

**W**hen we began Steptoe's Arizona Tax Update, we had hopes of making it an annual update of Arizona tax developments, including legislation, cases and Department of Revenue rulings and procedures but because of the day to day deadlines of our state and local tax practice, we have fallen behind. This update is the first since our 2002 Update and will provide you with the highlights of Arizona tax developments, both legislation and cases, for 2003, 2004 and 2005.

We hope that you find this Update useful and interesting. Should you have any questions about the developments, please feel free to call Pat Derdenger, the head of our state and local tax practice, at (602) 257-5209, or email him at [pderdenger@steptoe.com](mailto:pderdenger@steptoe.com)

## TABLE OF CONTENTS

<b>2005 Tax Legislation</b> .....	<b>3</b>
Income Tax .....	3
Transaction Privilege Tax and Use Tax .....	6
Property Tax .....	7
Miscellaneous .....	9
<b>2005 Cases</b> .....	<b>12</b>
Income Tax .....	12
Transaction Privilege Tax and Use Tax .....	12
Property Tax .....	14
<b>2004 Tax Legislation</b> .....	<b>17</b>
Income Tax .....	17
Transaction Privilege Tax and Use Tax .....	18
Property Tax .....	20
Miscellaneous .....	21
<b>2004 Cases</b> .....	<b>22</b>
Income Tax .....	22
Transaction Privilege Tax and Use Tax .....	23
Property Tax .....	23
<b>2003 Tax Legislation</b> .....	<b>25</b>
Income Tax .....	25
Sales and Use Tax .....	25
Property Tax .....	26
Other Taxes .....	27
<b>2003 Cases</b> .....	<b>27</b>
Income Tax .....	27
Transaction Privilege Tax and Use Tax .....	27
Property Tax .....	29
<b>Department of Revenue Rulings and Decisions</b> .....	<b>30</b>
Transaction Privilege Tax and Use Tax Rulings .....	30
Transaction Privilege Tax Procedures .....	31
Corporate Income Tax Rulings .....	31
General Tax Rulings .....	31
Individual Income Tax Rulings .....	32
Decisions of Director .....	32
<b>Steptoe's State and Local Tax Practice</b> .....	<b>34</b>
<b>Steptoe's Federal Tax Practice</b> .....	<b>36</b>

Some of the more significant developments that we would call your attention to are:

## 2005

### **House Bill 2139—Super-Weighted Sales Factor Legislation.**

The Arizona Legislature finally passed sales factor legislation, which upon election by a taxpayer increases the weight of the sales factor from the current 50% to 80%. This super-weighting of the sales factor will be phased in and will become fully effective beginning in 2009. The phase in to the 80% weighted sales factor is contingent upon one or more corporations, on or after June 1, 2005, publicly announcing and reporting to the Joint Legislative Budget Committee and the Governor's Office of Strategic Planning and Budgeting their intent to construct one or more projects cumulating capital cost in excess of \$1 billion, and then no later than December 15, 2007 notifying the Budget Committee and the Governor's Office that the project or projects have commenced.

### **House Bill 2771 - Reduction of Business Property Assessment Rate From 25 Percent to 20 Percent Over a Ten Year Period.**

Business property currently has an assessment rate of 25 percent, while residential property has an assessment rate of 10 percent. The effect of this differential is that business property of the same value will bear a property tax burden 2.5 times greater than the residential property. Given this structure, Arizona has one of the highest business property tax burdens in the country. This legislation will reduce the business property rate from 25 percent to 20 percent over a ten year period, with a .5 percent reduction each year. Beginning in the year 2015 and thereafter, the rate will be 20 percent. It is expected that the business community will approach the legislature this coming year to accelerate the rate decrease.

The reduction of the business property assessment rate would ordinarily result in a shifting of the property tax burden to homeowners. However, the legislature has increased the "homeowners rebate" in order to offset this shift. Thus, homeowners will not be paying additional property taxes as a direct result of the business assessment rate decrease. Rather, the state will absorb that shift.

**Baker v. Arizona Dept. of Revenue**, in which the Court of Appeals upheld the Legislature's retroactive limitation of alternative fuel tax credits.

## 2004

**Hibbs v. Winn**, in which the United States Supreme Court held that the Federal Tax Injunction Act, which precludes taxpayers from litigating state tax issues in federal court, does not preclude a taxpayer from challenging the constitutionality of a state income tax credit in Federal Court.

**Dept. of Revenue v. Capitol Castings**, where the Arizona Supreme Court overturned the Court of Appeals' narrow definition for exempt "machinery or equipment" and adopted a much more flexible approach that looks to the "nature of the item and its role in the operations" to determine whether an item constitutes exempt machinery or equipment. This case is probably the most important of the tax cases that have come out over the last couple of years. It is very taxpayer friendly, offering a much more expansive view of what exempt machinery or equipment is.

## 2003

**Luther v. Arizona Dept. of Revenue** is another important, if not landmark case like the *Capitol Castings* decision. In *Luther*, our Court of Appeals held that the Department of Revenue can be estopped from issuing an audit assessment based upon the taxpayer's reliance on a prior audit assessment dealing with the same issue.

## 2005 LEGISLATION AND CASES

### LEGISLATION\*

#### Income Tax

**House Bill 2155 (Ariz. Sess. Laws 2005, Chapter 11). *2005 Tax Corrections Act.*** This Bill makes technical, conforming and clarifying changes to Arizona tax statutes. With regard to income taxation, it:

- Corrects a bad retroactivity date for enterprise zone credits under A.R.S. § 42-1074 (individual income tax) and A.R.S. § 42-1161 (corporate income tax). In 2004, these statutes were amended to allow taxpayers to claim second or third year credits for taxable year 2002 and third year credits for taxable year 2003 when the first year credit was claimed on an amended (rather than an original) return if a qualified employment position was created prior to January 1, 2002 and certified. The 2004 amendment, however, was meaningless because it was only made retroactive to December 31, 2003. The 2005 Bill changes the retroactivity date to years beginning after December 31, 2001, thereby allowing taxpayers to take advantage of the 2004 amendment.
- This Bill also repeals a defunct statute that allocated a portion of the luxury tax collected on Arizona-produced wine to the Arizona Wine Promotional Fund (the statutes dealing with the Arizona Wine Commission were repealed on January 1, 2005).

**House Bill 2156 (Ariz. Sess. Laws 2005, Chapter 12). *Income Tax Credit Review Schedule.*** This is the annual Bill that updates the income tax credit review schedule based on the recommendations of the Joint Legislative Income Tax Credit Review Committee. It removes the income tax credits that were reviewed in 2004 (agricultural pollution equipment, solar energy and agricultural water conservation system credits) and adds these credits to the review schedule in 2009.

**Senate Bill 1466 (Ariz. Sess. Laws 2005, Chapter 115). *New National Guard Relief Fund and Tax Checkoff.*** This Bill creates the

National Guard Relief fund that will assist families of Arizona National Guard members when the Guard member is in combat. The Bill provides for a check-off on Arizona individual income tax forms, where taxpayers can donate to this fund.

**House Bill 2059 (Ariz. Sess. Laws 2005, Chapter 148). *Income Tax Credits for Pollution Control Equipment Restricted.*** This Bill amends both the Individual and Corporate income tax credits for pollution control equipment. The amendment comes in response to taxpayer attempts to expand the definition of pollution control equipment. For example, taxpayers attempted to claim credits for water retention basins and drainage gutters used for flood, rather than pollution, control. The amendments restrict the types of property and equipment that qualify for tax credits. To qualify under the amendments, the property or equipment must: (1) reduce pollution that directly results from the taxpayer's operations; (2) not serve dual purposes, such as flood and pollution control; and (3) not be equipment that is included as a standard or an integral part of another property.

**Senate Bill 1224 (Ariz. Sess. Laws 2005, Chapter 264). *New Income Tax Credit for National Guard Employees on Active Duty.*** This Bill adds an income tax credit for individuals and corporations that employ members of the Arizona National Guard if those employees are placed on active duty during the tax year for a period that exceeds the required training period. The amount of the credit is \$1,000 for each employee placed on active duty and unused credits can be carried forward for up to five years. The credits become effective beginning in taxable year 2006.

**Senate Bill 1283 (Ariz. Sess. Laws 2005, Chapter 278). *Requirements Necessary for Businesses to Qualify for Forest Health Tax Incentives are Eased.*** In 2004, Arizona passed legislation to promote healthy forests by reducing hazardous fuels on state and federal lands within Arizona. This Bill amends that legislation. The Bill eases the requirements that individuals and businesses must meet to qualify for the tax incentives under A.R.S. § 43-1076 and §43-1162. Under the amendments, businesses need only employ three (as opposed to ten) new full-time employees in qualified

employment positions in the first year the credit is claimed. The amendment redefines 'full-time employment' as 1,550 hours per year (unless weather conditions or forest closures limit the work year) instead of 1,700 hours per year. It also reduces the percentage of health insurance premiums that the taxpayer must pay for qualified employees. Last year's version required the taxpayer to pay 50% of the premiums. This Bill requires the taxpayer to pay at least 25% in the third year the taxpayer claims a credit, at least 40% in the fourth year, and at least 50% in the fifth year. The final change clarifies that credits can only be recaptured if a business's certification of qualification is revoked or terminated by the DOC and not for some other failure to qualify for or claim credit.

**House Bill 2139 (Ariz. Sess. Laws 2005, Chapter 289). *New Corporate Super-weighted Sales Factor Provides Incentive for Capital Investment in Arizona.*** This Bill provides an optional apportionment formula for calculating corporate income tax for multistate corporations. This formula is favorable to businesses that have substantial payroll and property in Arizona but make a majority of sales outside the state. It is intended to encourage additional capital investment in Arizona by both corporations moving into the state and corporations with ongoing activities in the state and to create more high tech, knowledge-based jobs in the state. Currently, multistate corporations calculate corporate income tax using a combination of Arizona property, payroll, and sales, with sales double-weighted. The new option allows corporations to give greater weight (80%) to the sales factor in calculating Arizona tax liability. The 80% sales factor will be phased in over three years, with a 60% sales factor effective in tax year 2007, a 70% sales factor in 2008, and an 80% sales factor in 2009. The optional apportionment formula becomes effective in tax year 2008, but will be retroactive to 2007 if the following two conditions are met:

- At least one corporation announces, on or after June 1, 2005, that it has one or more capital investment projects in Arizona that, individually or collectively, exceed \$1 billion and the corporation reports its activity to the Joint Legislative Budget Committee (JLBC) and the Governor's Office of Strategic Planning and Budgeting (OSPB). The report must contain a description of the project and the project's estimated completion date, cost, and economic impact on the labor force. Intel has already announced that it has planned capital investment projects sufficient to satisfy this condition.
- The corporation reports to JLBC and OSPB by December 15, 2007 that construction has commenced and verifies that project's costs will exceed \$1 billion.

**House Bill 2323 (Ariz. Sess. Laws 2005, Chapter 292). *New Tax Credits for Water Conservation Systems.*** This Bill adds § 43-1090.01 (individual income tax) and §43-1182 (corporate income tax), which provide individual and corporate income tax credits for individuals and builders who install water conservation systems or plumbing stub-outs for water conservation systems in residences. These systems promote water conservation by enabling the homeowner to recapture and store either rainwater or graywater for future use in household gardening, composting, lawn watering, or landscape irrigation. Both credits are available for tax years beginning after December 31, 2006 and ending before January 1, 2012. Taxpayers must get pre-approval for this credit from the DOR and can carry the credit forward for up to five years.

- The individual credit is up to 25% of the cost of installing the system but cannot exceed \$1,000. A husband and wife who file separately can each claim only one-half of the maximum credit. The DOR may not certify more than a total of \$250,000 of individual tax credits per calendar year.
- The corporate credit for builders is for the full cost of installing the plumbing stub outs for a graywater system, but cannot exceed \$200 per house. The DOR may not certify more than a total of \$500,000 of corporate tax credits per calendar year.

**Senate Bill 1027 (Ariz. Sess. Laws 2005, Chapter 303). *Income Tax Exemption for Active Duty Military Compensation.*** This Bill exempts all active duty military pay from Arizona income tax. Before this amendment, only pay received during service in a combat zone was exempt from Arizona income tax. Additionally, this Bill exempts individuals, whose only source of income is active duty military pay, from filing requirements unless the taxpayer is claiming a refund. This Bill only applies to the 2006 tax year.

**Senate Bill 1335 (Ariz. Sess. Laws 2005, Chapter 316). *New "Angel Investment" Tax Credit for Investments in Small Businesses.*** This Bill adds an individual income tax credit for qualified investments in qualified small businesses for tax years beginning after December 31, 2006 and ending December 31, 2014. The Bill is in response to the Governor's Council on Innovation & Technology's recommendation for strengthening Arizona's technology-based, entrepreneurial community. The taxpayer must apply and the Department of Commerce (DOC) must certify that both the investment and the small business qualify. To qualify, the investment must be made after July 1, 2006, must exceed

\$25,000, and the investor and its affiliates cannot own more than 30% of the voting power in the small business. The small business must be located in Arizona, have at least two full-time employees who are Arizona residents, cannot have more than \$2 million in assets, and cannot be engaged in a statutorily disqualified business activity. Disqualified activities include: retail, food, and restaurant businesses; real estate investment and development businesses; professional services businesses other than hardware or software services; non-research oriented health care providers; human cloning and embryonic stem cell research companies; financial services businesses; and natural resource extraction businesses. The DOC can also directly certify small businesses that make applications for qualified small business status. These certifications are generally valid for one year.

The credit is 10% of the investment amount for each of the three years following the investment unless the small business is a bioscience company or located in a rural area. A slightly higher percentage is allowed for rural and bioscience businesses (12% for the first two year's credits and 11% for the third year credit). Thus, over three years the credit amounts to 30-35% of the total investment, depending on the type of business.

The Bill, however, limits the availability of the tax credits by placing restrictions on both the DOC and individual investors. The DOC cannot authorize credits after June 30, 2011. Nor can it authorize credits that exceed \$20 million dollars for all years. Investors are limited to \$250,000 in investments in any given year and total investments in any single business cannot exceed \$2 million for all years.

**Senate Bill 1347 (Ariz. Sess. Laws 2005, Chapter 317). *New Tax Incentives for Movie Production.*** This Bill provides new corporate and individual income tax incentives to motion picture production companies that: pay a minimum of \$250,000 in production costs; employ a certain percentage of full-time workers in Arizona; and submit an application to the DOC, which must pre-approve the credit. The income tax credit is effective beginning from and after December 31, 2005 through December 31, 2010 and ranges from 10%-20% of the taxpayer's production costs depending on the amount of total production costs. Additionally, unclaimed tax credits under this new incentive may be sold or transferred.

**Senate Bill 1529 (Ariz. Sess. Laws 2005, Chapter 334). *Internal Revenue Code Conformity Bill—No Bonus Depreciation and Section 179 Expensing; School Tuition and Public School Credits Increased; January 2005 Tsunami Contributions Deductible in 2004.*** This is the annual Bill that conforms the Arizona income tax statutes to changes made to the Internal Revenue Code during the past year. The Bill does not provide for full conformity to all changes in the Internal Revenue Code. The following conforming changes are made:

- While the Bill conforms the State income tax statutes to the Working Families Tax Relief Act of 2004 and the American Jobs Creation Act of 2004, including retroactive conformity to the effective dates of the provisions of those federal acts, the Bill continues to exclude three provisions where Arizona did not previously conform to federal changes. As a result, Arizona tax payers must add back the federal bonus depreciation provided in the Job Creation and Worker Assistance Act of 2002 and both the 50% bonus depreciation and the Section 179 expensing in the Jobs and Growth Tax Relief Reconciliation Act of 2003 and then subtract the amount allowable by Arizona when calculating Arizona income tax.
- The Bill also amends A.R.S. § 43-1041 to provide for indexing the standard income tax deduction for inflation based on the average annual change in the Metropolitan Phoenix consumer price index.
- The Bill increases the maximum credit allowed to married couples for:
  - (1) charitable contributions to organizations that assist the working poor from \$200 to \$300 for tax year 2005 and from \$300 to \$400 beginning in tax year 2006;
  - (2) contributions to school tuition organizations from \$625 to \$825 for tax year 2005 and from \$825 to \$1000 beginning in tax year 2006; and
  - (3) fees and contributions made to public schools from \$200 to \$300 in tax year 2005 and from \$300 to \$400 beginning in tax year 2006.
- Additionally, it allows taxpayers who made tsunami relief contributions in January 2005 to claim those contributions on their 2004 tax returns.

