

A Report from Steptoe & Johnson LLP

When Experience Matters®

An Overview of Arizona Property Tax for New Owners

As a new owner of Arizona real estate property, there are a few things that are useful to know as you consider how best to manage your real property tax liability. Let's start at the end. The bottom line for most taxpayers that we work with really is the bottom line: *how much will I have to pay in property taxes?*

To calculate your property tax burden, you need to know four things:

1. What is your full cash value?
2. What is your limited value?
3. What is your assessment ratio? and
4. What are the tax rates that apply to your full cash and limited values?

Once you know those things, the formula to calculate taxes is:

Dual Values

Property taxes in Arizona are assessed using one of the more complicated systems in the United States today. The complexity begins with the valuation itself. Property taxes here are based not on one value, but two. The first is the most familiar, but not necessarily the most important. The "full cash value" is the value that property owners focus on the most and it is the value which can be appealed. The full cash value is also called the "secondary value." The full cash value is supposed to equal "market value," unless a specific statutory method of valuation has been created. Types of properties that have specific statutory valuation methods include agricultural properties, shopping centers, golf courses, rail roads, airlines, and common areas. If there is no statutory methodology then the full cash value should equal the market value, and standard appraisal methods and techniques are used to

Full cash value X assessment ratio X secondary tax rate = **Secondary tax liability**

+

Limited value X assessment ratio X primary tax rate = **Primary tax liability**

TOTAL TAX LIABILITY

The total tax liability is the sum of the secondary tax liability plus the primary tax liability.

determine the market value. Typically that means that the full cash value of the property will be determined via the cost approach, the income approach or the sales comparison approach to value.

The other value that affects an owner's property tax burden is the "limited value." This is also called the primary value. The limited value increases each year by a statutory formula, but it can never exceed the full cash value. The reason that the limited value is very important, and that it is referred to as the "primary value", is that it bears the greater portion of the tax burden. Funding for the maintenance and operation of school districts, cities, community college districts and the counties comes from taxes imposed on the limited value. The tax rate that is applied to the limited value is almost always significantly higher than the tax rate that is applied to the full cash value and in many cases is twice as high.

Assessment Ratios Based on Use

Valuation is only the first step in the assessment process. Property taxes are also affected by the classification of the property. Property is classified based upon its use. Commercial and industrial properties are classified as Class 1 or Class 2. Agricultural property and vacant land is classified as Class 2 property. Commercial properties have a 21% assessment ratio (which will go down to 20% for 2011 and later years). Agricultural properties and vacant land, as well as exempt properties, have a 16% assessment ratio. Residential properties are classified as Class 3 or 4. Residential properties enjoy a low assessment ratio-10%. There are 11 tax classifications in all. As you can tell by looking at the formula above, the assessment ratio is a very important factor in taxation because it dramatically affects the assessed value to which the tax rate is applied.

Tax Rates

The tax rates differ for each geographical area. They can be most easily found by looking at the

tax bill. If you are a new owner or don't have your tax bill, you can look up the most recent tax rates for your property by going to the county treasurer's website at <http://treasurer.maricopa.gov> and looking at the tax bill for your particular parcel online. If your property has several contiguous parcels, they are most likely all within the same taxing jurisdictions and will thus all have the same tax rates, so it is not necessary to look up each of them individually.

Property Tax Calendar

Not only is the valuation and assessment process complicated, but the calendar for property taxation is not intuitive and can present traps for the unwary. The valuation date for any particular tax year is January 1 of the prior year. This means that for the 2010 tax year, the valuation date was January 1, 2009.

