

ARIZONA TAX 2009 UPDATE

This update will provide you with an overview of Arizona tax developments that have occurred over the past year focusing on 2009 tax legislation and court cases. We trust that you will find this annual compilation of Arizona tax developments useful and interesting. Should you have any questions about the developments reported here, or their potential applicability to your business, please feel free to call Pat Derdenger, the head of our state and local tax practice, at 602.257.5209, or e-mail him at pderdenger@steptoe.com. We are also happy to announce that the past editions of our Arizona Tax Updates are now available on our website; please visit www.steptoel.com/resources-area-4-x.html to view them.

Following are what we consider to be the more significant 2009 developments that we would like to call to your attention. Interestingly, they all involved property tax:

Level 3 Communications, LLC v. ADOR, 2009 WL 2195048 (July 23, 2009). Obsolescence Does Not Apply When Obsolescence is Based On Factors Within Owner's Control—Decision Effectively Does Away with Obsolescence For Property Tax Purposes.

Level 3, a telecommunications company, argued that the Department of Revenue failed to adequately account for functional and economic obsolescence when valuing its property for tax purposes. Level 3 owns an extensive fiber-optic cable network, much of which goes unused because of market saturation and technological advances making each fiber more efficient. The Department of Revenue argued adjustment for obsolescence was unnecessary because its valuation already fell below the actual fair market value. Level 3 countered with an expert who calculated values that took into account both functional and economic obsolescence. The Appellate Court affirmed the tax court's decision, which held the loss in value of Level 3's property was not due to obsolescence, but rather Level 3's erroneous "business judgment" in building a network that was too large. The court also noted that Level 3's property was not affected in a meaningful way by various economic forces, in that it had not filed for bankruptcy and was in fact expanding in Arizona. The court also noted Level 3's lack of data specific to the income, productivity or profitability of its Arizona tangible assets was fatal to its claim for economic obsolescence. In sum, the court of Appeals held that a taxpayer may not establish obsolescence as a result of factors within the taxpayer's control. Overbuilding the network caused a self-inflicted value loss that is not to be taken into account in valuing the property. The Court held that the taxpayer's erroneous "business judgment" does not create obsolescence. The Taxpayer has filed a petition for review with the Arizona Supreme Court, asking the Court to take review and reverse the Court of Appeals Decision. The Institute

of Tax Professionals (IPT) and the Committee on State Taxation (COST) have filed amicus briefs in support of Level 3's petition.

Safeway Inc. v. Maricopa County, 2009 WL 2486774 (August 13, 2009). Supermarket Walk-in Coolers are Personal Property and Subject to Personal Property Tax. Their Value Cannot be Included in the Real Property Valuation—To Do So Results in Double Taxation.

Maricopa County challenged the tax court's grant of summary judgment for Safeway, Inc., holding that Safeway was subject to double taxation for its supermarket walk-in coolers during tax year 2000. The Appellate Court affirmed. In order to support a motion for summary judgment, Safeway had the burden to produce prima facie evidence of double taxation. It did so, by showing it reported the cost of the walk-in cooler components on the business personal property renditions it submitted to the Assessor, and paid personal and real property taxes assessed against stores where the walk-in coolers were located. The County could not produce competent evidence creating a genuine issue of material fact—in this case, any evidence that the walk-in cooler values were removed during the course of valuing the property for taxation purposes. Therefore, summary judgment was properly granted, and the Appellate Court awarded Safeway its costs and reasonable attorneys' fees.

House Bill 2332: Chapter 101. Grid-Tied Photovoltaic Systems, Energy Efficient Building Components (Green Buildings) and Combined Heat and Power Systems Add No Value To The Structure They Are Attached To.

This bill provides that grid-tied photovoltaic systems, energy efficient building components (used in "green buildings"), renewable energy equipment and combined heat and power systems for property tax valuation purposes have no value and add no value to the structure (example home or commercial building) to which they are attached. The owner must provide the assessor with documentation of the elements that qualify for the no added value treatment.

TRANSACTION PRIVILEGE (SALES) TAX AND USE TAX

LEGISLATION

The general effective date for 2009 legislation is September 30, 2009, unless otherwise noted in the summaries.

House Bill 2371: Chapter 103. Eases Procedural Requirements for Hospitals To Purchase Utilities Sales Tax Free; Hospital No Longer Must Give Utility Copy of DOR Exemption Letter.

Arizona statute already allows qualifying hospitals and healthcare organizations an exemption from transaction privilege taxes on the purchase of energy. In order to receive this exemption, the qualifying organization is required to file an annual exemption certificate with the Department of Revenue and submit the certificate to the utility companies so taxes will not be collected. This bill permits the Department of Revenue to directly provide the names and addresses of qualifying organizations to utility companies.

House Bill 2572: Chapter 122. Pima County Is Authorized to Form A Sports Authority District and Charge Additional Tax To Fund New Spring Training Facilities To Attract Replacement Teams for D-Backs and Rockies.

This bill authorizes the Pima County Board of Supervisors to form a Sports Authority District and ask voters to approve taxing and bonding authority. The excise tax would be imposed on the following activities: car rentals (0.35%); hotel/motel rentals (0.45%); restaurant and bars (0.25%); amusement and sporting events (0.35%); and retail activities (0.15%). The purpose of the new district would be the financing of Cactus League spring training facilities to attract new major league teams to the Tucson area since the Diamondbacks and Rockies are moving from Tucson to new facilities on the Salt River-Pima-Maricopa Indian Reservation (just east of Scottsdale).

CASES

City of Mesa v. Val-Pak East Valley, Inc., Mem. Dec. 1 CA-TX 08-0010 (January 5, 2010). City Use Tax Applies Only to the Cost of Paper Used By Out-Of-State Printer In Printing Advertising Material for Mesa Taxpayer and Not to the Total Cost of the Printing. Court Follows Prior *Qwest Dex* Decision.

The taxpayer was an Arizona corporation in the business of direct mail solicitation, and was the Mesa area franchisee of Val-Pak Direct Marketing Systems, Inc. The taxpayer would sell advertising space. The advertisements were then created, printed, and mailed by Val-Pak from its location in Florida to addresses in the

Mesa, Arizona area provided by the taxpayer. The City of Mesa sought to assess use taxes against the taxpayer measured by the full amount paid by the local franchisee to Val-Pak Florida for the printing and mailing of the advertising material, covering transactions between the taxpayer and Val-Pak between June 1996 and July 2002. When the taxpayer protested, the Municipal Tax Hearing Officer determined that the dominant purpose of the transactions between the taxpayer and Val-Pak were for the purchase of printing services, with the cost of paper for the advertisements accounting for no more than 9 percent of the total invoice. Therefore, the Hearing Officer held that the taxpayer would be subject to use tax on that 9 percent.