## Transaction Privilege Tax (TPT) and Use Tax

**House Bill 2155 (Ariz. Sess. Laws 2005, Chapter 11). Tax Corrections Act.** This Bill makes technical, conforming, and clarifying changes to the Arizona tax statutes. The Bill makes the following changes to TPT and Use taxes:

The Bill corrects A.R.S. § 42-3251 (tobacco tax levy). Prior to the correction, Arizona statutes contained two nearly-identical provisions. One version required monies collected to be 'deposited with' the state treasurer. The other required that monies be 'paid to' the state treasurer. The former version has been repealed.

- The Bill also corrects § 42-5160 (use tax). Arizona statutes contained two similar provisions for the use tax liability. One provision did not account for a business that pays use tax directly to the DOR. The other provision does. The former provision has been repealed.
- The Bill amends the use tax deduction under A.R.S. § 42-5159(13)(f) for tangible personal property used by 501(c)(3) non-profit organizations that provide services to mentally and physically handicapped persons. The language of this provision now conforms with the complementary TPT deduction at A.R.S. § 42-5061(A)(29).
- The Bill moves the exemption for gross receipts derived from transporting fertilizer (A.R.S. § 42-5062.01) into the transporting classification statute (A.R.S. § 42-5062).

**Senate Bill 1439 (Ariz. Sess. Laws 2005, Chapter 62). Lodging Sales Tax Application Clarified.** This Bill resulted from industry and DOR confusion over how to tax certain ancillary services that hotels provide to guests. Hotels, for example, arrange amusement activities and transportation services for guests as well as provide telephone, laundry, internet, and fax services. This Bill clarifies which activities are subject to and exempt from TPT taxation under the telecommunications, transportation, transient lodging, and amusement classifications. Most of the Bill's provision became effective Aug. 12, 2005. The specific provisions regarding amusement and transportation services are retroactively effective as of July 1, 1993. However, retroactive refund claims must be filed before January 1, 2006. The Bill adds the following provisions:

- Transportation arranged or provided solely as an ancillary or convenience service to customers or guests is exempt from the transportation classification. Businesses that dispatch vehicles upon customer request and send bills and receive payments are not exempt.

- Telephone, fax or internet services provided to customers for an additional and separately-invoiced charge are subject to the telecommunications classification.
- The following are excluded from gross proceeds under the transient lodging classification: (a) transactions not limited to transients that would not be taxable to persons not subject to TPT; (b) transactions not limited to transients that would not be subject to TPT because of an exemption or deduction under the transporting or amusement classifications; and (c) certain commission payments.
- Arranging an amusement activity for a customer is not taxable under the transient lodging classification. As with transportation services, this exception does not apply to businesses that operate amusements pursuant to customer orders, send billings, and receive payments.

**Senate Bill 1185 (Ariz. Sess. Laws 2005, Chapter 196). New Use Tax Percentage-Based Reporting Method.** Arizona imposes a use tax on the purchaser of tangible personal property that is used, stored, or consumed in the state. Currently, businesses calculate and report use tax liability based on the actual cost of their purchases. This Bill was passed to promote efficiency, simplicity, and flexibility by providing businesses with an alternative. The Bill permits taxpayers to calculate and report use tax liability under a percentage-based, rather than an actual cost, system. Until June 30, 2007, only taxpayers who are currently eligible for direct payment of use taxes under A.R.S. § 42-5167 may elect a percentage-based alternative. In other words, the option is limited to taxpayers who purchased more than \$500,000 of tangible personal property for their own use in the preceding tax year. However, the Bill will allow *all* use taxpayers to choose the percentage-based alternative beginning on June 30, 2007. Taxpayers may only elect a percentage-based system if they obtain a letter of authorization from the DOR. This letter will outline standards for calculating the use tax liability and will be valid for four years. The DOR can revoke the letter if it determines that the standards for calculating the taxpayer's liability have become inaccurate due to changes in law, rules, or factual circumstances. Revocations cannot be appealed and are effective the first day of the month beginning 90 days after the taxpayer receives notification. Finally, the DOR can audit taxpayers who receive letters of authorization for transactions listed in the letter. The audit, however, is limited to verifying the accuracy of the calculation based on the terms of the letter.

**Senate Bill 1283 (Ariz. Sess. Laws 2005, Chapter 278). *TPT and Use Tax Exemptions for Equipment Used for Forest Health Projects Restricted.*** As discussed above in the income tax section, this bill amends the 2004 Forest Health legislation. It amends the TPT and Use tax exemptions as follows:

- **TPT Retail Classification and Use Tax Exemptions:** Under the original legislation, A.R.S. § 42-5061(B)(22) (retail classification) and § 42-5159(B)(22) (Use Tax) provided exemptions for 'qualifying equipment' purchased for or used in harvesting, transporting, or the initial processing of qualified forest products. This Bill redefines 'qualifying equipment.' That term now includes items such as trailers for hauling forest products but excludes log trucks, chip trucks, ash trucks, and other self-propelled vehicles that require state licensing. In short, trucks used for hauling products are no longer exempt.
- **Prime Contracting Exemption:** The Bill restricts the prime contracting exemption by more narrowly defining several key terms in the exemption. The exemption applies to improvements or developments owned by a 'qualified business.' Businesses qualify by being primarily engaged in a 'qualifying project.' The amendment redefines 'qualifying project' in several ways. First, it defines 'qualifying project' as "harvesting, transporting, or the initial processing of qualifying forest products" (i.e. dead standing and fallen timber, small diameter timber, slash, wood-chips, peelings, brush). Second, it requires that 70% of the project's products be qualifying forest products and that 75% of those products are harvested within the state. These definitions serve to restrict the overall type and number of businesses whose improvements and developments are eligible under the exemption. Moreover, as with the retail classification and use tax exemptions, the prime contractor exemption no longer applies to improvements and developments related to transportation. Rather, it only applies to harvesting and initial processing of forest products.
- **Fuel Tax:** Beginning from August 31, 2005 and ending December 31, 2010, the Bill reduces the fuel tax for transporting qualifying forest products from the standard rate of 26 cents per gallon to 13 cents per gallon.

**Senate Bill 1347 (Ariz. Sess. Laws 2005, Chapter 317). *New TPT and Use Tax Exemptions for Movie Production.*** In addition to providing new income tax incentives, this Bill allows for new TPT and Use Tax exemptions for certified movie production companies. To claim these exemptions, movie production companies must provide proof of certification to the appropriate vendor or contractor at the point of purchase or contract. The Bill provides TPT and Use tax exemptions for:

- machinery, equipment, and tangible personal property purchased and used directly in motion picture production under the retail classification. A.R.S. § 42-5061(B)(23). The same property is exempt from use tax under A.R.S. § 42-5159(B)(23).
- the gross proceeds derived from the rental or lease of lodging space to a certified motion picture production company under the transient lodging classification. A.R.S. § 42-5070(C)(2).
- the sales of catered food and drinks to certified motion picture production companies under the restaurant classification. A.R.S. § 42-5074(B)(10).
- the gross proceeds of sales or gross income received from a construction contract for any building or structure associated with motion picture production in Arizona under the prime contracting classification. A.R.S. § 42-5075(B)(20).

## Property Tax

**House Bill 2134 (Ariz. Sess. Laws 2005, Chapter 40). *The State Board of Equalization Must Review and Consider All Competent Evidence of Value.*** This bill states the obvious in requiring the State Board of Equalization to review and consider all competent evidence, including similar property values, presented as evidence at the time of the Board hearing.

**House Bill 2056 (Ariz. Sess. Laws 2005, Chapter 66). *The Definition of "Plant" For Electric Utility Valuation Purposes Excludes Contributions In Aid of Construction ("CIAC").*** An example of CIAC is buried electric lines. Electric utilities are required to put in electric distribution lines in a new subdivision but the governmental required installation standard is above ground lines. If the developer wanted underground utility lines instead of above ground lines, the developer would pay the electric utility the difference in cost, with this payment being the developer's "contribution in aid of construction" of the buried electric line. [It should be noted that the current standard in subdivisions calls for buried electric lines.]

There has been ongoing litigation between the Department of Revenue and electric utilities over the issue of whether CIAC should be included in "original plant in service" cost, which is the starting point for valuing an electric utility. The utility valuation statute provides that all terms and application of terms are to be interpreted according to the federal energy regulatory commission uniform system of accounts, which provides that CIAC is not to be included in the original cost of the electric plant. The Department of Revenue had taken the position that the FERC provision should not apply but rather the Arizona statutory definition of plant should control. This case is before the Arizona Court of Appeals, awaiting decision. The legislation resolves the CIAC issue for years beginning in 2005, but leaves unresolved prior years, which are subject to the ongoing litigation. Under the new legislation, CIAC will not be included in the electric utility's original plant in service cost.

**House Bill 2252 (Ariz. Sess. Laws 2005, Chapter 131). *Property Tax Administration Changes.*** This bill makes a number of administrative changes, including:

- **Refund Interest.** This bill makes a significant change in the errors correction statutes of A.R.S. §42-16252 (Notice of Error) and A.R.S. §42-16254 (Notice of Claim) involving the interest rate on refunds to be made under the error correction statute and changes the refund rate from the legal rate (the legal rate for pre and post judgment interest is ten percent; the interest rate for late property tax payments is sixteen percent) to the interest rate of A.R.S. §42-1123, which is the same as the federal interest rate for refunds (which currently is significantly less than ten percent). It should be noted though that the interest rate charged on any underpayments of property tax determined to be due under the error correction statutes remains at the legal rate. The effect of this change, which was billed as "clarifying" by the Department of Revenue and the county treasurers is to pay refunds with a lower rate of interest than charged for underpayments of property tax.
- **Tax Liens Assigned to State.** Adds new A.R.S. §42-18005, which authorizes the county treasurer or board of supervisors to act as the agent of the state in the collection of property taxes for tax liens that are assigned to the state or any property that is held by the state.
- **Water Company Tax Liens.** Adds a new A.R.S. §42-17153(B), which provides that a tax lien on any property owned by a water utility company centrally valued by the Department of Revenue is a tax lien on all of the company's property. This

change was made to prevent a water company from paying property taxes on its property located in one taxing jurisdiction but not paying taxes on property located in another jurisdiction with the result being that the property tax lien would attach only to the property in the taxing jurisdiction where the taxes had gone unpaid.

- **Tax Lien Foreclosures.** The tax lien foreclosure provisions are changed in two respects. First, A.R.S. §42-18202, which requires a tax lien purchaser to send a notice of intent to file a foreclosure action at least thirty days before filing such an action, is amended to add a new provision, which provides that if a purchaser fails to send such a notice, the purchaser is considered to have substantially failed to comply with the notice provisions and a court may not act on the foreclosure action until the purchaser sends the required notice. Second, A.R.S. §42-18208 is amended. This section provides that if a lien is not foreclosed by the purchaser within ten years from the date the lien was purchased, the lien is void. A new section is added which provides that if a judicial proceeding prohibits the bringing of a tax lien foreclosure action, the ten year period is extended by twelve months following the completion of the judicial proceeding. As an example, if a bankruptcy case had been instituted that somehow prohibited a purchaser from foreclosing on a property tax lien, and if the ten year period would have run while the bankruptcy was pending, the purchaser would have an additional twelve months from the end of the bankruptcy proceeding to initiate the foreclosure proceedings.
- **Amnesty for Water Companies.** Provides a property tax amnesty for water utility companies that allows the county treasurer to waive the accrued interest on property tax delinquencies for periods before September 30, 1995 if the water utility pays the amount of the property tax for that period and pays any tax, penalty or interest accruing after September 30, 1995, as long as the payment of post September 1995 delinquencies is made on or before December 31, 2005.

**Senate Bill 1041 (Ariz. Sess. Laws 2005, Chapter 186). *Property Tax Exemption for Widows, Widowers, and Disabled Persons; Annual Filing Requirement Dropped.*** This bill amends A.R.S. §42-11111, which provides a partial property tax exemption for widows, widowers, and disabled persons. Those individuals must annually file an application to claim the exemption. This bill does away with

the annual application process and requires that the individual file a one-time only application and also requires the individual to self-report any exemption disqualifying events.

**House Bill 2500 (Ariz. Sess. Laws 2005, Chapter 243). *Removal of the Identity of Public Officers From Property Tax Rolls.*** County assessors, treasurers and recorders beginning January 1, 2006 will be required, on receipt of a court order, to remove from public access the addresses and phone numbers of certain public officers, such as police officers, judges and parole officers.

**House Bill 2441 (Ariz. Sess. Laws 2005, Chapter 276). *Property Tax Exemption for Tribal Housing.*** This bill exempts property located off the reservation that is owned and operated by a federally recognized Indian tribe or its tribally designated housing authority if the property is used for the purpose of providing low income rental housing and related facilities for the use of Indians and is not used, held or operated for profit, with no part of the net earnings of the housing authority inuring to the benefit of any private shareholder or individual. The housing must also be designed and constructed, in whole or in part, using federal financial assistance pursuant to the Native American Housing Assistance and Self Determination Act (P.L. 104-330) or using tribal government monies. This new exemption is contained in A.R.S. §42-11131.

**House Bill 2771 - *Reduction of Business Property Assessment Rate From 25 Percent to 20 Percent Over a Ten Year Period.*** Business property currently has an assessment rate of 25 percent, while residential property has an assessment rate of 10 percent. The effect of this differential is that business property of the same value will bear a property tax burden 2.5 times greater than the residential property. Given this structure, Arizona has one of the highest business property tax burdens in the country. This legislation will reduce the business property rate from 25 percent to 20 percent over a ten year period, with a .5 percent reduction each year. Beginning in the year 2015 and thereafter, the rate will be 20 percent. It is expected that the business community will approach the legislature this coming year to accelerate the rate decrease.

The reduction of the business property assessment rate would ordinarily result in a shifting of the property tax burden to homeowners. However, the legislature has increased the "homeowners rebate" in order to offset this shift. Thus, homeowners will not be paying additional property taxes as a direct

result of the business assessment rate decrease. Rather, the state will absorb that shift.

**Senate Bill 1178 (Ariz. Sess. Laws. 2005, Chapter 309). *Property Tax Exemption for Widows, Widowers and Disabled Persons; Income Limits Increased.*** This bill increases the income limits for widows, widowers and disabled persons seeking a property tax exemption from \$13,200 to \$25,000 if the individual does not have children under 18 years old living with them and from \$18,840 to \$30,000 if the individual has one or more children living at home.

## Miscellaneous

**House Bill 2133 (Ariz. Sess. Laws 2005, Chapter 39). *Pima County Excise Tax for Hotels Increased.*** This Bill amends the current county excise tax on hotels under A.R.S. § 42-6108. The statute only applies to Pima County. The Bill both increases the maximum allowable tax rate from 2% to 6% and strikes the limitation of a flat rate of 1% after December 31, 2012. Prior to the change, the tax applied to all hotels within the County but when the hotel was located in a municipality that levied a similar tax it was given a credit for that city tax. This Bill changes current law by applying the tax only to hotels located in *unincorporated areas* of Pima County. It also changes the percentage of revenues the county may use for stadium and economic development purposes.

**House Bill 2343 (Ariz. Sess. Laws 2005, Chapter 80). *Special Registration Period for Non-resident Vehicle Purchases Extended.*** This Bill amends motor vehicle registration statutes for vehicles purchased by non-residents. Formerly, when a non-resident purchased a vehicle in Arizona for use out of state, the registration certificate was valid for thirty days. This Bill extends the validity of a registration certificate from 30 to 90 days. The Bill also amends the existing full and partial TPT exemptions to conform to this change in duration.

**Senate Bill 1169 (Ariz. Sess. Laws 2005, Chapter 94). *Beginning in 2007, Luxury Tax on Wine Wholesalers Will be Due When Sold Rather Than When Purchased.*** Currently, wine wholesalers pay luxury tax on wine in the month they purchase the product for resale. The tax on beer is levied the same way. Unlike beer, however, wine has a far longer turn-around time. This Bill changes the point at which the luxury tax on wine will be due from wholesalers. Beginning on January 1, 2007, the luxury tax will be due in the month the wholesaler *sells*, rather than purchases, the product. This Bill also amends the alcoholic beverage regulation

provisions of A.R.S. § 4-243.01. Currently, Arizona requires beer to be held at the wholesaler's premises for at least 24 hours after delivery. This Bill extends that waiting period to all alcoholic beverages. Finally, the Bill amends § 4-226 by exempting wine used for bona fide religious ceremonies from the alcoholic beverage regulations.