Not only is the valuation date significantly before the tax year, but the timing for appeals and for the tax bill that is ultimately issued are also confusing and can mislead taxpayers into missing important deadlines to ensure their right to a fair valuation. To file an appeal at the administrative level, the taxpayer has sixty days from the date that the Notice of Value was mailed out. That typically means that appeals to the Assessor must be filed no later than late April, and sometimes as late as mid-May. Failure to file an appeal with the Assessor's office is not, however, fatal. A taxpayer can still file an appeal with the Arizona Tax Court by December 15 of the valuation year. That means that to appeal the 2010 tax value, the taxpayer must file in the Arizona Tax Court by December 15, 2009. In addition, if a taxpayer becomes dissatisfied with the administrative appeals process, he may jump into Tax Court so long as he does so within sixty days of the last administrative decision.

The tax rates for the year are not established until the third Monday in August of the tax year. That means that the value you receive in February of 2009 for the 2010 tax year will not have any tax

rate applied to it until the fall of 2010. By that time, it is usually too late to appeal the value of the property. This is why the timing becomes a trap for the unwary. For many people, the importance of their property tax value does not really hit home or rise to the top of the priority list until that tax bill hits the mailbox, but by that time, it really is too late unless you have a special type of appeal available that will be discussed below.

New Owner Appeals

New owners of property, those who buy the property during the tax year, have a special window of opportunity for appeals that is not open to the regular taxpayer. If you buy property in 2009, you are not stuck with the 2009 property tax value that was mailed to your seller in February, 2008, unless your seller actually appealed that value to the Assessor or to Tax Court. If he did not appeal the value, then a new owner may bring an appeal in Tax Court so long as he does so by December 15, 2009.*

Other appeals. There are two other potential property tax appeals available to those whose property has been incorrectly taxed, an error claim and an illegal tax claim. Error claims, as the name implies, are challenges to the value of the property not because the taxpayer thinks that the assessor made a judgment error in setting the value of the property, but because the Assessor made an objectively verifiable mistake in either the size, use, type, description, or ownership of property or in the tax rate applied to it. A.R.S. § 42-16251. An error claim can be made for the current tax year and for the preceding three years, so long as it is being brought by the owner of the property.

* This does mean that there is a short period of time in which a new owner might purchase property and have no right to pursue a new owner appeal. This occurs when the sale closes between December 15 and the end of the year. Those owners are stuck with the value for the year in which they purchased the property as well as for the following year because all appeals needed to have been brought by December 15.

An illegal tax claim can be brought within one year of making the first half tax payment, so its use is limited to one tax year at a time. It arises in number of circumstances such as when the tax that is being imposed is not authorized by statute, or the statute that authorizes it is unconstitutional. It can also arise where the property is not owned by a taxable taxpayer, such as where it is owned by a governmental entity, but merely operated by a private taxpayer. Other times an illegal tax claim can arise when the Assessor refuses to value or classify the property properly despite knowledge of the facts necessary to treat it correctly. Illegal tax claims can also be pursued where the tax rate that is imposed is incorrect. Illegal tax claims are not as common as the valuation appeal or the error claim, but they do arise from time to time.

Another property tax issue that is important for new owners to understand is the treatment of agricultural property. Agricultural property is one of those unique classes of property that has a statutory valuation method applied to determine value rather than the fair market value. Agricultural property is valued at a very low number. A property that is valued at \$5,000,000 on a fair market value basis may be worth less than \$35,000 when valued as agricultural land. Obviously, this is a very tax advantageous valuation method and one must follow statutory requirements in order to obtain it. Those requirements include the use of the property to support a specific amount of field crops or a specific number of head of cattle. The property must be used as agricultural property for a period of time and is usually subject to an agricultural lease where the owner of the property is not actually farming or ranching but is leasing the land to another who is farming it or ranching it along with other properties in the area. When such property is sold, the new owner is obligated to submit two documents to the Assessor's office. Failure to submit the forms upon change of ownership can result in the loss of agricultural valuation.