Mesa filed a complaint with the tax court, which ruled in their favor. On appeal, the Arizona Court of Appeals reversed the tax court and agreed with the Hearing Officer, stating that “the dominant purpose of the transaction was job printing, a service, not the purchase of tangible personal property.” Therefore, the taxpayer was only liable for Mesa’s use tax on 9 percent of the invoiced amounts. The Court of Appeals followed its prior decision in *Qwest Dex, Inc. v. Ariz. Dep’t of Revenue*, 210 Ariz. 223, 229–30, 109 P.3d 118, 124–25 (App. 2005). This is notable because in *Qwest Dex*, *Qwest* provided the paper to the out-of-state printer and was charged only for the printing services, while in this case, the out of state printer provided the paper and billed the taxpayer for paper and printing services. The Appellate Court also awarded the taxpayer its reasonable attorney’s fees on appeal.

ARIZONA DEPARTMENT OF REVENUE DECISIONS

Case No. 200700222 S (6/15/2009). RV Dealership Was Not Able to Substantiate Out-Of-State Sales or Sales To Native Americans.

The Director held that an RV dealership which failed to prove out-of-state residency and residency on reservations for Native Americans for various sales of RVs was not entitled to exemptions for sales of motor vehicles to out-of-state residents or to Native Americans. In the case of out-of-state residents, the RVs were often delivered to locations just outside of the Arizona border. In the case of sales to Native Americans, the address listed on an exemption certificate was clearly outside the reservation. The dealership also kept contradictory records—in some cases there was no ADOR exemption certificate (also known as a Form 5000), in some cases an incomplete Form 5000, and in some cases a Form 5000 that indicated an Arizona address despite the claim of sale to an out-of-state resident. This led the Director to conclude that the dealership did not accept the forms in good faith and was not entitled to the exemptions.

Case No. 200800088-S (4/24/2009). Use Tax Applied to Purchase of Boat From An Out-Of-State Retailer; Test Drive of Boat Did Not Constitute First Use Out-Of-State.

A taxpayer argued that because he purchased a watercraft from a private party, not a retailer, and that the first use took place outside of Arizona, he did not owe use tax on the watercraft. The Director held that the seller was a retailer, even though some of the boats it sold were on consignment, and that a test drive in the course of purchasing the watercraft was not a first use out-of-state. Therefore, use tax is due on a watercraft bought with the intent to use in Arizona and then brought into and used in Arizona.

PRIVATE TAXPAYER RULINGS

Private Taxpayer Ruling LR09-003 (July 8, 2009). The Rental of Reusable Food Containers To Farmers Do Not Qualify for the Food Exemption; The Rental Charge, Deposits, Pallet Charges and Fuel Surcharges Are a Part of the Taxable Rental Base.

The taxpayer rented plastic and returnable containers to farmers and growers in Arizona. The farmer will load produce into the container and ship it to the customer or retailer. The produce is sometimes displayed in the containers. When the container is emptied, either by the consumer or retailer, it is sent back to the taxpayer's distribution center, where they were sent to be washed, sanitized, and put back into inventory for re-rental. The taxpayer argued that as a rental transaction, the charges associated with rentals were exempt from transaction privilege tax when rented to farmers in Arizona, pursuant to the food exemption of ARS § 42-5103 and ARS § 42-5106. The Department concluded that the rentals were not exempt. The Department then concluded that container rental charges, deposits, pallet charges and fuel surcharges are all part of the rental tax base and subject to transaction privilege tax.

Private Taxpayer Ruling LR09-002 (July 13, 2009). Telescope Qualifies for the Research and Development Equipment Exemption but the Dome Covering and Protecting the Telescope Does Not.

An organization that was constructing a dome over a large-scale telescope requested a ruling on whether purchases of tangible personal property from out of state retailers used in constructing the dome constituted purchases of machinery or equipment that fell under the "research and development" equipment use tax exemption. ARS § 42-5159(B)(1) provides that research development means "basic and applied research in the sciences and engineering, and designing, developing or testing prototypes, processes or new products, including research and development of computer software that is embedded in or an integral part of the prototype or new product...." It does not mean "manufacturing quality

control, routine consumer product testing, market research, sales promotion, sales service, research in social sciences or psychology, computer software research that is not included in the definition of research and development, or other nontechnological activities or technical services." However, if the machinery or equipment constitutes part of the building, it is no longer exempt. ARS § 42-5159(C).

There was no dispute that the telescope and its ancillary equipment qualified for the research and development equipment exemption, including the lift which moved the largest scientific equipment. However, the Department concluded that the dome and its component parts were affixed to a building, and therefore did not meet the exemption requirements.

Private Taxpayer Ruling LR09-001 (February 3, 2009). For Software Hosted on A Server and Licensed to A User, the Location of the Server is Irrelevant; The Location Where the Licensee Uses the Software is Determinative. There are several important points that the Department made in this private ruling dealing with software maintained on a host server:

1. The Department makes no distinction between software transmitted electronically or by the way of a CD-ROM or DVD, or other tangible means. "It is a tax on that copy as tangible personal property itself. It is irrelevant, for tax purposes, how a vendor chooses to transfer the copy to the buyer or lessee, whether it is by using a physical storage device like paper or disc, or by electronic means."
2. Transaction privilege tax on software licenses is imposed based on where the lessees compiled and executed the applications and generated data files using the applications.
3. The server location where the software and files are "physically" stored makes no difference for tax purposes. The location where the lessee uses the leased property on a non-temporary basis is what is determinative.
4. A software lessor hosts software on servers in Arizona and licenses the software to an out-of-state lessee. In this scenario, the Department held that the Arizona TPT does not apply.
5. A software lessor hosts software on out-of-state servers and licenses the software application to an Arizona lessee. In this scenario, the lessor is liable for the TPT because the lessee uses the software in Arizona.

PROPERTY TAX

LEGISLATION

The general effective date for 2009 legislation is September 30, 2009, unless otherwise noted in the summaries.

House Bill 2314: Chapter 169. Reduces Personal Property Value of Telecommunications Companies By Decreasing the Minimum Value for Personal Property from 20% to 10%.

This bill changes the statutory valuation method that the Department of Revenue will use for the valuation of the personal property of telecommunication companies. The bill will maintain the current practice of providing a minimum value for buildings of 20% of original cost. This means that, regardless of age, the buildings owned by a telecommunication company cannot be deemed to have depreciated below 20% of their original cost. However, the bill reduces the minimum value for personal property—such as cable, equipment, etc.—from 20% to 10% of the equipment's original cost.

