order of a court.

3. Made in settlement of litigation or under threat or imminence of litigation.

E. If the exclusion under subsection B of this section results in:

1. A net operating loss for the prior taxable year or years for purposes of computing the decrease in tax for the prior year or years under subsection B of this section:

(a) The loss shall be carried over under this chapter to the same extent and in the same manner as provided under section 43-1123, and under prior law.

(b) No carryover beyond the taxable year may be taken into account.

2. A capital loss for the prior taxable year or years, for purposes of computing the decrease in tax for the prior taxable year or years under subsection B of this section:

(a) The loss shall be:

(i) Carried over under this chapter to the same extent and in the same manner as was provided under prior law for taxable years beginning on or before December 31, 1987.

(ii) Carried back and carried over to the same extent and in the same manner as provided under section 1212 of the internal revenue code for taxable years beginning from and after December 31, 1987.

(b) No carryover beyond the taxable year may be taken into account.

F. In computing Arizona taxable income for taxable years subsequent to the current taxable year, the net operating loss or capital loss determined in subsection E of this section shall be taken into account to the same extent and in the same manner as a net operating loss or capital loss sustained for prior taxable years.

Sec. 9. Retroactivity

A. Section 3 of this act is effective retroactively to midnight June 30, 1986.

B. Section 4 of this act is effective retroactively to July 17, 1994.

C. Section 5 of this act applies retroactively to taxable years beginning from and after December 31, 1989.

D. Section 6 of this act applies retroactively to taxable years beginning from and after December 31, 1994.

E. Sections 7 and 8 of this act are effective retroactively to July 13, 1995.

APPROVED BY THE GOVERNOR MARCH 25, 1996

FILED IN THE OFFICE OF THE SECRETARY OF STATE MARCH 25, 1996