**House Bill 2055 (Ariz. Sess. Laws 2005, Chapter 116). *More Protection for Businesses Seeking Municipal TPT Refunds.*** Arizona is one of the few states that allows municipalities, within certain limitations, to set their own transaction privilege tax base. Using, though, the structure of the Model City Tax Code. This Bill responds to the difficulty businesses have had in securing refunds for overpaid transaction privilege taxes from some municipalities. Some cities required businesses to provide information regarding each purchaser in order to obtain a refund. Other cities required the taxpayer to issue the refund to the purchaser, even though the tax liability fell on the business. This Bill controls municipal behavior by setting refund and credit provisions in state statute. It requires cities using the Model City Tax Code to compute interest on assessments or refunds based on State TPT rates and calculation methods and clarifies that interest calculation on refunds runs from the date of filing the refund claim to the date of payment. It prohibits cities from refusing to process valid refund claims or requiring taxpayers to refile valid claims. If a tax collector refuses to process a valid claim, the refusal is deemed a denial and the taxpayer may petition for a hearing under the Model City Tax Code or state statute (whichever applies). Additionally, the Bill prohibits cities from requiring that the taxpayer return the refund to the customer regardless of whether the tax collected was separately itemized. The Bill is effective as of September 30, 2005.

**Senate Bill 1274 (Ariz. Sess. Laws 2005, Chapter 200). *Municipal Governments Now Required to Make Financial Benefit and Necessity Findings Before Entering into Retail Development Tax Incentive Agreements with Businesses.*** Arizona cities provide tax incentives to retail businesses in order to entice those businesses to locate within their borders. Moreover, Arizona cities compete with one another for incoming businesses. This Bill helps ensure that cities do not act arbitrarily when vying for incoming businesses. Effective August 12, 2005, it requires a municipal government to make two findings before entering into a retail development tax incentive agreement with the taxpayer. First, the municipality must anticipate that the revenues derived from the incentive plan will exceed the value of the incentives for the duration of the agreement. If the town cannot make this finding, it

cannot enter the agreement. Second, the municipality must find that, absent the agreement, the retail business would locate elsewhere. These findings must be verified by an independent third party and must pass by a majority or two-thirds vote depending on the location and population of the town. Tax incentives given to businesses in redevelopment areas, however, are exempt from the findings requirements.

**Senate Bill 1287 (Ariz. Sess. Laws 2005, Chapter 105). *Municipal Governments Can No Longer Make an Economic Development Expenditure or Enter a Development Agreement by Emergency Measure.*** In keeping with the concerns outlined under the previous Bill, this Bill amends A.R.S. §§ 9-500.05 and 9-500.11 and prohibits municipalities from making an economic development expenditure (which includes all waivers, deductions, exemptions, and reductions from tax liability) or entering into a development agreement by enacting an emergency measure. Normally, a city ordinance or resolution takes effect 30 days after passage by the council and approval by the mayor. Emergency measures are generally effective immediately after passage and approval. Consequently, no economic development expenditure or development agreement will be effective until at least 30 days after final approval.

**House Bill 2365 (Ariz. Sess. Laws 2005, Chapter 248). *Special Joint District for Theme Park & Car Dealers.*** This Bill sets the requirements and procedures and allows for the establishment of a joint Theme Park and Vehicle Support Facility District in a city with a population of more than 1 million (Phoenix) or a county with a population between 125,000 and 150,000 (Coconino). The Bill requires any District established to levy a 9% TPT on any business activity within the district. The Bill also authorizes an established District to issue \$1 billion in negotiable revenue bonds.

**House Bill 2626 (Ariz. Sess. Laws 2005, Chapter 249). *Military Reuse Zone Tax Incentives Extended and Pre-qualification Requirement for TPT Exemption and Class Six Property Tax Classification Removed.*** In the 1990s, Arizona established a tax incentive program to lessen the impact of military base closures. The program creates incentives for aviation and aerospace businesses that create jobs and make capital investments in designated military reuse zones. This Bill extends the termination and renewal terms for military reuse zones from five to ten years and changes some of the requirements that businesses must satisfy to make use of the incentives. The Bill eliminates the requirement that the taxpayer prequalify with the DOC to be eligible

for the prime contracting exemption or the class 6 property tax classification. Instead, taxpayers must provide the DOC with information regarding the amount of tax benefits the taxpayer receives during each year in which military reuse incentives are claimed. The Bill also sets an eligibility period of five years for taxpayers who qualify for income tax credits and the class 6 property classification. Currently there are two military reuse zones in Arizona: Williams Gateway Airport and Phoenix/Goodyear Airport.

**Senate Bill 1413 (Ariz. Sess. Laws 2005, Chapter 259). *Heavy Equipment Rental Agreements Must Include Surcharge for Property Tax.*** Arizona's property tax system classifies property according to its usage. Commercial and industrial property, including heavy equipment, is generally Class 1 property with a 25% assessment value. This Bill amends Arizona's trade and commerce statutes. Effective August 12, 2005, taxpayers in the business of renting heavy equipment property must include a one and one-half percent surcharge on the gross rental receipts in all rental agreements. The Bill stipulates that the surcharge will be used to pay the personal property tax levied against the heavy equipment. The statute defines 'heavy equipment property' as "rental property of an industry that is described under code 532412 or 532490 of the 2002 North American Industry Classification System." These classifications include equipment leased without operators for construction, mining, or forestry as well as non-consumer machinery, such as manufacturing, metal-working, and telecommunications equipment.

**Senate Bill 1238 (Ariz. Sess. Laws 2005, Chapter 311). *Employer Can Elect Not to Withhold Wages in December.*** Arizona requires employees to select a percentage of their wages to be withheld each pay period. Each month the employer pays the withholding directly to the state as a credit against the employees' personal income taxes. This Bill adds a provision that allows employers to elect not to impose Arizona withholding in December. It has an effective date of August 31, 2005. To make this election for 2005, employers must notify both the DOR and its employees (so that they can change their withholding percentage accordingly) in writing by October 1, 2005. For subsequent years, the due date for the same notification is July 1.

## Administration

**Senate Bill 1171 (Ariz. Sess. Laws 2005, Chapter 95). *Taxpayers May Audit Themselves Under Managed Audit Agreements With the DOR.*** Recognizing that DOR's audit capability is limited by its resources, Arizona has followed the lead of other states in adopting legislation that allows the taxpayer and the DOR to work together to conduct an audit. This Bill allows taxpayers to enter Managed Audit Agreements with the DOR. Under these agreements, the taxpayer actively participates in auditing its own books. Taxpayers may enter agreements to conduct TPT, local excise, and use and luxury tax audits beginning in January 2006 and Corporate Income tax audits beginning in January 2007.

- **Procedures.** The DOR has sole discretion over whether to allow a taxpayer to conduct its own audit and may consider all relevant factors, including compliance history and pending disputes, when making its determination. Under a Managed Audit Agreement, the taxpayer must make and submit written findings to the DOR. The DOR then reviews and accepts or rejects the taxpayer's findings and issues either a deficiency assessment or a refund. The taxpayer's appeal rights under Managed Audit Agreements are the same as under a conventional DOR audit. Managed Audit Agreements may include local excise tax audits at the taxpayer's request. Upon such request, the DOR must notify the relevant cities and towns. If the local jurisdiction refuses to participate in the managed audit, it may not independently audit the taxpayer for 42 months following the end of the last tax period covered by the Managed Audit Agreement unless a limited exception applies.
- **No Penalties and No Interest.** No penalties will be assessed under a managed audit unless the taxpayer commits fraud or willful tax evasion. No interest will accrue on deficiency assessments or refunds if they are paid within 45 days of the assessment or refund determination.
- **Limited Audits.** Managed Audit Agreements may be limited to certain periods, activities, transactions, geographic areas, or lines of businesses. When audits are completed under limited agreements, the DOR remains free to audit issues not covered by the agreement within the appropriate statute of limitations.

## 2005 CASES

### Income Tax

*Baker v. Arizona Department of Revenue*, 209 Ariz. 561, 105 P.3d 244, (App. Feb. 3, 2005). *Court Of Appeals Upholds Retroactive Limitation Of Alternative Fuel Tax Credits*. The court found that the December 2000 retroactive amendment of the Arizona statutes providing tax credits and other tax incentives for the purchase and conversion of alternative fuel vehicles that limited those benefits did not violate the contract clauses of the Arizona and U.S. Constitutions because the original Act providing for the tax credits and other incentives did not create a contract between the state and the taxpayers. The court stated that the general rule in Arizona is that statutes do not create contractual rights. The court also noted that even if the original April 2000 Act had created a contract, there would be no constitutional violation because the amendments did not substantially impair the taxpayers' rights. The court noted that the taxpayers had conceded that they were "very skeptical" of the original law, finding it "hard to believe such an incentive was available" and that the benefits sounded "a little too good to be true." Additionally, by the time the taxpayers converted their vehicles in November 2000, they had notice from what they had read and heard in the media that the governor and the legislature were going to change the statute to close the loopholes and contain the cost. The court then concluded that the December 2000 law change allowed the taxpayers to recover one hundred percent (100%) of their costs and to keep the profits from selling their vehicles and that they could not reasonably have expected more from a taxpayer-funded program designed to curb air pollution. As a result, the court concluded that the December 2000 amendments did not substantially impair the taxpayers' rights.

Additionally, the court held that even if the December amendment substantially impaired a contract with the taxpayers, it would not offend the Constitution if the adjustment of the rights and responsibilities of the contracting parties was upon reasonable conditions and appropriate to the public purpose, which the court found was the case with the alternative fuel amendment.

### Transaction Privilege Tax and Use Tax

*DaimlerChrysler Services North America, LLC v. Arizona Department of Revenue*, 210 Ariz. 297, 110 P.3d 1031 (App. May 3, 2005).

**Bad Debt Deduction Under The Arizona Sales Tax Regulations Is Limited To The Dealer That Sold The Automobile And Not The Finance Company That Had Been Assigned The Installment Purchase Contract By The Dealer.** DaimlerChrysler financed the sale of automobiles by its dealers, including dealers located in Arizona. The dealer would sell a car to a purchaser, with the purchaser making a down payment and entering into an installment payment contract with the dealer to pay the balance over a period of months. The dealer would assign the installment sale contract to DaimlerChrysler. The assignments at issue in this case were made "without recourse" meaning that DaimlerChrysler assumed all the risk if a purchaser did not pay the full amount agreed upon in the installment sale contract, with the dealer assuming no risk. [In a "recourse" assignment, the dealer would assume the risk of non-payment by the purchaser and be obligated to pay the assignee finance company for any amounts not paid by the purchaser.] DaimlerChrysler would pay the dealer the face amount on the installment payment agreement (net of the down payment) and the dealer would then report and pay sales tax to the state on the full sales price (down payment + face amount of the installment payment contract). As can be expected, a number of purchasers would default on the installment payment contract and stop making payments. At that time the car would be repossessed with the proceeds from the sale of the car at auction going to DaimlerChrysler; which would then apply that amount against the outstanding balance of the installment contract and write off the remainder as a bad debt for both federal income tax purposes and financial reporting purposes.

For Arizona transaction privilege tax purposes, Department of Revenue Regulation R15-5-2011 allows a bad debt deduction if the following three conditions apply: (1) the gross receipts from the transaction on which the bad debt deduction is being taken have been reported as taxable; (2) the debt arose from a debtor/creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money; and (3) All or a part of the debt is worthless. The regulation also provides that a bad debt deduction is to be allowed on conditional or installment sales if: (1) the tax liability is paid on the full sales price of the tangible personal property at the time of sale; or (2) the contract or other financial obligation is sold to a third party as a sale with recourse

and principal payments are made by the vendor to the third party, pursuant to the default to the original payor. The regulation provides that such principal payments may be taken as a bad debt deduction if the tax was paid by the vendor on the original sale of the tangible personal property or on the subsequent sale of the financing contract. The regulation does not mention or cover assignments "without recourse."

DaimlerChrysler, in addition to its automobile financing, also engaged in other taxable activities in Arizona and paid state transaction privilege tax on those other activities. DaimlerChrysler filed a refund claim for the bad debts it incurred with respect to the automobile financing transactions. The refund claims were disallowed by the Department and DaimlerChrysler appealed to tax court and then to the court of appeals. DaimlerChrysler argued it was entitled to the bad debt deduction on either of two grounds: (1) Since it had paid sales tax with respect to other transactions, it was entitled to the bad debt deduction in its own right as a taxpayer. Or, (2) as the assignee of the installment sale contract from the dealer, DaimlerChrysler has stepped into the shoes of the dealer and was entitled to claim the bad debt deduction as an assignee under the general principles of the Arizona law of assignment.

The Court of appeals concluded that DaimlerChrysler, as the purchaser of retail installment sale contracts, was not a retailer or a vendor entitled to take a bad debt deduction; rather, the automobile dealer was the retailer or vendor who was required to pay the transaction privilege tax, and the regulation covering the bad debt deduction only permitted such a deduction by the vendor or the retailer. With respect to the assignment argument, the court held that DaimlerChrysler, as the assignee of the dealer, was not entitled to the bad debt deduction after buyers defaulted on consumer installment contracts since the dealer was paid in full for the vehicle and suffered no bad debt that the assignee could assert. Additionally, the Court concluded that the bad debt deduction was not available to an assignee under general principles of assignment law; rather, the Court stated that tax deductions must be strictly construed against the taxpayer, and as such the general law of assignment would not apply in this situation. In other words, the court concluded that the bad debt regulation superceded the Arizona law of assignment. DaimlerChrysler has requested the Arizona Supreme Court to take review of the court of appeals decision and reverse it.

*Qwest Dex, Inc. v. Arizona Department of Revenue*, 210 Ariz.223, 109 P.3d118, 2005 WL 768449 (App. April 5, 2009). *Cost Of*

*Out Of State Printing Services Not Subject To Arizona Use Tax; Only Cost Of Paper Subject To Use Tax.* Qwest Dex publishes the white pages and yellow pages telephone directories. It purchases the paper that it needs for those directories from out of state paper mills and has the paper shipped to out of state printers for printing of the directories. The taxpayer initially paid the use tax on the purchase price of the paper from the out of state paper mill and on the printing services. The taxpayer then filed a claim for refund for the amount of taxes paid on the cost of the printing services but agreed that the use tax applied to the cost of the paper purchased from the out of state paper mill. The Department audited Qwest Dex and asserted use tax on the cost of the printing services. The Arizona use tax is imposed upon the purchase of tangible personal property from an out of state retailer where that property is brought in to the state and is used, consumed or stored in Arizona. The measure of the use tax is the acquisition cost of the tangible personal property as purchased from the out of state retailer. The use tax does not apply to services. The Tax Court held that the printing services, being services, were not taxable under the retail classification and thus would not be subject to the Arizona use tax. The Court of Appeals agreed, applying what is called the "common understanding test." Under this test, whether a transaction qualifies as a sale of tangible personal property or the sale of a service is determined by the parties' common understanding of the particular trade, business or occupation. Using the common understanding test, the court determined that the taxpayer does not owe a use tax on the printing of the directories because printers provide a service. The court observed that the very nature of the term "printing" denotes a service and not a tangible item. The court also cited to several out of state cases that held printers who print specific material on paper for a customer are not engaged in the business of selling tangible personal property, but are instead engaged in a service, reasoning that the paper is of no use to anyone except the customer for whom the printing is done.

The Court also noted that the printing service would be taxed in Arizona under the job printing classification of the transaction privilege tax but held that this varying treatment would not change the court's conclusion as to the use tax. The court reasoned that the job printing classification, unlike the use tax, specifically includes a provision for a tax on printing services while the use tax, in contrast, imposes no specific tax on printing services.

## Property Tax

**4501 Northpoint LP v. Maricopa County**, 209 Ariz. 569, 105 P.3d 1188 (App. Feb. 8, 2005). *Rule 68 Offer Of Judgment Was Not An "Adjudication On The Merits" Qualifying The Taxpayer To Receive Attorneys' Fees.* A.R.S. § 12-348 authorizes an award of attorneys' fees to the prevailing taxpayer in tax litigation if a taxpayer prevailed in an "adjudication on the merits" of the case. While the case was pending in Tax Court, Maricopa County offered to settle the case based upon a \$12 million value. The taxpayer rejected the offer and the County then tendered to the taxpayer an offer of judgment under Arizona Rules of Civil Procedure, Rule 68. That Rule allowed a party to tender an offer of judgment to the other party to essentially force a settlement of a case. It usually contains two components, one pertains to the merits of the case and the other for attorneys' fees. In this case, Maricopa County tendered an offer of judgment to the taxpayer to resolve the case based upon a \$12 million full cash value (the original full case value was set at \$13,597,923 for the 2000 tax year) for the property in question and indicated that the County would not pay attorneys' fees. The taxpayer accepted the offer of judgment component dealing with the \$12 million full cash value but argued that it should nevertheless be entitled to attorneys' fees (the case had progressed to the stage where trial was imminent and a good deal of preparatory work had been done by the taxpayer). The Tax Court ruled that the taxpayer was not entitled to attorneys' fees and the Court of Appeals upheld that determination.