Step toe's Property Tax Practice

Our real and personal property tax representation spans the full administrative process, including state tax boards of review, state superior courts, and appellate courts of appeals. In addition, we are active members of the National Association of Property Tax Attorneys, a national non-profit organization committed to providing exceptional property tax representation for its members' clients. Our property tax practice includes the following non-exclusive representative matters:

- Represented clients in managing their property tax liability from Notice of Value through the Administrative Appeal process and through the Tax Court
- Obtained private tax rulings and drafted state tax legislation for clients and industry groups
- Represented 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
- Represented a major electric utility in property tax litigation over the value of a nuclear generating plant, the treatment of contributions in aid of construction, and other valuation issues
- Represented operators of federally owned national park facilities seeking refunds for erroneous assessments of property tax

- Represented land developers and investors in obtaining and maintaining agricultural valuations
- Represented clients in tax litigation challenging the inclusion of federal tax credits in the valuation of low-income rental housing
- Represented clients faced with Notice of Change or Notice of Correction proceedings and in obtaining refunds and/or valuation changes through Notice of Claim proceedings and in tax court and the court of appeals
- Represented non-profit corporations in tax court to obtain and retain property tax exemptions
- Represented owners of improvements on land leased from governmental entities
- Represented industrial manufacturers in personal property audits and valuation appeals in tax court and the court of appeals involving issues of value and obsolescence

The foregoing summaries are not intended as legal advice on any particular question of law. If you have any questions about these or related developments, please contact Dawn Gabel at 602.257.5231 or dgabel@step toe.com

STEPTOE'S STATE & LOCAL TAX PRACTICE

Our Washington, Phoenix, Los Angeles, and Century City 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, a steel mill, semi-conductor, aerospace and other 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.

STATE AND LOCAL TAX LITIGATION

Steptoe's State and Local Tax group includes experienced tax litigators who have broad commercial litigation and tax litigation experience. Their practice is national in scope, including practice in many states. Pat Derdenger served as a Justice Department trial attorney in the honors program representing the IRS in numerous trials during his time there. He has over thirty years of tax litigation experience, including property tax, sales and use tax and income tax litigation. Dawn Gabel began her career as a commercial litigator, litigating a broad range of commercial disputes including banking litigation, CERCLA litigation, toxic torts, bad faith insurance disputes and general contract disputes. She has been practicing for over twenty years. For the last sixteen years she has focused on tax litigation, primarily property tax litigation. We combine trial-tested litigation skills with up-to-date substantive tax experience. This combination enables us to take on the most challenging cases and achieve outstanding results for our clients.

Our attorneys have proven skills and extensive experience in all aspects of tax controversy and litigation:

- Managing audits
- Prosecuting property tax valuation and classification appeals through the administrative hearing and review process
- Filing appeals of administrative actions in tax or superior court and bringing original actions in court
- Negotiating litigation settlements
- Trying cases in court
- Arguing appeals in state appellate courts

Our active controversy and litigation docket keeps us at the cutting edge of evolving administrative and judicial practice and procedures, strategy, and tactics.

In addition to our litigation skills, we are widely recognized for our substantive tax knowledge and experience. Many members have LL.M. degrees in taxation from, and teach classes at, top law schools, and are constantly researching, writing, and speaking to professional audiences on a broad range of substantive tax issues.

Pre-controversy Advice and Counsel. Our tax attorneys combine litigation and substantive tax experience to assist clients in effectively anticipating and planning for future controversies. Often, when the tax treatment of an item or transaction is challenged, the ultimate resolution is influenced significantly by actions taken or not taken when the transaction was planned, implemented, or first reported. With this in mind, we provide experience-based advice on reporting, document retention, and other pre-controversy matters.

Settlement Efforts. We fashion creative and effective approaches to settlement. Our experience encompasses not only direct negotiations for single clients, but also group representations of taxpayers with the same or similar issues. We work hard

to achieve favorable results for our clients and to identify the most effective approach to resolve the matter, which in many cases may be a favorable settlement for the client rather than prolonged litigation.