The bill also eliminates the requirement that the Department of Revenue use 1993 depreciation schedules for telecommunications property. It now requires the property to be depreciated using a straight line basis.

The bill also replaces the term “historical cost” with “cost” and defines “cost” as the original cost as reported by the company.

House Bill 2083: Chapter 33 (2009 Tax Corrections Act). Clarifies that Personal Property Tax Appeals to State Board of Equalization are to Be the Same as For Real Property Appeals; Clarifies Throughout the Property Tax Appeal Statutes That Legal Classification and Not Just Valuation of Property May Be Appealed.

This is the annual tax corrections act and it made two noteworthy changes affecting property tax. Most noteworthy, the bill made it clear that the statutory procedures in place for an appeal of real property to the state board of equalization will also apply to appeals of personal property. Previously, there were no appeal procedures specifically in place for personal property although the state board always handled personal property appeals in the same manner as real property appeals.

The bill also clarified throughout the property tax appeals statutes that the legal classification of property may be appealed not just the property's valuation. The prior language referring only to the appeal of valuation was an oversight when title 42 was re-codified in 1997.

House Bill 2332: Chapter 101. Grid-Tied Photovoltaic Systems, Energy Efficient Building Components (Green Buildings) and Combined Heat and Power Systems Have No Value.

This bill provides that grid-tied photovoltaic systems, energy efficient building components (used in “green buildings”), renewable energy equipment and combined heat and power systems for property tax valuation purposes have no value and add no value to the structure (example home or commercial building) to which they are attached. The owner must provide the assessor with documentation of the elements that qualify for the no added value treatment.

House Bill 2346: Chapter 87. Property Leased to a Non-Profit Charter School is Class 9 With an Assessment Ratio of 1%.

The Arizona Constitution provides that all property is subject to tax unless specifically exempt. Land owned by non-profit, educational, charitable and religious associations is exempt if the owner files an affidavit with the county assessor stating the reason for the exempt status. There is a current exemption for property owned by an educational, religious or charitable organization and leased to a non profit educational association used for educational purposes through grade 12. This bill also allows property (owned by anyone and not just an educational, religious or charitable organization) and leased to a nonprofit charter school, if it is used for educational purposes through grade 12, to be classified as class nine with an assessment ratio of 1%. Only the portion of the property used by the non-profit charter school qualifies for the 1% ratio. The bill also requires the property owner to file an affidavit with the assessor stating that the charter school will be the sole beneficiary of the change in property classification and that the lease rate is comparable to the rates charged other tenants.

Senate Bill 1421: Chapter 118. Levy Limit For Secondary Property Taxes Is Established For Fire Districts.

State, counties, community college districts, cities, local school districts, and most special districts, including fire districts all have authority to levy property taxes. Arizona allows for two types of property taxes, primary and secondary. Primary property taxes are used to fund maintenance and operation budgets of state and local governments and schools. Secondary property taxes are used to fund voter-approved bond issues, voter-approved budget overrides, and special district levies, like flood, library, jail or fire districts.

While most special districts do not have limitations on the growth of secondary tax levies from year to year, some of the secondary county districts, including fire districts have statutory maximum tax rates. The maximum tax rate for a fire district is \$3.25 per \$100 of assessed value. A fire district that had a rate below the

maximum could raise its rate for the next year to the maximum without restriction. This bill establishes a levy limit (i.e., a limit on the total amount of property taxes collected for the year by the district). The limit is the lesser of (i) 8% greater than the prior year's levy or (ii) \$3.25 per \$100 of assessed value. The effect is that a fire district is limited in the amount of taxes it can collect in each year.

CASES

Luz Social Services v. Arizona State Board of Equalization, Mem. Decision, No. 1 CA-TX 08-004 (April 14, 2009). In Order to Maintain a Valuation or Classification Appeal to Court, the Taxes Must be Timely Paid. A Special Action in Lieu of The Statutory Court Appeal Does Not Get Around the Payment Requirement.

A nonprofit corporation that operates charter schools in Tucson filed a notice of claim against Pima County, alleging entitlement to a property tax exemption. The County Assessor denied the exemption for tax year 2001, and the corporation's taxes became delinquent. The corporation timely appealed to the State Board of Equalization, which refused jurisdiction. The corporation then brought a successful special action, which it won. The court directed the Board to consider the corporation's appeal. At the hearing, the County Assessor argued that the corporation was required to pay the property taxes before delinquency in order to pursue an appeal to the Board. The corporation conceded it had not paid the taxes. The Board issued a decision holding that it lacked jurisdiction. The corporation did not appeal, and in 2007 filed a special action complaint and petition for order to show cause in the superior court. The tax court denied the petition.

The Court of Appeals affirmed the tax court's dismissal of the special action. Parties have a right to appeal a Board decision to the tax court. ARS § 42-16203(c) (2006). However, if an appeal is not taken within 60 days, the decision of the Board becomes final. ARS § 42-16169 (2006). Parties must also pay their taxes in order to preserve the right to appeal. ARS § 42-16254(G) strips courts of appellate jurisdiction if taxes become delinquent. Furthermore, the statutory procedure for remedies to a prevailing taxpayer are to refund pre-paid taxes. There is no statutory basis to enjoin a tax obligation. Even though in this case the corporation filed a special action, not an appeal, the Appellate Court found that it could not avoid the payment requirement.

Premiere RV and Mini Storage, LLC v. Maricopa County, 222 Ariz. 440 (September 15, 2009). A Split of A Property Tax Parcel Does Not Occur When A Portion of the Parcel is Sold But Rather When the Assessor Completes the Formal Paperwork Process.

This case involved a 17-acre parcel of land. In December 2003, the owner of the parcel sold one acre of vacant land to Desert West Holdings and 16 acres of mini-storage property to KTP Holdings, DLP Holdings, and MKP Holdings. In December 2004, the 16 acre piece was sold to Premiere RV & Mini Storage.

In April 2004, the Assessor became aware of the sales, but had already valued the total parcel for the 2005 tax year and mailed the notice to the original owner. A "split" of a parcel of land triggers a valuation of the property according to its market value. The question in this case is whether the split occurs when a private transaction results in a transfer of ownership, or when the assessor completes the process of identifying and valuing the resulting parcels.