In order to be entitled to attorneys' fees as a prevailing taxpayer in a tax case, including property tax cases, there must be an "adjudication on the merits." The issue in this case was whether a Rule 68 judgment was "adjudication on the merits." The Court of Appeals held no, indicating that "adjudication on the merits" means either a determination following a trial in a case or the court's decision based upon a motion for summary judgment.

**Lyons v. State Board of Equalization**, 209 Ariz. 497, 104 P.3d 867 (App. Jan. 27, 2005). *Taxpayer Could Bring A Claim Under The Notice Of Claim And Notice Of Error Procedures To Contest An Exemption Denial From A Prior Year.* The property tax error correction statutes, A.R.S. § 42-16251 through § 16258, provide a mechanism for a taxpayer to file a notice of claim for a refund of property taxes paid in the past as well as for the County to issue a notice of correction of error to correct an error relating to prior

year's property taxes. The requirement is that the particular error must meet the statutory definition of "error." The Eastside Assembly of God Church owns real property in Tucson and in January 2000, filed an affidavit with a Pima County assessor, Rick Lyons, claiming a property tax exemption for religious property for the 2000 year. The taxpayer stated that an exemption was warranted because later in that year it planned to use the house on the property as a parsonage. The assessor denied the exemption request because "ownership and usage must be in effect as of the lien date January 1<sup>st</sup>." In January 2001, the taxpayer again filed an affidavit for a property tax exemption, this time for the 2001 year on the same basis as for the prior year. The assessor also denied that exemption request (the affidavit filed for 2001 did not indicate whether the house on the property was then being used as a parsonage).

The taxpayer, in August 2002, initiated proceedings under the error corrections statutes by filing two notices of claim asserting that the assessor had erred by denying the request for exemption for 2000 and 2001 because the taxpayer held the property "primarily for religious worship." The assessor denied the notices of claim on the basis that the error correction statutes were not the appropriate procedure to contest the denial of an exemption claim and also, alternatively, declaring that "the property does not meet the qualifications for property tax exemption." After initial meetings between the taxpayer and the assessor, which were to no avail, the taxpayer filed an appeal with the State Board of Equalization. The Board decided for the taxpayer holding that its "use of the property complied with the exemptions granted by the state constitution" and therefore granted the property exemption for the 2000 and 2001 years. The assessor appealed to Tax Court and the Tax Court ruled that the State Board of Equalization "has no jurisdiction or authority to hear and decide exemption issues" and that "the error correction procedures are not the proper procedures to appeal the denial of an exemption." Rather, the Tax Court indicated that the proper method to appeal an exemption claim disallowance was through a 42-204 suit (now A.R.S. § 42-11005), which is a suit brought to contest an illegal tax.

The Court of Appeals reversed the Tax Court and held that a taxpayer could bring a claim under the notice of claim and error procedures to contest an exemption denial and that 42-204 (now 42-11005) was not the exclusive procedure. The court held that the term

“error” in the error correction statutes was not limited to factual errors, but extended to discretionary errors such as assessor’s decisions concerning property tax exemptions. It is interesting to note that the taxpayer did not appeal the matter to the Court of Appeals but rather the State Board of Equalization did.

***Griffith Energy LLC v. Arizona Department of Revenue*, 210 Ariz.132, 108p.3d 382 (App. March 18, 2005). *Department Of Revenue’s Adoption Of A Twenty-Five Year Valuation Table For Electric Generation Plants Upheld*.** The taxpayer owns a new merchant natural gas-fired, combined cycle electric generation plant in Mohave County, which provides wholesale electricity in Arizona and other states. It started operations in 2001 and the Department of Revenue valued it for the first time on January 1, 2002 for the tax year 2003. The Department followed the methodology set out in A.R.S. § 42-14156 in valuing the plant. Subsection (A)(3) provides that the valuation of personal property [equipment] used in operating the facility is the cost multiplied by the valuation factors as prescribed by tables adopted by the Department. The Department adopted a twenty-five year valuation table for depreciation of the electric generation equipment, with a ten percent (10%) floor at which depreciation levels out (salvage value). The taxpayer appealed the Department’s valuation to the State Board of Equalization, which upheld the Department’s valuation table and the taxpayer appealed to the Tax Court. The Tax Court concluded that the Department did not act arbitrarily and capriciously in adopting the twenty-five year life table.

The Court of Appeals also concluded that the Department’s adoption of the twenty-five year life table was not arbitrary and capricious. The court noted that the legislature directed the Department to adopt tables prescribing appropriate depreciation for valuing personal property used by electric generation facilities, which the Department did. The court also observed that the record reflects the Department’s selection of the twenty-five year life span for depreciation was based on a rational basis and after due consideration. Both the Tax Court and Court of Appeals gave substantial deference to the Department’s analysis and judgment in adopting a 25 year life.

***SFPP, L.P. v. Arizona Department of Revenue*, 210 Ariz.151, 108 P.3d 930 (App. February 25, 2005). *For Purposes Of Valuing A Pipeline Company, “Original Cost” Means The Original Cost Of Placing The Pipeline In Service And Not The Acquisition Cost To The Current***

***Owner*.** Arizona has a statutory method for valuing pipeline companies, with the valuation starting point being “original cost.” The issue in this case is whether “original cost” means the original cost of initially placing the pipeline assets in service or the acquisition cost to the current owner where there has been a change in ownership. SFPP owned the pipeline in 1998 and sold its interests in the pipeline to Kinder Morgan. For the 2000 property tax year, the taxpayer filed with the Department the required annual property tax report, in which it listed the original cost of the property as the original cost of placing the pipeline property in service. Based upon this information, the Department initially valued the taxpayer’s pipeline at \$121,000,000. The taxpayer also filed a copy of its federal energy regulatory commission (FERC) Form 6 with the Department. That form reported the value of the pipeline, as adjusted to reflect the Kinder Morgan transaction. The Department revalued the pipeline property at \$232,000,000, using its interpretation of original cost as being the original cost to the current owner. The taxpayer appealed to the State Board of Equalization and the State Board affirmed the Department’s determination. The taxpayer then appealed to the Arizona Tax Court, which reversed the Board of Equalization and held that original cost meant the original cost of placing the pipeline property in service, which results in the \$121,000,000 value, rather than the \$232,000,000 value. The Department of Revenue appealed to the Court of Appeals, which upheld the Tax Court’s determination.

The pipeline valuation statute also has a provision which provides that “all terms and applications of terms shall be interpreted as nearly as possible, under the circumstances, according to the federal energy regulatory commission uniform system of accounts for pipelines in effect on January 1, 1989.” The court examined the FERC uniform system of accounts definitions in effect on January 1, 1989 and found that the definition of “original cost” for gas pipelines coincides with the taxpayer’s position and the ruling of the Tax Court. However, the uniform system of accounts for oil pipelines does not define “original cost” but defines “cost” in language that is consistent with the Department’s position: “cost means the amount of money actually paid for property or services or the current cash value of the consideration given when it is other than money.” The taxpayer’s pipelines are used for transmission of oil, not gas and the Department thus contended that the definition of “original cost” in the FERC uniform system of accounts for gas pipelines is not applicable and the court should apply the definition of “cost” from

the uniform system of accounts for oil pipelines. The taxpayer argued that because the Arizona statute refers the court, for definitional assistance, to the federal energy regulatory commission uniform system of accounts for pipelines in effect on January 1, 1989, the court should apply the only specific definition of "original cost" found in those regulations.

The court reasoned that the Department's argument would lead to a different definition of "original cost" depending on whether the pipeline carried oil or gas. The court noted that there is no reason to believe that the Arizona legislature intended the statutory method of valuing pipelines should produce a different result for gas pipelines compared to oil pipelines. The court thus concluded that the FERC uniform system of accounts for pipelines does not provide the dispositive guidance regarding the intended meaning of "original cost" and the court thus looked to the language used by the legislature, specifically the use of the term "original" in the term "original cost." The court concluded that the use of the term "original" in "original cost" supported the taxpayer's interpretation that original cost means the cost of originally placing the pipeline in service. The court agreed with the taxpayer's position that the pipeline's value was \$121,000,000, which was based upon the cost of originally placing the pipeline in service.

## 2004 LEGISLATION AND CASES

### LEGISLATION\*

#### Income Tax

**House Bill 2040 (Ariz. Sess. Laws 2004, Chapter 61). 2004 Tax Corrections Act; Repeal Of Day Care Income Tax Credit.** This Bill makes technical, conforming and clarifying changes to the Arizona tax statutes and makes the following change to the income tax statutes:

- (i) The income tax credit for dependent day care services had to be claimed by January 1, 1995 and thus has no current validity. The Tax Correction Act repeals this obsolete credit and removes the reference to this credit under additions to Arizona gross income.

**Senate Bill 1389 (Ariz. Sess. Laws 2004, Chapter 196). Partial Conformity To Internal Revenue Code.** This is the annual Bill that conforms the Arizona income tax statutes to changes made to the Internal Revenue Code during the past year. This Bill did not provide for full conformity to all changes to the Internal Revenue Code. The following conforming changes are made:

- (ii) This Bill conforms the state income tax statutes to the Jobs and Growth Tax Relief Reconciliation Act of 2003, the Military Family Tax Relief Act of 2003, and the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, including retroactive conformity to the effective dates of the provisions of those federal acts.
- (iii) The Bill suspends the statute of limitations to allow taxpayers to claim refunds resulting from retroactive conformity to the provisions of the Military Family Tax Relief Act of 2003. Specifically, Internal Revenue Code Section 121 was amended to allow an election for military and foreign service personnel to ignore the time spent on extended duty (up to 10 years) in order to meet the 2-out-of-5 year requirement for exclusion of gain on the sale of personal residences. The federal provision was effective for

sales or exchanges occurring after May 6, 1997 and provided a one year period for taxpayers to claim refunds that were otherwise barred by the statute of limitation. The Arizona conformity Bill allows taxpayers to file amended Arizona returns at any time before the close of the one-year federal extended period beginning on November 11, 2003 (which means they have until November 11, 2004 to file the amended returns).

- (iv) The Bill requires an add-back of the Internal Revenue Code Section 179 expense deduction in excess of \$25,000 but allows it to be subtracted ratably over a five year period.
- (v) The Bill requires Arizona taxpayers to add-back the amount of depreciation allowed under Internal Revenue Code Section 167(a). The Bill also requires Arizona taxpayers to compute depreciation for Arizona purposes as if bonus depreciation had not been elected for federal purposes. As a result, Arizona taxpayers that claim depreciation on their federal returns must add that depreciation to their Arizona gross income and then take a subtraction for the allowable Arizona amount. This provision applies retroactively to taxable years beginning from and after December 31, 1999. The Department of Revenue has indicated that this provision will affect taxpayers that depreciated luxury automobiles for taxable years prior to 2004. This amendment requires taxpayers to depreciate luxury automobiles for which the taxpayer claimed federal bonus depreciation using the same depreciation rate that would have been allowed if the taxpayer had not claimed bonus depreciation. These taxpayers may amend their prior years returns to make this adjustment or alternatively may elect to recognize the cumulative amount of the retroactive change on the tax return for the first taxable year ending on or after December 31, 2003.
- (vi) The Bill also allows taxpayers to claim a subtraction to reflect the difference in federal and state basis of bonus

depreciation property when the property is sold. This provision applies retroactively to taxable years beginning from and after December 31, 1999. The taxpayer may file an amended return to make this adjustment for a prior year or alternatively may elect to recognize the cumulative effect of the retroactive change on the tax return for the first taxable year ending on or after December 31, 2003.

**Senate Bill 1003 (Ariz. Sess. Laws 2004, Chapter 214).**

**Income Tax Exemption For Stillborn Children.** This Bill provides an income tax exemption of \$2,300 for each stillbirth, if the child otherwise would have been a member of the taxpayer's household. The taxpayer may claim the exemption in the year in which the stillbirth occurred. This act is retroactive to taxable years beginning from and after December 31, 2003.

**Senate Bill 1415 (Ariz. Sess. Laws 2004, Chapter 284).**

**Withholding Tax Rates Increased.** This Bill increases all withholding rates except for the lowest ten percent (10%) rate. The increased rates and the old rates are contained in the following chart:

CURRENT RATES	NEW RATES FOR 2005
10.0%	10%
18.2%	19%
21.3%	23%
23.3%	25%
29.4%	31%
34.4%	37%

This Bill is effective for tax years beginning from and after December 31, 2004.

**House Bill 2045 (Ariz. Sess. Laws 2004, Chapter 289). *Income Tax Credit Review Schedule; Amendments To Enterprise Zone Credits.***

This is the annual Bill that updates the Income Tax Credit Review Schedule based upon the recommendations of the Joint Legislative Income Tax Credit Review Committee. It removes the income tax credits that were reviewed in 2003 and adds these credits to the review schedule in 2008. It also repeals the individual and corporate income tax credit for corrective action costs for underground storage tanks.

This Bill also amends A.R.S. Sections 43-1074 (individual income tax section) and 43-1161 (corporate income tax section) to allow enterprise zone credits unless more than ten percent (10%) of the business at the zone location consists of retail sales of tangible personal property. It also amends those same sections to provide that taxpayers may claim second and third year credits for taxable year 2002 and third year credits for taxable year 2003 when the first year credit was claimed on an amended return if a qualified employment position was created prior to January 1, 2002 and certified to the Department of Commerce. These changes apply retroactively to taxable years beginning from and after December 31, 2003.

## Transaction Privilege Tax and Use Tax

**House Bill 2040 (Ariz. Sess. Laws 2004, Chapter 61). *2004 Tax Corrections Act; Qualifying Hospital And Handicapped Program Exemptions Clarified.***

This Bill makes the following technical and clarifying changes, among others, to the Transaction Privilege Tax statutes:

- (i) Current law provides that a contractor can deduct the cost of building materials with respect to the construction of a facility for a qualifying hospital. When a new hospital is being constructed, it would not meet the definition of a qualifying hospital because it is not yet licensed by the state (which is a requirement for the deduction). The current statute provides that when such a facility is under construction and then on completion will qualify as a "qualifying hospital," the deduction will nevertheless apply. See A.R.S. § 42-5001(11). Such a qualifying hospital may give the contractor an exemption certificate based on the condition that the hospital will qualify and will be licensed when construction is completed. Current law provides that if such an exemption certificate is given, if the conditions are not met within a "reasonable time," then the tax is due. See A.R.S. § 42-5009(G). This Bill defines "reasonable time" as the time limitation that the Department determines, which may not exceed the time limitations provided by the statutes of limitations of A.R.S. Section 42-1104.
- (ii) The Bill clarifies the transaction privilege tax exemption for the sale of tangible personal property to non-profit charitable organizations for programs that are exclusively for mentally or physically handicapped persons. The Bill clarifies that the exemption is only available if the programs

are "exclusively for" training, job placement, rehabilitation or testing. See A.R.S. § 42-5061(B)(29).

**House Bill 2459 (Ariz. Sess. Laws 2004, Chapter 143). *First Month's Car Lease Payment Not Taxable To Dealer If Lease Is Assigned To A Leasing Company.*** This Bill provides a deduction under the personal property rental classification for the first month's lease payment received by an automobile dealer when the dealer assigns the lease to a third party leasing company.

**Senate Bill 1141 (Ariz. Sess. Laws 2004, Chapter 234). *Sales Tax Rate Increases: Blanket Grandfather Provision For Pre-existing Transactions.*** This bill provides a blanket grandfather provision with respect to all taxable classifications except the contracting classification for state sales tax rate increases. Specifically, the Bill provides that a state transaction privilege tax rate increase will not take effect with respect to pre-existing transactions where there is a written contract in place until 120 days after the effective date of the rate increase. The Bill also provides that it does not apply to any taxpayer that has entered into a contract which contains a pass-through provision allowing the taxpayer to recover the increased tax amount from the purchaser. This provision applies regardless of the accounting method used by the taxpayer and does not apply to any rate increases for county excise taxes. For construction contracts, the prime contracting classification of A.R.S. Section 42-5075 has a specific grandfather provision for pre-existing construction contracts. This Bill's grandfather provision applies to all other classifications.

**Senate Bill 1001 (Ariz. Sess. Laws 2004, Chapter 240). *Exemption For A Railroad's Transportation Of Fertilizer.*** This Bill provides a new exemption from the transporting classification of the transaction privilege tax for amounts received by a railroad for the transportation of fertilizer from one point in Arizona to another point in the state. This Bill is effective from and after September 30, 2004.