DEEP AND CURRENT TRIAL AND APPELLATE EXPERIENCE

Settlement of Cases in Litigation. Many cases, when not settled administratively, can be favorably settled in litigation. We have a history of achieving such settlements, drawing on our litigation skills and our experience as litigators.

Actual Trial Experience. Relying on our courtroom experience, we develop and implement efficient, effective, and thorough trial strategies. Whether the case is presented by dispositive motion, or by trial, we have the required skill and experience, including handling intricate discovery and evidentiary disputes, the preparation and examination of fact and expert witnesses, and utilization of the most sophisticated electronic trial presentation and briefing techniques. Our experience enables us to be prepared for all the twists, turns, and surprises of trial advocacy.

Effective Appellate Advocacy. Steptoe tax attorneys have argued cases in state courts and every major federal Court of Appeals, as well as before the US Supreme Court. Our brief writing and appellate advocacy skills are recognized as leading in the bar.

Step-in Litigation Ability. We have successfully litigated cases in which we were not involved in the administrative process. These clients sought the highest level of litigation experience, and chose us for our premier tax litigation talent.

UNRIVALED TALENT

Substantive Tax Experience. Attorneys in our tax department have experience in ad valorem property tax matters, constitutional property tax matters, corporate tax, partnership tax, consolidated returns, international tax, transfer pricing, financial instruments and products, ERISA, employee benefits, tax-exempt organizations, sales and use tax, and other areas of tax law.

Litigation Experience. Our state and local tax attorneys litigate tax matters on a daily basis from the administrative level, through state tax or superior court, the courts of appeals and the Supreme Court. Attorneys in our Litigation Department litigate across the United States and in other countries and are available to assist our tax litigation attorneys with complex and innovative litigation strategies.

Our specific experience and particular skills, as well as backup provided by our colleagues in other practice disciplines, provide Steptoe's tax litigation attorneys with a valuable resource readily available as necessary to effectively represent our clients.

PROPERTY TAX

Our real and personal property tax representation spans the full administrative process, including state tax boards of review, state superior and tax courts, and appellate courts of appeals. In addition, we are active members of the National Association of Property Tax Attorneys, a national non-profit organization committed to providing exceptional property tax representation for its members' clients.

TELECOMMUNICATION INDUSTRY TAX LAW

Our attorneys have considerable experience in dealing with federal and state and local telecommunications excise tax matters, including issues relating to the Mobile Telecommunications Sourcing Act (sources cell phone calls for purposes of local taxation). We have represented telecommunications clients on real and personal property tax matters, including valuation issues. Of note, our attorneys have represented a start-up international telecommunications carrier in structuring its state and local telecommunications excise tax reporting requirements, including nexus issues. Our telecommunications clients in the tax area have included local, long distance, cell phone and satellite carriers.

ELECTRIC UTILITIES AND PIPELINES

Steptoe's state and local tax practice has considerable experience in representing electric utilities and pipelines in a wide range of state tax issues. We have represented electric utilities on property tax valuation matters, both generation and transmission and distribution facilities, including a nuclear generation station. [See *ADOR v. SRP and APS*, 212 Ariz. 35, 126 P.3d 1063 (App. 2006).] We have also advised electric utilities on corporate income tax issues, including the sourcing of sales of electricity when generated in one state and sold in another (particularly the costs of performance and market tests dealing with the sales factor), nexus and Public Law 86-272 questions, as well as research and development tax credit issues. Our attorneys have also advised electric utilities on sales tax issues dealing with the construction of generation plants and the applicability of various sales tax exemptions to the construction of those facilities and operation of generation plants, including sales tax issues on the sale of the electricity both in-state and out-of-state. In addition to electric utilities, we have represented natural gas pipelines on sales tax, income tax and property tax matters.

CONSTITUTIONAL TAX ISSUES

Steptoe's state and local tax attorneys have considerable experience with federal commerce clause, due process clause and equal protection clause issues, as well as state-specific constitutional provisions such as the uniformity clause, which deals with property taxes and requires that property taxes as imposed on a class of property be uniformly applied.