The Appellate Court stated that because Arizona law addresses the shared responsibility of jointly owned parcels, a mere change in ownership will not constitute a split. Property taxes are a liability of the land, not the owner. In the case where one parcel of land is owned by two parties, each party may pay the portion that he or she owes, or pay the entire tax. If the party pays the entire tax, he or she can then take out a lien on the share of the land he or she does not own for amount of tax overpaid. "Because the Legislature has clearly anticipated the possibility that a single parcel will be owned by more than one owner ... a private transaction transferring ownership of part of a parcel does not constitute a 'split' for purposes of valuation." Therefore, the taxes were properly assessed because the property in this case was only split when the Assessor completed the process of valuing the two separate parcels.

Safeway Inc. v. Maricopa County, 2009 WL 2486774 (August 13, 2009). Supermarket Walk-in Coolers are Personal Property and Subject to Personal Property Tax. Their Value Cannot be Included in the Real Property Valuation—To Do So Results in Double Taxation.

Maricopa County challenged the tax court's grant of summary judgment for Safeway, Inc., holding that Safeway was subject to double taxation for its supermarket walk-in coolers during tax year 2000. The Appellate Court affirmed. In order to support a motion for summary judgment, Safeway had the burden to produce prima facie evidence of double taxation. It did so, by showing it reported the cost of the walk-in cooler components on the business personal property renditions it submitted to the Assessor, and paid personal and real property taxes assessed against stores where the walk-in coolers were located. The County could not produce

competent evidence creating a genuine issue of material fact—in this case, any evidence that the walk-in cooler values were removed during the course of valuing the property for taxation purposes. Therefore, summary judgment was properly granted, and the Appellate Court awarded Safeway its costs and reasonable attorneys' fees.

***Bill Staples; Pima County v. Concord Equities, LLC*, 221 Ariz. 27 (March 31, 2009). Valuation “Roll Over” Provision Applies to Value Reductions Obtained at the Arizona Tax Court and Not Just In An Administrative Appeal.**

A.R.S. § 42-16002 mandates that, if an administrative appeal results in a reduction in value or a change in classification of property, the reduction or change will be applicable for the full tax year following the appeal (in absence of new construction, change in use, or a statutory valuation formula). Here, the county argued that this “roll-over” provision should not apply when a taxpayer prevails in a judicial (as opposed to administrative) appeal. Although a 2006 bill revised A.R.S. § 42-16002 to include judicial appeals, this bill was not retroactive to the year at issue in the case. The court ultimately determined that the legislature did not intend to exclude judicial appeals from the roll-over provision, and found in favor of the taxpayer.

***Calpine Construction Finance Company v. ADOR*, 221 Ariz. 244 (April 16, 2009). Court Determined that Generation Facility Located On Indian Reservation Land Leased From Tribe was Owned By Calpine and Thus Subject to Property Tax (If Facility Were Owned By Tribe, It Would Not Be Taxable). Language Of Lease Agreement Determined Ownership of the Improvements.**

A state cannot tax property located on a reservation if that property is owned by an Indian tribe or an individual Indian. However, property on reservation land owned by a non-Indian is taxable. Here, Calpine, a non-Indian owned company, built an electric plant on land leased from an Indian tribe for 50 years. Upon the lease's termination, the plant would become the property of the tribe. Calpine argued that the plant was the tribe's property and therefore tax exempt. However, provisions in the lease documents explicitly referred to the power plant as the personal property of Calpine, the tribe did not charge Calpine rent for use of the plant, and an amendment to the lease allowed Calpine to remove or replace any improvements to the leased land without the tribe's consent.

While the court noted that a permanent structure that a tenant attaches to leased land is usually real property belonging to the lessor, an exception exists when the parties expressly agree to treat the improvements as personal property belonging to the lessee. Here, the extent of control that Calpine had over the plant led the court to conclude that Calpine was the plant's true owner, noting that “Calpine bears nearly all of the risks of ownership

and it receives nearly all of the benefits.” Although the court deemed the value of the tribe's reversionary interest to be relevant to the ownership determination, it did not think that current ownership should be completely controlled by speculation as to the property's value at some future point in time.

***Level 3 Communications, LLC v. ADOR*, 2009 WL 2195048 (July 23, 2009). Obsolescence Does Not Apply When Obsolescence is Based On Factors Within Owner's Control—Decision Effectively Does Away with Obsolescence For Property Tax Purposes.**

Level 3, a telecommunications company, argued that the Department of Revenue failed to adequately account for functional and economic obsolescence when valuing its property for tax purposes. Level 3 owns an extensive fiber-optic cable network, much of which goes unused because of market saturation and technological advances making each fiber more efficient. The Department of Revenue argued adjustment for obsolescence was unnecessary because its valuation already fell below the actual fair market value. Level 3 countered with an expert who calculated values that took into account both functional and economic obsolescence. The Appellate Court affirmed the tax court's decision, which held the loss in value of Level 3's property was not due to obsolescence, but rather Level 3's erroneous “business judgment” in building a network that was too large. The court also noted that Level 3's property was not affected in a meaningful way by various economic forces, in that it had not filed for bankruptcy and was in fact expanding in Arizona. The court also noted Level 3's lack of data specific to the income, productivity or profitability of its Arizona tangible assets was fatal to its claim for economic obsolescence. In sum, the court of Appeals held that a taxpayer may not establish obsolescence as a result of factors within the taxpayer's control. Overbuilding the network caused a self-inflicted value loss that is not to be taken into account in valuing the property. The Court held that the taxpayer's erroneous “business judgment” does not create obsolescence.

***Aida Renta Trust v. Maricopa County*, 221 Ariz. 603 (June 11, 2009). The County Impermissibly Discriminated Against a Class of Taxpayers by Deliberately and Systematically Applying Different Valuation Procedures to Properties in the Same Class.**

This case involved numerous taxpayers who owned apartment buildings. In previous years, some apartment building owners appealed the valuation of their buildings and received a valuation reduction, which the county allowed them to roll over to the next year. Other apartment building owners did not appeal the valuation of their buildings, and the county did not allow them a lower valuation (as they had for the taxpayers who previously appealed). The Arizona Constitution states that for property tax purposes all property in the same

class must be treated equally. The Court of Appeals interpreted this provision to include equality in the manner of valuing of property. Proof of such prohibited discrimination in valuing property occurs when 1) the taxing officials acted deliberately and systematically and 2) their conduct resulted in greatly disproportionate tax treatment within a particular class of property. In this case, the County satisfied these requirements. It acted deliberately and systematically, and its conduct resulted in disproportionate tax treatment within the class.