**House Bill 2086 (Ariz. Sess. Laws 2004, Chapter 242). *Sales Tax Refund To Auto Manufacturer On Repurchase Of "Lemon" Vehicles.*** This Bill provides a refund mechanism for automobile manufacturers who repurchase vehicles from consumers under Arizona's lemon laws. If a vehicle is deemed to be a "lemon" under the Arizona lemon law provisions, the dealer is required to repurchase the vehicle and will now receive a refund of sales taxes paid on the purchase of the vehicle if the following conditions are met:

- (i) The manufacturer must repurchase a vehicle under Arizona's lemon law provisions or for "reason of consumer satisfaction."

- (ii) The manufacturer is required to refund the amount of the sales tax to the consumer; and
- (iii) The manufacturer must provide the Department with "satisfactory proof" that the sales tax with respect to the lemon vehicle was collected from the consumer and refunded by the manufacturer to the consumer.

If a refund is paid to the manufacturer, that refund is in lieu of a refund of sales taxes that the dealer would otherwise be entitled to receive.

**House Bill 2460 (Ariz. Sess. Laws 2004, Chapter 296). *Sales of Motor Vehicles To Nonresidents.*** Under current sales tax law, a nonresident may purchase a motor vehicle in Arizona and not be subject to Arizona sales tax if the nonresident secures a thirty (30) day nonresident registration permit for the vehicle and the nonresident's home state does not allow a corresponding use tax exemption for Arizona sales tax with respect to the purchase of the vehicle. See A.R.S. § 42-5061(A)(28). It amends the statutes dealing with the motor vehicle division's thirty (30) day nonresident registration permit certificates to require a nonresident motor vehicle purchaser to affirm that the vehicle is to be registered in another state within thirty (30) days. That requirement was not part of prior law. This Bill also provides that if the purchaser registers the vehicle in Arizona within 365 days after getting the thirty (30) day nonresident registration permit, the purchaser will be liable for any Arizona transaction privilege tax, county excise tax, penalties and interest that the motor vehicle dealer would have been required to pay. See new A.R.S. Sections 28-2154 and 28-2154.01.

It should be noted that this Bill does not apply to the transaction privilege tax exemption for motor vehicles sold to nonresidents where the vehicles were delivered out of state. See A.R.S. § 42-5061(A)(14).

**Senate Bill 1293 (Ariz. Sess. Laws 2004, Chapter 309). *Legislation Clarifies That Design Services Are Not Subject To Tax Under The Prime Contracting Classification.*** As background, the Department of Revenue in two recent audits took the position that the design portion of a "design-build" contract was subject to tax under the prime contracting classification even though the design revenue was separately invoiced and accounted for. The Arizona Supreme Court made clear in the *Ebasco, Holmes & Narver* and *Parsons-Jurden* cases that design and engineering work was not subject to

tax under the prime contracting classification. This legislation reflects the holdings in those cases and clarifies that design, engineering and architectural services are not subject to tax under the prime contracting classification even when undertaken by a contractor. It provides an exclusion from the contracting classification for the direct cost of such design, engineering and architectural services. When a prime contractor subcontracts out the design and engineering services to a third party, the direct costs will be the amount paid to that third party. If the contractor performs those services in-house, the direct cost will essentially be the labor expense of personnel for performing those services, without any allocation of overhead (such as rent, utilities, etc.).

This legislation is retroactively effective to October 17, 1969, which is the date of the *Ebasco* decision. The Bill also provides a mechanism for requesting refunds of taxes paid on such design and engineering services. A client's refund must be submitted to the Department of Revenue by December 31, 2004. The aggregate amount of refunds to be provided to taxpayers submitting refund claims is \$100,000. If the total amount of refund claims exceeds \$100,000, then each taxpayer will receive a prorata refund amount. The \$100,000 aggregate refund cap limitation and the December 31, 2004 deadline for submitting refund claims should apply only to refund claims that would be now barred by the statute of limitations (four years). Claims for refunds that are filed within the four year statute of limitations (as an example, for the year 2002 or 2003) should not be subject to the \$100,000 refund limitation.

**House Bill 2277 (Ariz. Sess. Laws 2004, Chapter 318). *Sales Tax Exemption For Purchases Of Electricity And Other Energy By The Central Arizona Water Conservation District.*** This Bill exempts from the sales and use tax the purchase of electricity or other energy forms by the Central Arizona Water Conservation District that is used to pump CAP water. This Bill is retroactively effective to January 1, 1985 (see Section 13 of the Bill).

**Senate Bill 1288 (Ariz. Sess. Laws 2004, Chapter 337). *Sales Tax Treatment Of "Bundled" Telecommunications Services.*** Under current law, if a "bundled" transaction includes both taxable and nontaxable items (and since they are bundled, the nontaxable item is not separately stated), the entire amount will be subject to sales tax. This Bill provides that "bundled" telecommunications services can be allocated among their various components so that

only the taxable items will be subject to tax. This Bill adds a methodology for the identification of nontaxable charges on bundled transactions and allows a telecommunications company to elect to use allocation percentages derived from its entire service area instead of itemizing individual calls. The Department of Revenue may request the allocation information and may perform an audit to verify the allocation. Additionally, the telecommunications service provider must waive its right to any refund on taxes if the taxes paid were based on the allocation percentage deemed reasonable at the beginning of the tax year at issue.

## Property Tax

**Senate Bill 1091 (Ariz. Sess. Laws 2004, Chapter 15). *Correction Of Error Procedures Changed.*** This Bill changes the limitations provisions for the issuance of Notices of Error by County Assessors and the filing of Notices of Claim by taxpayers. The prior provision provided that a Notice of Error or Notice of Claim may be filed to correct an error that occurred more than three years before the Notice of Error or Notice of Claim is mailed or filed and in determining the three year period, if the Notice is mailed or filed after the third Monday in August, the three year period is the current year and the two immediately preceding years, and if the Notice is filed or mailed on or before the third Monday in August, the three year period is the three immediately preceding years. These provisions have been changed and simplified to provide that a Notice of Error or Notice of Claim is limited to the current tax year in which the Notice of Error or Notice of Claim was filed and the three immediately preceding tax years. The Bill also defines the term "tax year" to mean to the calendar year in which the taxes are levied (as opposed to the valuation year, which is the year prior to the year in which the taxes are levied).

**House Bill 2040 (Ariz. Sess. Laws 2004, Chapter 61). *2004 Tax Corrections Act; Pipeline Valuation Date; Airline And Private Car Company Values Are Matters Of Public Record; DOR Reporting Procedures For Telecommunication Companies' Values Changed.*** This Bill makes technical, conforming and clarifying changes to the Arizona tax statutes and makes the following changes to the property tax statutes:

- (i) The Department of Revenue is required to determine the location of pipeline property by November 30th instead of August 31st.
- (ii) Clarifies that the full cash values of airline and private car companies' properties are a matter of public record.

- (iii) The Department of Revenue under current law is required to report the apportionment of telecommunication companies' valuation to all local jurisdictions. This Bill eliminates that requirement and instead requires the Department to report the necessary information only to the county Assessors.

**Senate Bill 1004 (Ariz. Sess. Laws 2004, Chapter 239). Home Value Limitation For Widows And Widowers Exemption Increased.** This Bill increases the value of a residence eligible for the \$3,000 property tax exemption for widows, widowers and disabled persons. The Bill increases the value of a residence that may qualify for the exemption from \$100,000 or less to \$200,000 for widows, widowers or disabled persons. The Department of Revenue is required by December 31st of each year to increase the residence valuation limit of \$200,000 based on annual inflation as determined by the GDP price deflator.

**House Bill 2258 (Ariz. Sess. Laws 2004, Chapter 295). Property Tax Agents' Authority Expanded; County Assessors Required To Change Tax Rolls To Reflect Changes From Judicial And Administrative Appeals; Requirement That Property Tax Cases Must Go To Trial Within 270 Days Repealed; Expands Property Tax Exemption For Institutions For Relief Of Indigent Or Afflicted; New Property Exemption For Non-Profit Organizations That Provide Financial Support For Public Libraries.** This Bill makes a number of changes in the property tax laws. The major changes are:

- (i) Expands the authority of property tax agents to act on behalf of the taxpayer to discuss tax matters with the County Assessors, the Department of Revenue or the County or State Board of Equalization.
- (ii) County Assessors are required to make changes in the tax roll to reflect any changes from judicial and administrative appeals, as well as from corrections of errors and omissions.
- (iii) The current requirement that a property tax case must go to trial within 270 days of filing the complaint is repealed.
- (iv) The property tax exemption for institutions for the relief of the indigent or afflicted is expanded to include administrative buildings or property.
- (v) A new property tax exemption is established for non-profit organizations that provide financial support for public libraries

## Miscellaneous

**House Bill 2059 (Ariz. Sess. Laws 2004, Chapter 135).**

**Changes To Unclaimed Property Procedures.** This Bill makes a number of changes to Arizona's Unclaimed Property Act. The major changes are:

- (i) Excess proceeds deposited with the County Treasurer are presumed to be abandoned after three years if there is no pending application for distribution.
- (ii) Excess proceeds of \$50 or less that are presumed abandoned are to be transferred to the county general fund.
- (iii) Excess proceeds greater than \$50 presumed abandoned are to be reported to the Arizona Department of Revenue as with all other unclaimed property.
- (iv) The abandonment period for property held by a court, governmental subdivision, agency or instrumentality is increased from one to three years.

**House Bill 2549 (Ariz. Sess. Laws 2004, Chapter 326). Transaction Privilege Tax, Use Tax And Income Tax Incentives For Healthy Forests.** This Bill provides a deduction from the transaction privilege tax for qualifying equipment that is purchased from and after June 30, 2004 through June 30, 2014 by a qualified business for harvesting, transporting or the initial processing of forest products, including biomass. To qualify for this deduction, the qualified business at the time of purchase must present its certification approved by the Department of Revenue. See new A.R.S. Section 42-5061(B)(22). The Bill also provides the same deduction for the use tax. See A.R.S. § 42-5159(B)(22). The same deductions are also provided under the personal property rental classification of Section 42-5071. Additionally, the construction of any building, whether a structure or improvement owned by a qualified business for harvesting, transporting or the initial processing of forest products, including biomass, is not subject to tax under the prime contracting classification. See A.R.S. § 42-5075(B)(19).

On the income tax side, a credit is provided for increased employment by a healthy forest enterprise. See A.R.S. Sections 43-1076 (individual income tax) and 43-1162 (corporate income tax).

## 2004 CASES

### Income Tax

*Hibbs v. Winn*, 542 U.S. 88, 124 S. Ct. 2276, 159 L. Ed.2d 172 (2004). *Federal Tax Injunction Act Does Not Preclude Taxpayer From Challenging Constitutionality Of State Income Tax Credit In Federal Court*. The court held that the Tax Injunction Act ("TIA") does not bar federal suits that challenge the constitutionality of state tax credits and would increase tax the state will collect. The TIA prevents lower federal courts from "restraining the assessment, levy or collection" of state taxes. The TIA usually applies to prevent taxpayers from bringing federal actions that challenge their own state tax liabilities or state efforts to collect unpaid tax. *Hibbs v Winn*, however, involved Arizona taxpayers contesting in federal court an Arizona income tax credit for contributions to school tuition organizations. The taxpayers sought a declaration that the credit violated the Establishment Clause of the First Amendment, an injunction barring the Arizona Department of Revenue from allowing credits for contributions to organizations granting scholarships on religious grounds, and an order that the Department direct school tuition organizations making grants on religious grounds to turn their funds over to the state's general fund. The Department defended the credits by arguing that federal courts lacked jurisdiction over the matter. The Department relied on the TIA to bar any federal interference with state taxation schemes because the term "assessment" referred to the state's tax system as a whole - even in cases where third party taxpayers sought prospective relief which would increase the state's tax revenue. Thus, the case revolved around the meaning of the term "assessment" in the TIA.

The Court, however, rejected the Department's reasoning and ruled that the TIA did not apply to the state tax credit for three reasons. First, the context of the term "assessment" supports defining it as the recording of a tax liability that triggers levy and collection, rather than as the state's entire scheme for charging and collecting tax. Second, Congress's intent behind the TIA was to i) rule out disparities between taxpayers who could and could not qualify for federal jurisdiction and ii) protect the states from disruption of their finances, and neither of these purposes are violated by federal court challenges of tax credits, which result in the states collecting additional tax. Third, for decades, while federal courts have applied the TIA to bar suits by taxpayers contesting liability for

state tax, they have not done so when third parties challenged the constitutionality of state tax benefits. Thus, the TIA does not prevent federal courts from hearing challenges to state tax benefits that, if successful, will result in prospective relief that increases state tax revenue.

*Walgreen Arizona Drug Company v. Arizona Department of Revenue*, 209 Ariz. 71, 97 P.3d 896 (App. 2004). *The Return Of Investment Principal Is Not Includable In The Denominator Of The Sales Factor*. Walgreen operates retail drug stores as its primary business, with 120 stores in Arizona. Walgreen earns interest on short-term investments and typically reinvests the proceeds in similar interest-bearing instruments. The Court characterized this activity as a "treasury function" designed to maintain cash needed to operate the business on a daily basis (working capital). The investments included commercial paper, municipal securities, auction stock, Eurodollar investments, and money markets. In addition to including the dividends and interest received from its investments in the sales factor denominator, Walgreen filed amended returns including the return of principal in the denominator of the sales factor. This inclusion resulted in a smaller amount of taxable income attributable to Arizona, and the taxpayer requested refunds totaling more than \$1.3 million, excluding interest. The Department of Revenue denied the refund request, and Walgreen appealed.

The issue presented by this case is whether the return of principal from short-term investments is includable in a corporation's "total sales" pursuant to Arizona's version of the Uniform Division of Income for Tax Purposes Act. Walgreen's position was that the return of principal constituted "gross receipts" under UDITPA and thus should be included in the denominator of the sales factor. While the Court agreed that including gross receipts from the reinvestment of funds in inventory from the sales factor reflects ongoing business activity and does not artificially distort the sales factor, the inclusion of unadjusted gross receipts from investment and reinvestment of intangibles does distort the sales factor. The Court concluded that, while interest and dividends were properly included as "gross receipts" in the sales factor, the return of principal was not, relying upon the recent California Appellate Court decision in *General Motors Corp. v. Franchise Tax Board*, 120 Cal. App. 4th 114, 16 Cal. Rptr. 3d 41, *modified on other grounds*, 120 Cal. App. 4th 881, 16 Cal. Rptr. 41 (2004). The Court also

relied upon a report issued by the Multistate Tax Commission in 1997 finding that “the inclusion in the sales factor of gross receipts from the generally short-term investment and reinvestment of certain intangibles (idle cash) held for the future operation of the taxpayers’ business, inherently produces incongruous results.”

QUERY: Would and should the result be different, for, say, a dealer in securities or a mortgage company that packages its mortgages and sells them on the secondary market in order to obtain additional funds to acquire more inventory (mortgages)?

### Transaction Privilege Tax and Use Tax

**State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc.**, 207 Ariz. 445, 88 P.3d 159 (April 2004) (en banc). *Arizona Supreme Court Overrules The Court Of Appeals’ Narrow Definition For “Machinery Or Equipment”*; *Supreme Court Adopts A More Flexible Approach That Looks To “The Nature Of The Item And Its Role In The Operations” To Determine Whether An Item Constitutes Exempt “Machinery Or Equipment.”* As background, in 1998, *State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc.*, 193 Ariz. 89, 970 P.2d 443 (Ct. App. 1998) (“Capitol Castings I”) determined that sand, lime, cement, and other materials used to fabricate and operate molds for casting mining equipment did not qualify for the exemption for machinery and equipment used directly in manufacturing, processing, and other activities specified in A.R.S. Section 42-5959(B)(1). Because the materials were consumed in the manufacturing process after only a few uses, the Court held them to be “expendable materials,” which in 1998, were expressly excluded from the exemption. In 1999, the Legislature retroactively amended the exemption to provide that the exclusion for “expendable materials” does not apply to items that otherwise constitute machinery or equipment used in manufacturing, processing, or another of the activities specified in Section 42-5959(B)(1). On remand from the 1998 decision, Capitol Castings appealed from the tax court’s finding that, while the taxpayer had used the materials to make machinery and equipment that was used directly in manufacturing, the materials themselves were not “machinery” or “equipment” within the meaning of Section 42-5959(B)(1). Embracing the “fixed assets” approach to defining “machinery or equipment” from *Capitol Castings I*, *State ex rel. Arizona Department of Revenue v. Capitol Castings, Inc.*, 205 Ariz. 258, 69 P.3d 29 (Ct. App. 2003) (“Capitol Castings II”), ruled that the sand, lime, cement, and the other materials themselves are not “machinery or equipment” within the meaning of the exemption. In other words, *Capitol Castings II* held that component parts of machin-

ery and equipment do not qualify for the exemption.