Commerce clause issues handled include not only income, sales and use tax nexus issues but also issues dealing with discriminatory treatment of interstate commerce. Equal protection clause matters have included challenges to a state's unequal treatment of a taxpayer vis-à-vis the more favorable treatment provided to competitors. Additionally, Steptoe's attorneys in the Washington office have represented insurance companies in actions before the US Supreme Court involving constitutional issues relating to state premium taxes.

CORPORATE INCOME TAX

- Advised and represented 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).
- Advised and represented homebuilders on the issue of whether the "gross receipts" or "net receipts" as contended by the state, from the sale of mortgages on the secondary market are to be included in the denominator of the sales factor as well as whether the receipts from the sale of mortgages secured by Arizona property is to be sourced to Arizona or under the costs of performance test to the homebuilder's corporate headquarters state.
- Advised and represented 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).
- Advised and represented 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.

TAX CONSEQUENCES OF MERGERS & ACQUISITIONS

Our attorneys counsel 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. We also work with corporate counsel to draft tax provisions for merger and acquisition agreements.

MULTI-STATE TAXATION & NEXUS ISSUES

- Advised multi-state businesses on state income tax issues, including allocation and apportionment issues, business/non-business income questions, Public Law 86-272 nexus issues, throwback rule issues, Appeal of Joyce-types of issues, and intangible holding company issues and intangible nexus issues.
- Counseled clients on the multi-state taxation of flow-through entities such as partnerships, S-corporations, and limited liability companies.
- Advised Internet and other remote sellers on nexus issues relating to the obligation of the remote seller to collect the destination state's sales or use tax on sales made into the state, as well as advising clients in general on the sale and use tax implications of interstate sale transactions.
- Advised telecommunications clients, including satellite telecommunications providers, on their multi-state sales and excise tax reporting obligations, including sourcing issues under the Mobile Telecommunications Sourcing Act.

SALES & USE TAXES, PRIVILEGE TAXES, & EXCISE TAXES

Our attorneys represent clients in a wide array of sales tax issues, including advising; manufacturers, high tech companies, airlines, railroads, electric and telephone utilities and others on issues of whether the machinery and equipment they purchase and use in their operations qualifies for exemption from various states sales taxes; telecommunications companies on nexus issues and state and local tax collection obligations on inter-state and international calls; hotels and travel booking websites on sales and hotel tax issues; airlines and other air transportation companies on whether their sale or purchase of aircraft is subject to sales or use tax; out-of-state alarm monitoring services on nexus issues; 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; clients engaged in taxable and nontaxable business activities that have been taxed as if all receipts were from taxable business transactions; a bank in its protest of sales tax assessed on the sale of a debtor's business assets; petroleum companies on state fuel excise tax issues; providers of systems design, software development, and other computer services on exemptions from retail sales-and-use tax.

CONSTRUCTION & HOMEBUILDER TAX ISSUES

Our attorneys represent construction contractors, both general and subcontractors, and homebuilders on a wide array of federal, state and local tax issues, including construction manager tax issues, hospital construction projects and issues dealing with the installation of exempt machinery and equipment.

We also advise and work with homebuilders on the marketing arm-contracting arm structure used in Arizona for state transaction privilege tax purposes, as well as assist real estate developers deal with the Arizona "speculative builder" tax.

STATE & LOCAL TAX GROUP - PHOENIX

Attorney Contact	Phone	E-mail
Pat Derdenger	602.257.5209	pderdenger@steptoe.com
Dawn Gabel	602.257.5231	dgabel@steptoe.com
Bennett Cooper	602.257.5217	bcooper@steptoe.com
Frank Crociata	602.257.5261	fcrociata@steptoe.com
Benjamin Gardner	602.257.5291	bgardner@steptoe.com