***Brown Family Communities v. Maricopa County*, Ruling, TX 2009-000084 (May 18, 2009). Valuation and Classification Claims for the Same Property for the Same Year Cannot be Raised in Separate Tax Court Appeals But Must be Brought Together in One Appeal.**

The plaintiff filed two actions challenging the 2009 tax assessment for its property. The first action contested the 2009 valuation of the subject property. The second action contested the classification of the subject property. ARS §42-16212(a) states that when multiple actions are filed for the same taxable year with respect to the same property, “the actions shall be consolidated.” The tax court also noted that classification and valuation are two elements used to determine a single result—a property’s tax base. Because the plaintiff failed to address classification in its first action, the tax court dismissed the second action challenging the classification.

INCOME TAX

LEGISLATION

The general effective date for 2009 legislation is September 30, 2009, unless otherwise noted in the summaries.

Senate Bill 1185: Chapter 2. This Is The Annual Internal Revenue Code Conformity Bill. It Contains 3 Significant Provisions: 1) Conforms to 2008 Federal Tax Bills; 2) Makes Temporary Adjustments to Withholding Tax Rates; and 3) Decouples Arizona Withholding Rates From Federal Rates. Effective Date: April 9, 2009.

This bill conforms Arizona income tax statutes to the 2009 Internal Revenue Code, makes temporary adjustments to the Arizona withholding tax rates, and decouples Arizona’s withholding rates from federal withholding rates.

A. Conforms to following 2008 Federal tax law changes:

1. Economic Stimulus Act of 2008.
2. The Heartland, Habitat, Harvest and Horticulture Act of 2008.

3. The Heroes Earning Assistance and Relief Tax Act of 2008.
4. The Housing Assistance Tax Act of 2008.
5. The Emergency Economic Stabilization Act of 2008.
6. The Worker, Retiree and Employer Recovery Act of 2008.

B. Temporary adjustments to Arizona withholding tax rates:

1. May 1, 2009 to December 31, 2009: Employees with annual wages less than \$15,000 can elect to withhold 0%, 11.5%, 21.9%, 26.5%, 28.8%, 35.7%, or 42.6% of federal withholding. Employees with annual wages of \$15,000 or more can elect to withhold 0%, 21.9%, 26.5%, 28.8%, 35.7%, or 42.6% of federal withholding.
2. January 1, 2010 to June 30, 2010: Employees with annual wages less than \$15,000 can elect to withhold 0%, 10.7%, 20.3%, 24.5%, 26.7%, 33.1% or 39.5% of federal withholding. Employees with annual wages of \$15,000 or more can elect to withhold 0%, 20.3%, 24.5%, 26.7%, 33.1% or 39.5% of federal withholding.

C. Decouples Arizona’s withholding rates:

1. Beginning on July 1, 2010, Arizona’s withholding amounts will no longer be calculated as a percentage of federal withholding.
2. Instead, state withholding will be determined based on withholding tables established by the Department of Revenue.

House Bill 2286: Chapter 80. Expands Tax Credit For Working Poor to Include Donations to Organizations that Provide Services to Chronically Ill or Physically Disabled Arizona Children; Department Is Required To Review and Approve or Reject What Organizations Qualify; Previously, the Organizations “Self Certified.” Retroactively Effective From and After December 31, 2008.

There is a credit for contributions to charities that provide assistance to the working poor. This bill modifies that credit to include organizations that provide qualifying services to chronically ill or physically disabled children who are Arizona residents. These organizations must qualify by certifying that they are a 501(c)(3) organization or that it is a “designated community action agency,” and that they spend 50% or more of their funds on services to: Arizonans who receive TANF (Temporary Assistance for Needy Families); those who qualify

as low income residents; or children who are chronically ill or disabled. The bill defines chronically ill or disabled children as children under the age of twenty-one whose primary diagnosis is a severe physical condition which may require ongoing medical or surgical intervention. The bill also restricts the credit to taxpayers who itemize deductions.

The bill also makes a significant procedural change regarding the determination of a “qualifying organization.” Under prior law an organization “self certified” by providing the Department of Revenue with a certificate that it qualified. The Department would then include the organizations name in a list of “qualifying organizations” that was posted on the Department’s website. A person making a contribution could take the credit if the organization’s name was included on the website list. Now, an organization is required to submit an application to the Department, which the Department will review and either approve or reject. If approved, the name will go on the website list.

House Bill 2287: Chapter 167. Employees May Request that Their Employer Reduce Their State Income Tax Withholding for Contributions to School Tuition Organizations (“STO”) and Public Schools. Employer Can Honor or Refuse to Honor Request and If Honored IS Liable For Making Payment to the STO or Public School.

Individuals (as well as corporations) may make contributions to a STO or public school for extra-curricular activities and receive a credit against their state income tax for that contribution. Under this bill, employees may request an employer to reduce the amount of the employee’s withholding by the amount of the contribution. The reduction would be in the amount of the planned donation: (1) up to \$200 per year for contributions made by a single or head of household individual to a public school or charitable organization for extra-curricular activities and character education programs (up to \$400 for married couples filing jointly); and (2) up to \$500 for single or head of household individuals for donations to a school tuition organization for scholarships for students to attend private school (up to \$1000 for married couples filing jointly).

The employer is not required to honor the request but if it does, it will reduce the employee’s withholding by the amount of the contribution, but not below zero, and spread the reduction out over the rest of the year. Importantly, the employer is responsible for making the payment to the employee-designated school or organization and provide statements of the payment to the employee and the Department. The employer is liable to the school or organization, the employee and the Department for making the payment.

Senate Bill 1373: Chapter 116. Taxpayer Liable For Penalty Either For Failure to Pay 90% of Tax With Filing of Extension or For Failure to Timely Pay 100% of Tax but Not Both.

This bill provides that a taxpayer who is subject to penalties for filing an extension with less than 90% of the taxes paid is not also subject to penalties for failing to pay 100% of the amount of tax that is due. Before this bill, taxpayers could be subjected to double penalties.

House Bill 2001, Second Special Session: Chapter 1. Creates a New Corporate and Insurance Premium Tax Credit for Contributions to STO For Certain Foster Children.

This bill establishes a corporate income tax credit and insurance premium tax credit for contributions made to a school tuition organization that provides educational scholarships or tuition grants to disabled students and displaced students in a foster care program. Tax credits are limited to \$5 million in the aggregate among all contributors in any fiscal year, with the credit not limited at the individual corporate/insurance company level. The contribution must be pre-approved by the Department. See ARS § 43-1184. This credit is new and in addition to the already existing credit for contributions to STO’s (see ARS § 43-1183). A corporation or insurance company may claim either the credit under §§ 43-1183 or 43-1184 and not both.