In the latest decision, the Arizona Supreme Court found two independent grounds to hold that the approach of *Capitol Castings I* and *II* to defining “machinery or equipment” was “too narrow.” First, a narrow definition would frustrate the exemption’s purpose to stimulate the economy and thereby increase other tax revenues. Second, the language, legislative history, and effective date of the 1999 amendment indicates that the Legislature intended to negate the entire result of *Capitol Castings I* as well as to reinstate “the broader, function-based” tests contained in *Duval Sierrita Corp. v. Arizona Department of Revenue*, 116 Ariz. 200, 568 P.2d 1098 (Ct. App. 1977), which *Capitol Castings I* had distinguished. Rather, the Supreme Court requires courts to “apply flexible and commonly used definitions of machinery and equipment within the relevant industry.” To determine whether an item qualifies as “machinery or equipment,” a court must also look to a) how “essential or necessary” an item is “to the completion of a finished product” and b) how prominent a role the item has “in maintaining a harmonious integrated synchronized system.” Relevant factors for these inquiries include whether the item in question is in physical contact with raw materials or the work in process, whether the item somehow manipulates or has some other effect upon raw materials, and whether the item adds value to the finished product “as opposed to simply reducing costs or relating to post-production activities.” The Supreme Court held that sand, chemical binders, exothermic sleeves, mold cores, mold wash, and mold topping powder qualified as machinery and equipment because they were integral parts of and had a close nexus to the casting process. As an aside, the Court concluded that cement and lime used to neutralize toxic fumes generated during the casting process, however, did not qualify because they were used in an ancillary process for the control of pollution and, therefore, were not integral to the casting process.

### Property Tax

**Aileen H. Char Life Interest v. Maricopa County**, 208 Ariz. 286, 93 P.3d 486 (2004). *Uniformity Clause Requires That Taxpayers’ “Multi-Family Residential” Properties Be Valued The Same As Other Similarly Situated Properties.* For 1996 and 1997, as in prior years, the Maricopa County Assessor implemented a computer valuation program to determine the values of commercial properties, including multi-family residential properties. The value program calculated each property’s value using a computerized cost model. The County Assessor programmed the valuation program to “roll-over” or “freeze” the value of those parcels where the property owner had previously appealed the valuation and

received a reduced value. The valuation of these roll-over properties did not change from 1996 to 1997. If the valuation program did not roll-over the value of a multi-family residential parcel or if the parcel's value was not manually entered into the computer system, the value assigned by the valuation program was the property's value for that year. Evidence was produced at the Tax Court which showed that properties taxed under the roll-over method were valued at sixty-six percent (66%) of their full cash value in the aggregate, while the taxpayers' properties were valued at one hundred percent (100%) of their full cash value under the County's standard computer valuation method. The Tax Court found this violated the Uniformity Clause of the State Constitution and ordered a refund of the excess taxes paid. The Court of Appeals reversed and the Arizona Supreme Court took review.

The Supreme Court held that multi-family residential property was the appropriate class for evaluating the taxpayers' claim of discriminatory valuation. The Supreme Court also held that evidence showing that the properties taxed under the roll-over method were valued at sixty-six percent (66%) of their full cash value, while the taxpayers' properties were valued at one hundred percent (100%) of their full cash value under the standard method, established the elements of their claim of disproportionate valuation and provided a sufficient basis to support the Tax Court's finding that the taxpayers were subject to disproportionate valuation in violation of Arizona's Uniformity Clause. The Supreme Court ordered a refund of the excess taxes paid.

***Pinal Vista Properties, LLC v. Turnbull*, 208 Ariz. 188, 91 P.3d 1031 (Ct. App. 2004). *Transfer Of Real Property To The State By Issuance Of A Treasurer's Tax Deed Extinguishes All Privately-Held Tax Liens.*** Pinal Vista purchased tax liens on property in Pinal County ("Certificate of Purchase"). The Certificate of Purchase evidenced payment of delinquent taxes for the years 1987 through 1992 and represented a \$70,000 investment by Pinal Vista. Subsequent

years' taxes also went unpaid, but no one purchased any of those subsequent accruing tax liens, and thus they were assigned to the State pursuant to A.R.S. Section 42-18113. In June 2001, the Pinal County Board of Supervisors, after giving notice to lien holders, foreclosed on the property and issued a Treasurer's deed to the property to the State in accordance with A.R.S. Section 42-18261. The issue presented by the issuance of a Treasurer's deed to the State is whether that transfer of real property by Pinal County to the State extinguishes privately-held tax liens. The Court of Appeals concluded that it did, with the State taking the property free and clear of Pinal Vista's tax liens evidenced by its Certificates of Purchase. The lesson to be learned by this case is that if a prior holder of a Certificate of Purchase wishes to protect itself, it should pay the subsequent years property taxes on the property so that it will not have its prior years tax liens extinguished because of a transfer of the property to the State.

***Nordstrom, Inc. v. Maricopa County*, 207 Ariz. 553, 88 P.3d 1165 (App. 2004). *Nordstrom's Scottsdale Fashion Square Store Did Not Constitute A "Shopping Center" For Property Tax Valuation Purposes.*** The Arizona property tax statutes, specifically A.R.S. Section 42-13201 and following, provide an income method for the valuation of shopping centers (straight-line building residual method). The Court of Appeals held that Nordstrom did not qualify as a "shopping center" so that the income approach could be used. A shopping center must be comprised of three or more commercial establishments, and the Court of Appeals held that, although Nordstrom was attached to the Scottsdale Fashion Center Mall (by the way of a pedestrian overpass over Camelback Road) and was part of an area that was owned or managed as a unit, Nordstrom's store was nevertheless separate from the Mall and thus did not meet the requirement that a shopping center be comprised of three or more commercial establishments. The Court also noted that the lease between Nordstrom and the Mall owner provided that Nordstrom would use its diligent efforts to have the store separately assessed.

## 2003 LEGISLATION AND CASES

### LEGISLATION\*

#### Income Tax

**Senate Bill 1019 (Ariz. Sess. Laws 2003, Chapter 61). *Wheels To Work Program; Repeal.*** Repeals the state's Wheels to Work Program and the tax credit for donating motor vehicles to the program.

**House Bill 2057 (Ariz. Sess. Laws 2003, Chapter 68). *Internal Revenue Code Conformity.*** Conforms the Arizona income tax statutes to the current Internal Revenue Code, including the federal tax provisions enacted and in effect as of January 1, 2003.

**House Bill 2059 (Ariz. Sess. Laws 2003, Chapter 105). *Tax Corrections Act Of 2003 - Trust Income Tax Return Filing Increased.*** Increases the income tax filing requirement for trusts from \$100 to \$1,000 of Arizona taxable income, effective for taxable years beginning on or after December 31, 2003.

**House Bill 2058 (Ariz. Sess. Laws 2003, Chapter 122). *Tax Credit For Recycling Equipment Eliminated.*** The repealed provision, A.R.S. § 43-1076, permitted individual taxpayers a credit of ten percent of the installed cost of recycling equipment placed in service in the state. A credit of up to \$5000 or twenty five percent of total income tax had been allowed in the year the equipment was placed in service, and unused credits could be carried forward for fifteen years. The repeal is effective April 30, 2003 for tax years beginning on or after January 1, 2003, but carryovers of credits that accrued during tax years beginning before January 1, 2003 are not affected.

**House Bill 2396 (Ariz. Sess. Laws 2003, Chapter 169). *Reporting Requirement For Contributions To Public And Private Schools.*** Enacts a reporting requirement for tax credits for contributions to school tuition organizations and public school fees and contributions. School tuition organizations must annually report to the

Department of Revenue the number and total amount of cash contributions as well as the number and total amount of tuition grants awarded. Public schools must annually report to the Department of Revenue the number and total amount of fees and contributions received and information regarding the activities and programs so funded.

#### Sales and Use Tax

**Senate Bill 1066 (Ariz. Sess. Laws 2003, Chapter 3). *Sales Tax Increase "Grandfather Provision For Construction Contracts.*** Prevents increases in the privilege tax rate from applying to gross income from pre-existing contracts or written bids entered into by prime contractors. Contractors must maintain adequate records to document the date of the contract or bid. See A.R.S. § 42-5010(H).

**House Bill 2322 (Ariz. Sess. Laws 2003, Chapter 36). *Solar Energy Device Exemption Revised.*** Revises the exemption for solar energy devices under the prime contracting classification. The exemption, previously limited to the contractor's retail cost, now includes the entire contract price for the furnishing and installation of solar energy devices. In addition, while the exemption had been limited to \$5000 per solar energy device sold, the limit is now \$5000 per contract. When multiple devices are on one contract, the total exemption available may now be less than before the amendment. See A.R.S. § 42-5075(B)(14).

**House Bill 2059 (Ariz. Sess. Laws 2003, Chapter 105). *Tax Corrections Act Of 2003 — Rental Exemption For Semi-Trailers Repealed; Use Tax Statute Amended To Provide Deduction For Trade-Ins; Sales Tax Exclusion For Federal Excise Tax On Autos Repealed.*** Repeals the exemption from the personal property rental classification for the lease or rental of semitrailers manufactured in Arizona to persons registered with the United States Department of Transportation for use in interstate commerce. See prior A.R.S. § 42-5071(A)(5). That same exemption was repealed from the retail classification in 2002. In addition, Laws ch. 105 revised the

definition of "purchase price" and "sale price" for use tax purposes to specify that trade-in allowances are deducted from the sale price of new or used merchandise for use tax purposes. See A.R.S. § 42-5151(14)(e). The retail classification has such an exclusion for trade-ins and this amendment conforms the use tax to the retail sales tax. It also repealed the retail sales tax exclusion for federal excise taxes paid on new automobiles. See prior A.R.S. § 42-5061(D).

**House Bill 2529 (Ariz. Sess. Laws 2003, Chapter 267). Contracting Classification Exemption For State University Research Infrastructure Projects.** Adds a new exemption to the prime contracting classification for gross income from contracts to construct state university "research infrastructure" projects. The exemption applies to contracts executed by June 30, 2006, and the contracts must be reviewed by the Joint Committee on Capitol Review before the university enters into the contract. "Research infrastructure" means "installations and facilities for continuance and growth of scientific and technological research activities" conducted at an Arizona university. See A.R.S. § 42-5075(B)(18).

## Property Tax

**House Bill 2112 (Ariz. Sess. Laws 2003, Chapter 16). Small Claims Valuation Threshold Increased.** Increases the maximum dollar limit for appeals of valuations of class three property (residential property and property not covered by other classifications) in small claims court from \$300,000 to \$1,000,000. In addition, the \$500,000 limit on assessed value for appeals of class three properties that may be heard by just one member of the State Board of Equalization or one county hearing officer is increased to \$1,000,000.

**House Bill 2112 (Ariz. Sess. Laws. 2003, Chapter 16). Gas and Electric Utility Valuation Procedures.** Changes the definition of property of gas and electric utilities covered by class one to cover property of "gas distribution companies, electric transmission companies, electric distribution companies, combination gas and electric transmission and distribution companies, companies engaged in the generation of electricity and electric cooperatives." Ch. 16 also provides methods for adjusting the original cost of existing electric generation facilities and allocating electric utility property valuations among Arizona's counties. These changes are effective retroactively to December 31, 2002.

**House Bill 2059 (Ariz. Session Laws 2003, Chapter 105). Tax Corrections Act Of 2003 - Limits The Exemption Available For Personal Property Used In A Trade Or Business Or In Agriculture To \$50,000 Per Owner Of Such Property.** As background, Article 9 of the Arizona Constitution permits an exemption for personal property used in a trade or business or for agricultural purposes, but limits the exemption to \$50,000 per "taxpayer." In 1996, the Legislature enacted this exemption (which is currently codified at A.R.S. § 42-11127) subject to a maximum of \$50,000 "for each taxpayer." In 1998, the exemption was amended to allow a \$50,000 exemption for "each assessment account" by providing that "an assessment account is considered to be a taxpayer." Because a separate assessment account is created for each business location where qualifying personal property exists, the amendment allowed multiple \$50,000 exemptions to an individual owner of personal property in use at more than one business location. In 2001, *Circle K Stores, Inc. v. Apache County*, 18 P.3d 713 (Ct. App. 2001), held that the Constitution's \$50,000 limit applied to *each owner* of personal property rather than to *each business or property location*. A person who owns personal property used for commercial or agricultural purposes, per *Circle K*, is entitled to only one \$50,000 exemption. *Circle K* also reasoned that the 1998 amendment could not allow a \$50,000 exemption for each business location without violating the Constitution's "per taxpayer" limitation. (Because *Circle K* held that the 1998 amendment did not apply retroactively to the 1997 and 1998 tax assessments at issue, it did not need to rule on the constitutionality of the amendment.) 2003 Ariz. Session Laws, Chapter 105 conforms § 42-11127 to the holding and dicta of *Circle K* by repealing the multiple location provision in the 1998 amendment. Section 42-11127 now provides a maximum exemption of \$50,000 "per taxpayer" and no longer considers each assessment account to be a separate taxpayer.

**Senate Bill 1168 (Ariz. Sess. Laws 2003, Chapter 251). Improvements On Land Leased From Agricultural Improvement District Taxable.** Amends the exemption for property owned by government entities under A.R.S. § 42-11102 by providing that when permanent improvements have been constructed on land leased from an agricultural improvement district, persons who lease or sublease the land are, in the absence of a constitutional exemption, subject to property tax as if the property were owned by a private entity.

**Senate Bill 1168 (Ariz. Sess. Laws 2003, Chapter 251). *Property Tax Appeal Petitions Can Be Filed by E-mail.*** Permits a taxpayer to request delivery of annual notices of full cash value by electronic transmission. This law also permits a taxpayer to file a petition for review of an assessor's valuation by mail, common carrier, or by electronic transmission.

## Other Taxes

**Senate Bill 1348 (Ariz. Sess. Laws 2003, Chapter 52). *Penalties For Return Preparers.*** Makes several changes to the provisions for civil penalties imposed on return preparers for understated tax liability. First, the penalty may now be imposed only if the preparer has not disclosed the understatement to the Department of Revenue and there is no "realistic possibility" that the preparer's position would be sustained. Second, the time during which a preparer may pay only eighty-five percent of the penalty and file an appeal of the penalty is revised to thirty days from *the preparer's receipt of notification* that the penalty has been imposed. In addition, the time period that return preparers must retain records on electronically filed returns begins on the date the return is presented to the taxpayer for signature rather than the date the return is filed.

**House Bill 2533 (Ariz. Sess. Laws 2003, Chapter 263). *Income Tax Withholding; Tax Amnesty Program.*** Requires employers to withhold at least \$5 each month in state income tax from wages paid to an employee and increases the rates for state income tax withholding to offset reductions in federal income taxes.

Also enacted an amnesty program permitting taxpayers to file and pay back taxes with reduced interest and without civil penalties. Taxpayers applying for amnesty were required to pay at least a third of tax and reduced interest by October 31, 2003 and the remainder by May 1, 2004. The amnesty period was in effect from September 1, 2003 through October 31, 2003.

## 2003 CASES

### Income Tax

***Kocher v. Arizona Dep't of Revenue*, 80 P.3d 287 (App. 2003).**  
***Rejected Taxpayer's Claim That Stock Incentives Should Be Subtracted From Arizona Taxable Income On The Grounds That They Were Exercised Before The Taxpayer Became An Arizona Resident.***

The taxpayer asserted he was only residing in the state until a non-competition agreement expired. However, before exercising the stock options, he had accepted permanent employment in Arizona, purchased an expensive residence in Tucson, opened bank accounts and registered automobiles in Arizona, obtained an Arizona driver's license, enrolled his children in Arizona public schools, and filed tax returns as an Arizona resident. The mere fact that the taxpayer moved back to Texas after the non-competition agreement expired did not show that the taxpayer had always intended to return.

***Arizona Dep't of Revenue v. Raby*, 65 P.3d 458 (App. 2003).**  
***Only One \$2500 Subtraction From Income For State Retirement Benefits Applies To Benefits Received By A Married Taxpayer Even Though Both Spouses Have An Equal Community Property Interest In The Income.*** Arizona allows an exclusion of \$2,500 for amounts received from the state retirement system. Mr. Raby was a professor at the University of Arizona and thereafter Arizona State University and after retiring, began to receive yearly annuity payments from the state retirement system. Those payments are considered community property and were deposited into the taxpayers' community property bank account. The Raby's filed an amended return for their 1994 year, the first year that they received the retirement payments, claiming that each of them were entitled to a \$2,500 exclusion because the retirement payments were community property. The Board of Tax Appeals agreed with the taxpayers. However, the Tax Court reversed and the Court of Appeals upheld the Tax Court. The Court of Appeals concluded that although Mr. and Mrs. Raby's equal community property interests in the amounts that the state retirement system paid, only one taxpayer "received" those payments within the meaning of the statutory provision in question (A.R.S. § 43-1022 (2002) allowing the taxpayer to subtract up to \$2,500 from gross income for income received from benefits, annuities and pensions received from the state retirement system.