CASES

***State v. Reading*, 2009 WL 2136770 (June 18, 2009). Taxpayers Failed to File Protest Within 90 Days so Income Tax Assessment Became Final; Taxpayers’ Request for Copy of Their Audit File Did Not Extend Time to File Protest.**

The taxpayers appealed from the tax court’s summary judgment order holding that they failed to timely appeal their tax assessment, and the Court of Appeals affirmed. On January 2, 2003, the Department of Revenue sent Notices of Proposed Assessment for tax years 1994 and 1995 to the taxpayers. The taxpayers responded by sending a letter to the Department, requesting the audit files. The Department did not respond until April 25, 2003, when it sent a letter saying that because the taxpayers did not file a protest, the taxes were due.

The Appellate Court upheld the Tax Court’s decision that “no authority extends the 90-day protest period based upon a taxpayer’s submission of written questions or any failure of the Department to respond to such questions.” Under A.R.S. §42-1251(A), taxpayers must file a petition for hearing, correction or redetermination within 90 days of the Department mailing notices of proposed assessment for income taxes. When a taxpayer fails to appeal an assessment through the administrative process, the assessment becomes final as a matter of law.

***Watts v. Arizona Department of Revenue*, 221 Ariz. 97 (May 26, 2009). Lessor of Water Trucks and Water Wagons Not Entitled to Pollution Control Credit For “Dust Control” Because It Did Not Use the Equipment in Its Business for Dust Control.**

The taxpayers were the owners of Sunstate Equipment Rental. Sunstate was in the business of leasing equipment, including water trucks and wagons. The water trucks and water wagons are designed for multiple uses, including: (1) dust control and ditch jetting; (2) fighting fires; (3) washing equipment and/or machinery; (4) spraying horse arenas; (5) watering trees and city street plants; (6) “feeding” highway equipment; and (7) watering concrete slabs. Taxpayers applied for a tax credit under the theory that the majority of the time, these trucks were used to spray water, dust suppressant or adhesive soil stabilizer on undeveloped ground at construction sites, thereby improving air quality and controlling dust.

ARS §43-1170 and ARS §43-1081 provide an income tax credit for corporations and individuals, respectively, who “purchase real or personal property that is used to control or prevent pollution” in the amount of 10% of the purchase price. *Id.* at (A). These statutes were clarified in 1995 when the Legislature added the language “real or personal property that is used in the taxpayer’s trade or business in this state.”

The Appellate Court affirmed the tax court’s summary judgment holding that taxpayers are not entitled to pollution control income tax credits for the cost of water trucks and wagons they leased to others. Because the trucks and wagons were leased to others for their use, and the taxpayers had no control over what the trucks were ultimately used for, the court concluded that the equipment was not being used in the taxpayer’s own business for the purpose of pollution prevention. “Taxpayers stand in no better position than a retailer who sells water trucks and water wagons to end users, but does not use them itself to prevent pollution.”

***Arizona Department of Revenue v. Central Newspapers, Inc.*, 222 Ariz. 626 (November 3, 2009). Arizona Court Holds that Public Law 86-272 Does Not Protect Partnership Distributions.**

This case involves whether Public Law 86-272 precludes the State from including an out-of-state partnership’s revenues in the numerator of the apportionment formula of an Arizona consolidated corporate income tax return. The Appeals Court found that the inclusion was proper in this case, where the partnership’s only connection to Arizona is its shipment of newsprint to a buyer within the State, and was otherwise protected by PL 86-272 from Arizona income taxation.

If a corporation conducts business in several states, ARS § 43-1132(A) requires that its net income be allocated under Arizona’s version of UDITPA (Uniform Division of Income for Tax Purposes Act). Certain non-busi-

ness income is allocated to designated states. Business income is divided among states where the corporation does business according to formulas. Arizona employs three factors—sales, property, and payroll—by which a taxpayer’s Arizona sales, property and payroll are divided by the sales, property and payroll of the corporation’s total operations in all states to determine taxable income.

In this case, the primary dispute was over the sales factor. Ponderay Newsprint Company (“Ponderay”), a Washington general partnership, runs a newsprint mill. Central Newspapers, Inc. (“CNI”), through affiliates owned an interest in Ponderay. Ponderay conducts no business in Arizona except for solicitation of orders for its newsprint sales to Phoenix Newspapers, Inc., the publisher of The Arizona Republic, another CNI subsidiary. In 1995 and 1996, when CNI and its subsidiaries filed Arizona income tax returns, they included Ponderay’s payroll, property and sales in the denominator, but not in the numerator. In 1997, 1998 and 1999, CNI did not include Ponderay in either the denominator or numerator. After auditing these returns, the ADOR determined that Ponderay should have been included in both the numerator and denominator, resulting in underpayments in 1995 and 1996 and overpayments in 1997, 1998 and 1999. CNI appealed this decision, arguing Ponderay should only have been included in the denominator, and that its refund should have been larger. Specifically, CNI argued that federal statute, Public Law No. 86-272, which protects businesses from having to file tax returns in states where they do nothing more than solicit business, precluded Arizona from taxing Ponderay’s income, and that this exemption passed to CNI, precluding the inclusion of Ponderay’s Arizona sales in the numerator of the sales fraction.

The Appellate Court agreed with ADOR, which argued that it was not taxing Ponderay, but CNI’s consolidated group, which included Ponderay’s partners. Since CNI’s activities in Arizona exceeded mere solicitation, PL 86-272 did not apply. The Court added that PL 86-272 was not about making certain income tax exempt, but preventing a state from exercising taxing jurisdiction over out-of-state businesses. The court thus concluded that Ponderay’s sales were properly calculated in both the numerator and denominator factors. CNI has filed a petition for review with the Arizona Supreme Court.

***MDC Holdings v. Arizona Department of Revenue*, 222 Ariz. 462 (October 6, 2009). Net Receipts From Sale of Packaged Mortgages in the Secondary Market to be Included In Denominator of the Sales Factor and Not “Gross Receipts;” Under Costs of Performance Test, Gain On Sale of Mortgages Sourced to Colorado.**

The MDC case presented two important issues of first impression under the Uniform Division of Income for Tax Purposes Act (UDITPA) regarding the application of Arizona’s sales factor used to apportion gain. The first issue was whether sales of mortgage loans on the

secondary mortgage market should be measured in the sales factor denominator as gross receipts or instead as net income. The second issue was whether mortgages securing real property located in Arizona should be sourced to Arizona or Colorado where the activities of bundling and selling the mortgages on the secondary mortgage market took place at the Taxpayer's headquarters in Colorado.

MDC Holdings (Richmond American Homes) is a Denver-based corporation and one of the largest homebuilders in the United States. In addition to building and selling new homes, MDC and its subsidiaries provided mortgage financing for homes in Arizona and many other states. After MDC originated loans, it held the loans only for a short time until it could sell the loans on the secondary mortgage market for a gain or loss. All loan approval and processing took place in MDC's Denver office, and not in Arizona.

In applying Arizona's Uniform Division of Income for Tax Purposes Act, MDC asserted that the sales factor denominator should include the gross amount received from its sales of mortgage loans (loan principle plus profit) and not the net amount received (profit only). MDC also argued that its sales of mortgages on the secondary market should be sourced to Colorado, and not Arizona, because the loan processing and administration activities took place in Colorado, even though the homes secured by the mortgages were in Arizona.

That proportion indicates how much of the Arizona tax relates to the out-of-state income and the credit cannot exceed the amount of Arizona tax. Therefore, the Director held that the proper calculation of the credit for taxes paid to other states for the 2002 tax year includes a pro-rata application of Arizona exemptions and deductions to the income from the other state. Where the laws of another state provide for a credit for taxes paid to Arizona, but a taxpayer is unable to take the credit because of electing to file on a composite return in that state, the taxpayer is not eligible to take a credit for taxes paid to that state in Arizona. (*See Method to Calculate Tax Credit Below*).

Case No. 200900021-I (6/26/2009). Income Earned By Native American From Reservation Sources is Not Taxable by the State.

The Hearing Officer found that royalty payments for use of Reservation land received by a Native American who resided on the Reservation were derived from Reservation sources, and was therefore exempt from Arizona income tax.

ARIZONA DEPARTMENT OF REVENUE DECISIONS

Case No. 200800183-I (9/4/2009). Proper Method To Calculate Credit for Taxes Paid to Other States. Arizona residents may claim a credit for net income taxes imposed by or paid to another state. Under ARS § 43-1071(A)(3), the maximum credit allowed to a taxpayer filing in multiple states is calculated as follows:

$$\frac{\text{(Income Subject to Tax in Other State/County and Taxable Under Title 43)} \times \text{AZ Tax Liability Before Credit}}{\text{(Entire Income On Which AZ Tax is Based)}}$$

In a precedent setting decision, the Arizona Court of Appeals agreed with MDC that all of the proceeds from the sales of mortgages on the secondary market should be excluded from the numerator of the Arizona sales factor. Even though the property securing the loans was located in Arizona, the costs of performance occurred in Colorado. The court also held that only the net gain, rather than gross receipts, on sales of mortgage loans on the secondary market should be included in the denominator.

Case No. 200900022 I (6/26/2009). Income Earned By Native American From Reservation Sources is Not Taxable by the State.

The Hearing Officer found that royalty payments for use of Reservation land received by a Native American who resided on the Reservation were derived from Reservation sources, and was therefore exempt from Arizona income tax.

Case No. 200900004-I (6/16/2009). Proper Method To Calculate Credit for Taxes Paid to Other States.

Arizona residents may claim a credit for net income taxes imposed by or paid to another state under ARS § 43-1071(A)(3). The proper calculation of the credit for taxes paid to other states for the 2002 tax year includes a pro-rata application of Arizona exemptions and deductions to the income from the other state.

Case No. 200900019-I (3/12/2009). DOR Not Bound By Incorrect Advice.

The ADOR is not bound by the incorrect oral advice given to a taxpayer. Audit Section properly denied a claim for refund/offset where the Arizona tax return was filed more than four years after the return was due.

Case No. 200900006-I (2/17/2009). Closing Agreement Only Applies to Years Covered By Agreement and Not to Future Years.

An “offer-in-compromise” (an agreement between a taxpayer and the state) applies only to the tax liabilities that exist at the time the proposed offer-in-compromise is received. It does not preclude the Department from issuing an assessment on a later discovered tax liability based on income that was unreported at the time of the offer-in-compromise.

Case No. 200800180-I (2/4/2009). No Itemized Deduction for Pre-Tax Medical Insurance Premiums.

Pre-tax medical insurance (self-employed) premiums are not allowed as an itemized deduction because such premiums are already deducted from federal gross income in arriving at federal adjusted gross income (federal adjusted gross income equals Arizona gross income, which minus itemized deductions equals Arizona taxable income). Thus, allowing an itemized deduction from Arizona adjusted gross income for such premiums would result in a double deduction. Taxpayers also requested a hearing on the issue of abatement of interest but the Hearing Officer declined jurisdiction. Under A.R.S. § 42-2065, the discretion to abate interest is given to the Department’s Director and not the Hearing Office.

CORPORATE INCOME TAX

Case No. 200800192-C (10/16/2009). Credit for Increased Employment in Enterprise Zones is Based on the Number of Qualifying Employment Positions in Year One and Number of Positions Cannot Increase in 2nd and 3rd Years.

ARS § 43-1161 provides a corporate income tax credit for increased employment in enterprise zones with the credit spread out over 3 years. In this case, the taxpayer and the ADOR Audit Section disputed the calculation

method of the enterprise zone credit amount. The taxpayer sought a credit for employment positions in the 2nd and 3rd year that exceeded the number of employment positions allowed in the 1st year. The Department contended that for purposes of the credit the number of employment positions cannot increase in the 2nd and 3rd years but is limited to the number of positions in the 1st year. The Hearing Officer agreed with the Audit Section that the enterprise zone credit is a single credit paid out over a three-year period after being initially established and based on the number of positions in the 1st year, and therefore the number of qualifying positions/employees cannot increase in the 2nd and 3rd years.

Case No. 200800128-C (7/10/2009). Gain from Sale of Subsidiary Where 338(h)(10) Election Was Made Results In Business Income. The issue in this case was whether a taxpayer’s gain from the sale of a subsidiary, where the taxpayer and buyer made an election under §338(h)(10) to treat the sale as a sale of all its assets, should be treated as business income or non-business income. The Hearing Officer concluded that it should be treated as business income.

Case No. 200700189-C (2/6/2009). Taxpayer Not Able to Establish Entitlement to R&D Credit. ARS § 43-1168 allows a credit against income taxes for increased research and development activities. In this case, the Director found that there was not sufficient evidence to prove entitlement to an increased research and development credit.

MULTIPLE TAXES—INCOME AND PROPERTY TAX

Legislation Affecting Multiple Taxes

Senate Bill 1403: Chapter 96. New Tax Incentive Program For Expanding or Locating New “Renewable” Energy Operations in Arizona (That Manufactures Renewable Energy Equipment or For Regional, National or World Headquarters), With Refundable Income Tax Credit and Property Tax Classification as Class 6 With 5% Assessment Ratio. Effective January 1, 2010, Terminating January 1, 2016.