### Transaction Privilege Tax and Use Tax

***Interlott Technologies, Inc. v. Arizona Dep't of Revenue*, 72 P.3d 1271 (App. 2003).**

***A Business Leasing Lottery Vending Machines To The State Lottery Had Sufficient Nexus With Arizona To Subject The Business To Transaction Privilege Tax.*** Interlott leased 200 vending machines

within the state and stationed two employees in the state to make service calls, deliver and install the vending machines, train others to operate the machines, and move the machines to new locations. Under these facts, the court held that Interlott had sufficient nexus with Arizona for the state to impose its transaction privilege tax on Interlott's rental activity.

***The Tax Court Lacks Jurisdiction Over Municipal Tax Assessments Where The Taxpayer Fails To Include Any Reference To The Proposed City Assessments In The Taxpayer's Audit Protest Other Than A Request That "The Entire Audit Assessment" Be Vacated.*** The Department issued sixteen audit notices against Interlott, one for state privilege tax and the remainder for city tax on behalf of fifteen Arizona cities and towns, in one envelope. The taxpayer only addressed the dollar amount for and legal authorities concerning the state tax assessment in its protest. The court held that the taxpayer had not properly protested the city assessments. Thus, the Tax Court lacked jurisdiction over the city assessments and that such a lack of jurisdiction could not be waived by the Department.

***State ex rel. Arizona Dep't of Revenue v. Capitol Castings, Inc.***, 69 P.3d 29 (App. 2003) ("Capitol Castings II"). ***For Purposes Of The Exemption From Retail Sales Tax For Machinery Or Equipment Use Directly In Manufacturing, Fabricating, And Processing—Sand, Lime, Cement, And Similar Materials Do Not Constitute "Machinery Or Equipment" Even If The Materials Are Used To Fabricate Machinery Or Equipment That Would Qualify For The Exemption — In Other Words, Component Parts Of Machinery And Equipment Do Not Qualify For The Exemption.*** As background, in 1998, the Court of Appeals in *State ex rel. Arizona Dep't of Revenue v. Capitol Castings, Inc.*, 970 P.2d 443 (Ariz. Ct. App. 1998) ("Capitol Castings I") considered whether sand, lime, cement, and other materials used to fabricate molds for casting mining equipment and to neutralize noxious fumes produced when the molds were fabricated and used in the casting process qualified for the exemption for machinery and equipment used directly in manufacturing, processing, and other activities specified in A.R.S. § 42-5959(B)(1). Because the materials were consumed in the manufacturing process after only a few uses, the Court held that they were "expendable materials," which in 1998, were expressly excluded from the exemption. In 1999, the legislature retroactively amended the exemption to provide that the exclusion for "expendable materials" does not apply to items that otherwise constitute machinery or equipment used in manufacturing, processing, or another of the activities

specified in A.R.S. § 42-5959(B)(1). After the legislation became effective, Capitol Castings filed a motion for summary judgment arguing that the 1999 Legislation applied to it. However, the tax court held that, while the taxpayer had used the materials to make machinery and equipment it used directly in manufacturing, the materials themselves were not "machinery" or "equipment" within the meaning of section 42-5959(B)(1). Capitol Castings appealed the tax court's second decision, and the Court of Appeals held in *Capitol Castings II* that the 1999 amendment of the exclusion for "expendable materials" did not expand the definition of "machinery or equipment" to include materials that will ultimately become part of machinery or equipment qualifying for exemption and upheld the tax court's finding that sand, lime, cement, and the other materials themselves are not "machinery or equipment" within the meaning of the exemption. In other words, the Court held that component parts of machinery do not qualify for the machinery and equipment exemption. The Arizona Supreme Court has taken review of the Court of Appeals' 2003 decision and has held oral argument in this case.

***Luther Construction Co. v. Arizona Dep't of Revenue***, 74 P.3d 276 (App. 2003). ***A Taxpayer Claiming Equitable Estoppel Against The Department Of Revenue May Rely Upon A Written Letter From The Department, Formal Action Taken On A Refund Claim, And An Audit Assessment.*** An administrator's 1986 written guidance that contracting performed for the Bureau of Indian Affairs and for the benefit of Indian tribes was not subject to tax, a 1987 granting of a refund claim for tax collected on BIA contracts and a 1993 audit assessment not taxing BIA contracts where the work was for the benefit of the Indian tribe were inconsistent acts supporting estoppel against a subsequent state audit assessing tax on BIA contracts. The taxpayer relied upon the Department's prior positions that BIA contracts were not subject to the prime contracting classification tax to its detriment when it did not include the tax in its bid for the BIA job that was the subject of the subsequent audit and assessment. In addition, the Court of Appeals remanded the case to the tax court to determine whether the taxpayer was aware that a 1993 audit assessment against the taxpayer, which declined to tax contracts with the BIA, was in conflict with assessments against other taxpayers that taxed such contracts (in other words, was the taxpayer's reliance reasonable). Additionally, rather than showing that it would have been able to pass the tax on in a winning bid for the contract, the taxpayer only needed to show that it could have collected tax on the contract and suffered substantial detriment by not doing so.

**Arizona Joint Venture v. Arizona Dep't of Revenue**, 66 P.3d 771 (Ariz. Ct. App. 2003). **Department Not Estopped Because The Taxpayer Could Not Show Any Detriment To Its Reliance On The Department's Prior Positions.** The Court rejected taxpayer's argument that three prior audits that failed to adjust land value deductions estopped the department from challenging the taxpayer's land deductions in a subsequent audit. The Court found that the taxpayer failed to identify specific conduct inconsistent with the current audit, should have been aware that the failure to adjust the land deduction resulted from the Department's mistake, and most importantly could not demonstrate legal detriment merely by failing to pay taxes it was obligated to pay. In addition, Arizona Joint Venture holds that the Department is not barred from challenging the land value deduction after issuing an audit notice, nor does its acceptance of the deduction before the notice is issued transfer the burden of proof to the Department.

## Property Tax

**Cottonwood Affordable Housing v. Yavapai County**, 72 P.3d 357 (Ariz. Tax Ct. 2003). **Low Income Housing Tax Credits Should Not Be Considered When Determining The Value Of Residential Real Estate Via The Income Approach.** The tax credits, although providing an incentive to invest in the property, were intangible personal property that did not add to the long-term value of the real estate and were not part of the income flowing from the property. Furthermore, because the restrictions imposed by the tax credit program directly affect the property's marketability, the income stream for the property should be computed with actual rents received rather than market rents from ordinary apartment complexes.

**Citizens Telecommunications Co. of the White Mountains v. Arizona Dep't of Revenue**, 206 Ariz. 33, 75 P.3d 123 (App. 2003). **Because Interexchange Carriers Now Compete With Qwest For Long Distance Service Within Local Access And Transport Areas, Qwest Is Using "Functionally Identical" Telecommunications Property For Uses "Functionally Identical" To These Competitors And, Therefore, The Statutory Scheme That Mandated Market Valuation Of Telecommunications Property Used To Provide Local Service And A Cost Approach For Other Telecommunications Property Violated The**

**Uniformity Clause Of The Arizona Constitution.** The court concluded that telecommunications companies providing local service and its competitors (long distance carriers) were using functionally identical property for functionally identical uses and thus the application of the statutory "market value" method for valuing local telecommunications companies violated the uniformity clause when long distance companies were valued based on a cost approach. The court also held that to determine whether a property tax classification violates the Uniformity Clause, the court must consider whether the taxpayer (local telecommunications companies) and the comparison taxpayers (long distance telecommunications companies) are (1) direct competitors, (2) using the same equipment types, (3) providing identical services, (4) to the same customer base; additional factors include the property's physical attributes, productivity, use and purpose. Based on these factors, the court concluded that local telecommunications companies were in the same class as long distance telecommunications companies and it was a violation of the uniformity clause for the statutory valuation structure to value local companies based on the market approach and long distance companies based on a cost approach. See *U.S. West Communications Inc. v. Arizona Department of Revenue*, supra., which five years previously arrived at the opposite result based on the court's conclusion that local telecommunications companies were a separate class from long distance companies and they could be treated and valued differently.

**University Physicians, Inc. v. Pima County**, 75 P.3d 153 (App. 2003). **The Exemption For Property Used By A Charitable Organization "For The Relief Of The Indigent Or Afflicted" Is Not Satisfied Merely By Treating Persons Suffering From Serious Medical Conditions.** Rather, the statutory definition for "afflicted" requires a condition that renders persons "unable to reasonably take care of themselves or their families or to properly function in society without periodic or continuous assistance." The tax court applied too broad a definition of "afflicted" to the property of a non-profit organization of physicians operating a variety of clinics providing different medical services at each facility. The case was remanded to determine whether each facility was principally utilized to treat persons meeting the statutory definition of "afflicted."

## DEPARTMENT OF REVENUE RULINGS AND DECISIONS

### Transaction Privilege And Use Tax, Rulings

#### 2005 Rulings

**Arizona Transaction Privilege Tax Ruling 04-01 (Mobile Telecommunications Services)** covers in detail the sales taxation of mobile telecommunications services. It provides that mobile telecommunications services include both one-way and two-way wireless communications carried on between mobile stations or receivers and land stations, and by mobile stations communicating among themselves. Mobile telecommunications may include, but are not limited to, wireless local and interstate telephone service, paging services, two-way radio service, directory information, call forwarding, caller identification, call-waiting, broadband personal communication services, wireless radio telephone services, geographic-area specialized and enhanced specialized mobile radio services, and incumbent-wide area specialized mobile radio licensees. The ruling also indicates that Arizona follows the Mobile Telecommunications Sourcing Act and pursuant to the MTSA, Arizona taxes intrastate mobile telecommunications services according to the customer's place of primary use, which is the customer's residential street address or primary business street address.

#### 2004 Rulings: none

#### 2003 Rulings

**Arizona Transaction Privilege Tax Ruling 03-1 (Sales of Autos to Non-Residents)** clarifies the requirements for exemption from retail sales tax under A.R.S. § 42 5061(A)(28), which exempts the sale of a motor vehicle to nonresidents when the purchaser's state of residence does not allow a credit against sales or use tax owed on the purchase. Nonresidents purchasing motor vehicles must, in addition to obtaining a special thirty-day nonresident registration, complete a Transaction Privilege Tax Exemption Certificate, Form 5000. Nonresidents from states that allow a credit for Arizona sales tax are not exempt from Arizona sales tax. TPR 03-1 also clarifies the exemption from retail sales tax under A.R.S. § 42-5061(A)(14) for nonresidents purchasing motor vehicles that are shipped or delivered out of state by the vendor for use outside the state. The exemption does not apply to part-year residents nor to nonresident military personnel purchasing vehicles for use in Arizona during the military assignment. Registration in Arizona within three months will result in a presumption that the vehicle was purchased for use in Arizona. Arizona Form 5010, *Certificate of Delivery Out of State*, is the appropriate exemption certificate that

automobile dealers are required to secure from purchasers claiming exemption under section 42-5061(A)(14).

**Arizona Transaction Privilege Tax Ruling 03-2 (Motor Carrier Tax Exemption - Trailers and Semi-Trailers)** clarifies the application of the exemption for leasing or renting a motor vehicle with a gross vehicle weight in excess of twelve-thousand (12,000) pounds where the motor carrier fee is paid, whether by the owner, lessee or authorized third party, on the specific vehicle that is leased, including vehicles registered as an apportioned vehicle. Trailers and semi-trailers leased independently for use in a vehicle combination are not subject to privilege tax if the motor carrier fee has been paid on the power unit towing the trailer and the power unit is registered as a vehicle combination. Furthermore, the exemption from retail sales tax applies to the sale of a motor vehicle, trailers and semi-trailers that constitute a vehicle combination and repair and replacement parts sold to a person engaged in leasing vehicles.

**Arizona Transaction Privilege Tax Ruling 03-3 (Motor Carrier Tax Exemption - One Way Fleet)** provides that leasing or renting a truck less than twenty-six thousand (26,000) pounds gross vehicle weight that is operated as part of an identifiable one-way fleet and registered on an allocated basis is not subject to privilege tax regardless of the state in which the vehicle is registered. An exemption from retail sales tax also applies to the sale of motor vehicles including any repair and replacement parts sold to a person engaged in leasing such trucks.

**Arizona Transaction Privilege Tax Ruling 03-4 (Motor Carrier Tax Exemption - Payment on Apportioned or Allocated Basis)** provides that leasing or renting a motor vehicle to a person engaged in an activity subject to the transporting classification is exempt from privilege tax provided the motor carrier fee on the vehicles has been paid. The motor carrier fee may be paid in full, on an apportioned basis, or paid on allocated basis if the vehicle is part of a one way fleet. The lessee's income from operating such vehicles is also exempt from privilege tax.

**Arizona Transaction Privilege Tax Ruling 03-5 (Sales of Books to Libraries)** clarifies the exemption from retail sales tax for printed, photographic, electronic and digital media sold to public libraries for public use by providing examples of items that qualify for the exemption (such as books, magazines, videos, audio CDs, and educational software that are intended for use by library patrons) and items that are taxable (such as projection equipment, video players, computers, security devices, and various office supply items).

*[There was no TPR 03-6 issued.]*

**Arizona Transaction Privilege Tax Ruling 03-7 (Long-Term Lease of Autos)** provides that while a person engaged in the business of leasing automobiles on a long-term basis is subject to tax under the personal property rental classification, the tax base does not include reimbursements by the lessee for payments made by the lessor for vehicle title and registration fees, license plate fees, and vehicle license tax, if these amounts are separately identified and billed to the lessee. The ruling also provides that in addition to the lease payments, an automobile dealer or lessor is subject to tax on amounts received as a capitalized cost reduction or as lease termination charges. The ruling provides that the taxable capitalized cost reduction includes any cash payment, manufacturer's rebate, credit card bonus, or any other item for which credit is given to the lessee. It also provides that the amount of credit allowed for a vehicle that was traded in on the leased vehicle is not subject to tax. Lease termination charges, which are taxable, include, but are not limited to, an early termination fee, excessive mileage charge, or excessive wear and tear charge.

## TRANSACTION PRIVILEGE TAX PROCEDURES

**2005 Procedures: none**

**2004 Procedures**

**Transaction Privilege Tax Procedure 04-1 (Refund Procedure for "Lemons")** provides the procedures for claimants requesting a refund of transaction privilege taxes paid that is available under the provisions of House Bill 2086 (Laws 2004, Chap. 242) which provided a refund to motor vehicle manufacturers who repurchase motor vehicles pursuant to Arizona's "lemon law" statutes.

**Transaction Privilege Tax Procedure 04-2 (Refund Procedure for Design and Engineering)** provides guidance to taxpayers requesting a refund of transaction privilege taxes paid on design and engineering fees under the prime contracting classification that is available under the retroactive provisions under Senate Bill 1293 (Laws 2004, Chap. 309). The procedure provided that any claims needed to be filed by December 31, 2004. The legislation was retroactive to tax periods beginning from and after October 17, 1969 (which was the date of the Supreme Court's decision in the *Ebasco* case). Naturally, the statute of limitations for refund claims on periods back to 1969 have long closed. This ruling provides the details on how to file refund claims for those closed periods. It seems to be the Department's position, although not supported by the legislation itself, that any refund claims for design and engineering fees, whether for periods that are currently open or closed and back to 1969, have to be filed by December 31, 2004. However, we believe that the legislative intent was that the retroactive refund provision and the legislative requirement to file

refund claims by December 31, 2004 applies only to periods that were closed at the time that the legislation became effective in August, 2004. The statutory period for filing refund claims is four years and if a taxpayer paid tax on design and engineering fees under the contracting classification for open periods, say back to the year 2001, a refund claim could be filed under the normal refund statutory limitations period without having to be filed by December 31, 2004 and also not subject to the \$100,000 aggregate refund cap limitation provided by the legislation for retroactive refund claims.

**2003 Procedures: none**

## CORPORATE INCOME TAX RULINGS

**2005 Rulings: none**

**2004 Rulings**

**Corporate Tax Ruling 04-01 (Arizona Consolidated Return Election - Mergers)** provides that a consolidated group that has been acquired by another corporation or group of corporations in a reverse acquisition pursuant to U.S. Treasury Reg. § 1.1502-75(d)(3)(i) is considered to be the true acquiring corporation for federal tax purposes, and is subject to continued filing requirements. If the true acquiring group has elected the Arizona consolidated filing method, the group is required to continue filing an Arizona consolidated income tax return. The ruling goes on to hold that a consolidated group that acquires another corporation or group of corporations in a reverse acquisition is not considered to be the true acquiring corporation for federal tax purposes, and is not subject to continued filing requirements. If the acquiring affiliated group has elected the Arizona consolidated filing method, but the acquired group (true acquiring group) has not elected to file an Arizona consolidated income tax return, the new group must make an Arizona consolidated filing election if it desires to file an Arizona consolidated return.