This bill creates a new tax incentive program with refundable income credits and property tax incentives for expanding or locating renewable energy operations in Arizona. The income tax credits and property tax incentives are tied to minimum capital investment levels and the creation of new high-paying jobs in Arizona.

Income tax credits: To qualify for individual and corporate income tax credits, the business is required to make new capital investment in manufacturing or in regional, national or global headquarters, and meet the

following requirements: (1) 51% or more of new full-time employees at the qualifying facility must be paid a wage that equals or exceeds 125% of the Arizona median wage; and (2) the employer must pay 80% or more of the premium for all full-time employees' health insurance coverage.

Property tax incentives: Qualifying properties will be placed in class 6, with an assessment ratio of 5%, instead of class 1, with an assessment ratio of 22% (for 2009, phasing down to 20% in 2011). The property classification is limited to either 10 years or 15 years, depending on the amount of high-paying jobs produced. To qualify, a taxpayer must meet all the requirements listed above for the income tax credit, as well as have a capital investment of \$25 million or more in facilities, equipment, land and infrastructure, and provide annual documentation to the county assessor that the facility is engaged in renewable energy manufacturing or is a regional, national or global headquarters.

ADMINISTRATIVE PROVISIONS

House Bill 2081: Chapter 32. New Automatic Review Schedule Established for Income Tax Credits.

Previously, any new income tax credit was required to be reviewed 5 years after the credit was initially enacted. If a credit was to be reviewed again after the initial 5 year review, the Legislature had to enact legislation requiring such additional review. This bill repealed the current Income Tax Credit Review Schedule and establishes a new, permanent schedule so income tax credits will automatically be reviewed in five year intervals. Credits will be reviewed in years ending in 0 and 5; 1 and 6; 2 and 7; 3 and 8; and 4 and 9. The bill also retains the credits on the review schedule the previous year: individual and corporate income tax for research and development, individual and corporate income tax for pollution control equipment, and corporate income tax credit for taxes paid for coal consumed in generating electrical power.

House Bill 2083: Chapter 33. The 2009 Tax Corrections Act.

This bill makes technical, conforming and clarifying changes to Arizona tax statutes. The changes are not supposed to be substantive in nature.

House Bill 2480: Chapter 52. Lowers Population Requirement From 400,000 to 200,000 for a County to Form a Regional Transportation Authority.

Current law authorizes a county with a population between 400,000 and 1.2 million to form a regional transportation authority (RTA) and to levy a county excise tax equal to 10% of the state rate of 5%. An RTA is a public, political, tax levying public improvement and tax subdivision of the state and a municipal corporation.

The only county that now qualifies is Pima County with a population of 843,000 (note: Maricopa County is the only county with a population over 1.2 million (3,072,000)). This bill lowers the population requirement to 200,000. Currently Yuma and Mohave Counties have populations of just under 200,000 and it is anticipated that they will reach populations over 200,000 in the 2010 census, so that they would then qualify to set up an RTA.

MISCELLANEOUS TAXES

INSURANCE PREMIUM TAX

House Bill 2288: Chapter 168. Credit Against an Insurance Company's Premium Tax Allowed for Donations to Student Tuition Organizations.

This bill allows insurers to take a tax credit against their insurance premium tax liability for donations to student tuition organizations. Previously, the STO credit was available only against the income tax (corporate and individual). This bill also eliminates a previous sunset date for the corporate income tax credit, making tax credits for such donations permanent. The bill also removes a previous credit cap, and allows for successive increases.

The STO contribution credit is extended to insurance companies and allows them to take a tax credit against their insurance premium tax liability for donations to student tuition organizations. This bill also eliminates the previous sunset date for the corporate STO income tax credit, making tax credits for such donations permanent. The aggregate credit limit for corporations was set at \$10 million in 2007; this bill increases the cap by 20% in each successive year. See ARS § 43-1183.

PROCEDURAL

Case No. 200800107 O (1/7/2009). Taxpayer Could Not Establish That She Did Not Receive Refund Check and Thus Not Entitled to Second Check.

There is a "presumption of official regularity," under which it is assumed that government officials properly discharge their duties. In this case, a taxpayer's claim that she never received a refund check was outweighed by presumption of official regularity. The Hearing Office found that a preponderance of the evidence regarding the process the Department follows when issuing a refund check was enough to establish that a refund check was sent and cashed, and that the taxpayer was therefore not entitled to a second check.

RULINGS

Fiduciary

FTR 09-1 (7/8/2009). As of January 1, 2009, Arizona Conforms to Federal 5 Month Extension for Trust and Estate Returns (Previously Arizona Allowed 6 Months).

“When Arizona grants a filing extension for estates and trusts filing Arizona Form 141AZ, Arizona will no longer allow a six-month filing extension. For taxable years beginning on or after January 1, 2009 (returns due on or after April 15, 2010), Arizona will conform to the federal five-month extension period allowed for estates and trusts filing federal Form 1041. Therefore, the extended filing period allowed for estates and trusts filing Arizona Form 141AZ is reduced from six months to five months. Upon receipt of a properly completed extension application, the department will grant an automatic five-month extension for fiduciary income tax returns.”

Partnership

PTR 09-1 (7/8/2009). As of January 1, 2009, Arizona Conforms to Federal 5 Month Extension for Partnership Returns (Previously Arizona Allowed 6 Months). “When Arizona grants a filing extension for partnerships filing Arizona Form 165, Arizona will no longer allow a six month-filing extension. For taxable years beginning on or after January 1, 2009 (returns due on or after April 15, 2010), Arizona will conform to the federal five-month extension period allowed for partnerships filing federal Form 1065. Therefore, the extended filing period allowed for estates and trusts filing Arizona Form 141AZ is reduced from six months to five months. Upon receipt of a properly completed extension application, the department will grant an automatic five-month extension for fiduciary income tax returns.”

It merits note that 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 Pat Derdenger.

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 lawyers 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 lawyers 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 lawyers 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

The firm'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

Stephoe'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 DC 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 filing).
- 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. They 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.

Advised clients on the Streamlined Sales Tax Project, including registration and amnesty issues.

SALES & USE TAXES, PRIVILEGE TAXES, & EXCISE TAXES

- Advised high-technology businesses, telecommunication companies, and manufacturers on gross receipts and other privilege taxes imposed by various jurisdictions.
- Advised an international telecommunications company on nexus issues and state and local tax collection obligations on international calls.
- Advised airlines and other air transportation companies on whether their sale or purchase of aircraft is subject to sales or 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.

They 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 assisting real estate developers deal with the Arizona "speculative builder" tax.

PROPERTY TAX

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.

STATE & LOCAL TAX GROUP

{Phoenix Office}

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