**2003 Rulings: none**

## GENERAL TAX RULINGS

**2005 Rulings**

**General Tax Ruling 05-1 (Electronic Signatures For Tax Return Preparers)** provides that tax return preparers may use an alternative method of signing original returns, amended returns or requests for filing extensions by rubber stamp, mechanical device, or computer software program. These alternative methods must include either a facsimile of the individual preparer's signature or the individual preparer's printed name.

## 2004 Rulings

**General Tax Ruling 04-1 (Limitations Period Calculations)** details when the amount of taxes determined to be due become final for purpose of the limitation periods of A.R.S. §§ 42-1114 (suit by the State to recover taxes that remain unpaid), 42-1201 (limitations period on collection action by the department) and 42-2066 (six year statute of limitations on tax debts).

**General Tax Ruling 04-2 (Penalty Abatement)** sets out in detail the standards for abatement of penalties based on reasonable cause.

## 2003 Rulings: none

## INDIVIDUAL INCOME TAX RULINGS<sup>1</sup>

**Arizona Individual Income Tax Ruling 02-1 (Listing of Exempt Federal Bonds)** lists all the federal obligations, the interest on which is exempt from Arizona Income Tax. The ruling also lists federal taxable obligations.

**Arizona Individual Income Tax Ruling 02-2 (Distributions from Mutual Funds Holding U.S. Government Obligations)** provides that when a mutual fund invests exclusively in obligations that are exempt from state taxation by federal law, the amount of the distribution received from the fund may be subtracted from Arizona gross income. The ruling also provides that interest or other related expenses incurred to purchase or carry the mutual fund shares cannot be deducted.

**Arizona Individual Income Tax Ruling 02-3 (Allocation of Estimated Payments by Spouses)** provides that when spouses make estimated tax payments jointly and later file separate income tax returns, the spouses may allocate the estimated tax payments between their returns in whatever manner they agree by claiming the payments on their respective returns. It further provides that when spouses cannot agree on the allocation, the following formula will be used: "Tax imposed on husband's or wife's return divided by total tax imposed on both returns x (times) estimated payment."

**Arizona Individual Income Tax Ruling 02-4 (Estimated Tax Underpayment Penalty)** provides that if an individual taxpayer files a corrected return after filing the original return and before the due date for filing the original return (including extensions), the corrected return is the return for the taxable year for the purposes of

determining the underpayment of estimated tax penalty. It also provides that if an individual files an amended return after filing the original return and after the due date of the original return (including extensions), the original return remains the return for the taxable year for the purposes of determining the underpayment of estimated tax penalty.

**Individual Tax Ruling 02-5 (Tax Treatment of Stock Options)** details the Arizona individual income tax treatment of stock options when there is a change in residency, either an Arizona resident moving out of state, or an individual moving into the State and becoming a resident. As an example, if an Arizona resident is granted a non-statutory stock option while a non-resident of Arizona, and later exercises the option while an Arizona resident, the income included in the taxpayer's federal adjusted gross income is subject to Arizona income tax because the taxpayer is an Arizona resident when the income is recognized. Conversely, if a taxpayer is granted a non-statutory stock option while an Arizona resident and later exercises the option while a non-resident, the income recognized is compensation for services and is subject to Arizona income tax to the extent the services were performed in Arizona between the grant date and the exercise date. The ruling also provides guidance regarding incentive stock options and employee stock purchase plans.

## DECISIONS OF THE DIRECTOR

### Transaction Privilege Tax Decisions

#### 2005 Decisions

CASE NO. 200400092-S (golf green fees are taxable under the amusements classification)(October 24, 2005) held that gross receipts from green fees for the use of golf courses are subject to the transaction privilege tax under the amusement classification. The taxpayer argued that since neither "golf" nor "golf course" is listed in the enumerated taxable activities of the amusement classification, the green fees from its golf course are not taxable under that classification. The director in concluding that golf is an amusement referred to a 1979 administrative decision in *Par Rounds v. Arizona Department of Revenue*, 118-78-S (1979), in which the State Board of Tax Appeals summarily concluded that green fees and driving range fees are admission fees for amusement and taxable under the amusement classification. Additionally, the director noted that in an earlier supreme court case, *City of Phoenix v. Moore*, 57 Ariz. 350, 113 P.2d 935 (1941), the taxpayer and the Court did not question that green fees were generally taxable as an amusement.

<sup>1</sup> There are no 2003, 2004 or 2005 individual income tax rulings.

## 2004 Decisions

**CASE NO. 200300086-S (*Home Electric Generators Not Exempt*)** (March 19, 2004) held that the sale of small electric generators for household and farm use by a retailer were not exempt from the transaction privilege tax. A.R.S. § 42-5061(B)(4) provides an exemption for machinery, equipment, or transmission lines used directly in producing or transmitting electrical power, but not including distribution. The taxpayer argued that the generators in question should qualify under that exemption. The Director concluded that the exemption is intended for sales made to electric utility companies because their sales of electricity produced are in turn subject to the transaction privilege tax and that the exemption was thus not intended to apply to sales made for household and farm use.

## 2003 Decisions

**CASE NO. 200200180-S (*Design and Engineering Fees Taxable*)** (November 26, 2003) held that architectural, engineering and design fees were taxable under the prime contracting classification although separately stated in the construction contract and separately billed. It should be noted that this decision has been overruled by legislation — Senate Bill 1293, Laws 2004, Chapter 309 (amending A.R.S. § 42-5075.J).

**CASE NO. 200200148-S (*Non-Alcoholic Beer and Wine Not Exempt Food*)** (August 25, 2003) held that beer and wine labeled as non-alcoholic, but which contained less than one-half of 1% alcohol, constitutes alcoholic beverages and does not fall within the definition of food eligible to be sold by a qualified retailer exempt from the transaction privilege tax.

**CASE NO. 200200106-S (*Confusion Is Not Reasonable Cause*)** (March 6, 2003) held that a taxpayer did not present reasonable cause for the abatement of penalties. The taxpayer built townhouses. The Department audited the taxpayer and assessed transaction privilege tax under the contracting classification along with penalties and interest. The taxpayer accepted the audited tax liability but protested the assessment of penalties and interest. The taxpayer testified that it had been confused as to the tax liability between it and its affiliated development company and after it realized its error, filed late and

amended tax returns. The Director held that the taxpayer's actions were not reasonable and did not abate penalties or interest. It should be noted that while penalties can be abated for reasonable cause, interest cannot be abated unless the taxpayer relied upon erroneous written advice from the Department, which was not the case here.

## Individual Income Tax Decisions

### 2003 Decisions

**CASE NO. 200300122-I (*OK to Use IRS Tax Information*)** (October 7, 2003) held that basing an Arizona individual income tax assessment on information received from the Internal Revenue Service was valid.

## Corporate Income Tax Decisions

### 2005 Decisions: none

### 2004 Decisions

**CASE NO. 200400017-C (*Arizona Destination Sales Not Protected by P.L. 86-272*)** held that an Arizona consolidated group was required to include in the numerator of the Arizona sales factor a portion of the sales made by a partnership, in which some members of the group had an interest, to another member of the group doing business in Arizona. The taxpayer argued that the partnership had no nexus with Arizona and was protected from state income taxation by Public Law 86-272, which is a federal law that prohibits a state from imposing its state income tax on an out-of-state business whose only activity in the state is the solicitation of sales, where the orders are transmitted out of state for processing and acceptance and are filled from out of state. The Director held that since other members of the consolidated group were engaged in business in Arizona and not protected by Public Law 86-272, the partnership's sales into Arizona were to be included in the numerator of the Arizona sales factor and Public Law 86-272 did not apply.

### 2003 Decisions: none

## Step toe's State and Local Tax Practice

Our Washington, Phoenix, and Los Angeles attorneys represent business clients of many types and sizes in state and local tax matters, including high-technology businesses, electric utilities, telecommunications companies, mining and railroad companies, manufacturers, retailers, banks, printers, mail order businesses, tax-exempt organizations, and resorts.

On behalf of these clients, our attorneys litigate complex and varied income, sales and use, and property tax issues in administrative proceedings and state and federal courts, and they also seek legislative solutions to industry-wide concerns that affect firm clients.

In addition, our attorneys counsel the firm's clients on the multi-state tax implications of their business transactions. For example, the firm advises its e-commerce industry clients on their complex multi-state income tax responsibilities and their sales and use tax collection obligations.

### *Appellate State & Local Tax Practice*

Representing a financial institution appealing the disallowance of bad debt refunds arising from retail sales tax paid on assigned receivables, where those receivables were assigned without recourse by the retailer to the financial institution.

Representing a newspaper publisher on the issue of whether, for corporate income tax purposes, an affiliated corporation that was a partner in a partnership that manufactured newsprint satisfied the operational integration test for inclusion in the publisher's unitary group.

Representing an electric utility in the valuation for property tax purposes of its transmission and distribution network, and specifically whether contributions in aid of construction are to be included in the valuation base.

Representing a national apartment developer in the proper application of the state transaction privilege tax to construction managers.

Representing a developer of low income housing tax credit projects over the method to be used in valuing the apartment projects for property tax purposes, specifically whether the value of the federal tax credits are to be included in the valuation base, and whether for the income method of valuation, the income stream is to include the actual rents paid by the tenants (which is restricted) or market rent.

Representing a construction contractor in establishing that the state could be estopped from imposing taxes based on its communications and positions in past correspondence and audit assessments.

Defending a judgment for an operator of self-storage facilities in an action challenging property tax classification of housing provided for on-site managers.

Representing a pharmaceutical company in appealing state income taxes imposed on an out-of-state business based on protections for "solicitation of sales" under Public Law 86-272.

### *Corporate Income Tax*

Advising and representing corporations in controversies over "unitary" combination issues — i.e., whether a particular affiliate is a member of the unitary group or not under the various tests the states use for determining unitary combination (such as operational integration or functional integration).

Advising and representing corporations on income tax nexus issues, particularly with respect to the application of the protection from state income tax afforded by Public Law 86-272 (which prohibits a state from imposing a net income tax where the company's only contact with the state is the solicitation of orders where those orders are sent back to the home office for approval and filling).

Advising and representing companies on business income vs. non-business income issues (business income is apportioned to the various states the company does business in using factor apportionment while non-business income is allocated entirely to the source state). Some examples include gain on the sale of stock of a foreign subsidiary, the sale of a plant that had been closed for a number of years, the sale of land that had been acquired to build a new facility but where plans changed, royalty income from patents, income from court-awarded judgments.

Assisting E-commerce clients with state income tax planning, particularly with nexus and Public Law 86-272 issues.

Advising and representing clients on intangible holding company issues and whether for separate return reporting states such a holding company has nexus with a taxing state based on the presence of the holding company's intangibles in the state (e.g., trademarks, trade names). Also advising and representing clients on whether such an intangible holding company is properly included in a unitary group based upon the particular state's unitary test.

Representing companies protesting and appealing disallowed income tax credits for pollution control equipment, and specifically whether pollution control equipment installed on leased and rented automobiles qualifies for the credit and whether retroactive legislation providing that the credit does not apply to automotive pollution control equipment is constitutional.

Representing a newspaper publisher in an appeal involving the question of whether the flow through income from an out-of-state partnership to the publisher (the publisher was a general partner) where the partnership had no nexus with the taxing state was protected from taxation by Public Law 86-272.

Obtaining private corporate income tax rulings and drafting state income tax legislation for clients and industry groups.

### ***Tax Consequences of Mergers & Acquisitions***

Counseling clients on the state and local tax consequences of mergers and acquisitions, both income tax and sales tax, including whether an asset sale is a casual sale for state sales tax purposes.

Working with corporate counsel to draft tax provisions for merger and acquisition agreements.

### ***Multi-State Taxation Income Taxation***

Advising multi-state businesses on state corporate income tax issues, including unitary combination issues, consolidated return elections, allocation and apportionment issues, business/non-business income questions, Public Law 86-272 nexus issues, throwback rule issues, Appeal of Joyce types of issues, intangible holding company issues and voluntary compliance and amnesty filings.

Counseling clients on the multi-state taxation of flow-through entities such as partnerships, S-corporations, and limited liability companies, including nexus issues, composite return filings, and combined return issues.

### ***Sales and Use Taxation***

Advising clients on nexus issues: when remote vendors will be required to collect the destination state's sales and use tax on sales made into the state, voluntary compliance and amnesty filings, Streamlined Sales Tax Project issues and registration.

### ***Sales and Use Taxes, Privilege Taxes, & Excise Taxes***

Advising high-technology businesses, telecommunication companies, and manufacturers on gross receipts and other privilege taxes imposed by various jurisdictions.

Advising an international telecommunications company on nexus issues and state and local tax collection obligations on international calls.

Advising airlines and other air transportation companies on whether their sale or purchase of aircraft is subject to sales or use tax.

Advising out-of-state alarm monitoring services on nexus issues.

Advising contractors and homebuilders on the state and local tax treatment of their construction and homebuilding activities.

Representing clients during a state or local audit to avoid or limit an assessment before it is issued.

Representing developers and construction contractors appealing assessments of state and municipal privilege taxes.

Working with homebuilders to prepare and appeal denials of refund claims where land deduction claimed on tax returns was substantially less than the deduction allowed by statute.

Advising e-commerce clients on sales and use tax collection obligations in the various states where their customers are located and where the orders are shipped.

Representing clients in protests and appeals of tax assessments disallowing exemptions from sales and use tax claimed by clients engaged in mining, construction contracting, natural gas pipelines, advertising, and printing and publishing.

Representing clients engaged in taxable and nontaxable business activities that have been taxed as if all receipts were from taxable business transactions.

Representing a bank's protest of sales tax assessed on the sale of a debtor's business assets.

Representing a regional marketer of petroleum products protesting denied refunds of excise taxes on gasoline and diesel exports.

Advising providers of systems design, software development, and other computer services on exemptions from retail sales and use tax.

Obtaining private tax rulings and drafting state tax legislation for clients and industry groups.

### Property Tax

Our real and personal property tax representation spans the full administrative process through the Arizona Tax Court.

Advising and representing heavy and light industrial manufacturers, high-technology businesses, multi-family residential rental owners, golf course and common area land owners, and other property owners in real property tax valuation and classification appeals, including illegal tax claims.

Representing a major electric utility in property tax appeals over the value of a nuclear generating plant, the treatment of contributions in aid of construction, and other valuation issues.

Representing operators of federally-owned national park facilities seeking refunds for erroneous assessments of property tax.

Representing clients challenging the inclusion of federal tax credits in the valuation of low-income rental housing.

Representing clients faced with Notice of Change or Notice of Correction proceedings and in obtaining refunds and/or valuation changes through Notice of Claim proceedings.

Representing property owners who have been denied appropriate statutory exemptions.

Representing owners of improvements on land leased from governmental entities.

Representing industrial manufacturers in personal property audits and valuation appeals involving issues of value and obsolescence.

### Step toe's Federal Tax Practice

Step toe's federal tax practice covers the entire spectrum of federal taxation, including representation of businesses before the Congress, Treasury and the national office of the IRS; transactional planning for domestic and multinational corporations; complex audit and controversy work for corporations and other business interests contesting IRS adjustments; and litigation before the Tax Court, Court of Federal Claims, district courts, courts of appeals, and the Supreme Court. The firm's tax practice also encompasses all aspects of employee benefits (ERISA), executive compensation, tax exempt organizations, charitable giving, and estate planning.

#### State and Local Tax Group

##### Phoenix Office

Pat Derdenger*	602.257.5209	pderdenger@steptoe.com
Dawn R. Gabel	602.257.5231	dgabel@steptoe.com
Bennett Cooper*	602.257.5217	bcooper@steptoe.com
Randy Evans	602.257.5242	revans@steptoe.com
Mark Vilaboy	602.257.5256	mvilaboy@steptoe.com
Frank Crociata	602.257.5261	fcrociata@steptoe.com

##### Washington D.C. Office

Matthew Zinn	202.429.6422	mzinn@steptoe.com
Catherine Wilkinson	202.429.6262	cwilkinson@steptoe.com
Suzanne McDowell	202.429.6209	smcdowell@steptoe.com
Stanley Smilack	202.429.6464	ssmilack@steptoe.com

##### LA Office

Jay Smith	213.439.9430	jsmith@steptoe.com
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*\*Pat Derdenger and Bennett Cooper are also admitted to practice in California.*

# STEPTOE & JOHNSON <sup>LLP</sup>

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