ARIZONA TAX UPDATE
2013

OVERVIEW

The following update provides an overview of Arizona tax developments occurring in 2013, with a focus on the year’s tax legislation and court cases. We trust that you will find this annual compilation of Arizona tax developments useful and interesting.

Past editions of our Arizona Tax Update are also available on our website at www.steptoe.com/aztaxupdates.

ARIZONA SALES TAX SIMPLIFICATION COMING IN 2015 BUT THE PRIME CONTRACTING CLASSIFICATION REMAINS LARGELY INTACT

At a signing ceremony on June 25, 2013, Governor Jan Brewer signed House Bill 2111, Arizona’s transaction privilege (sales) tax simplification bill, one of her signature pieces of legislation for the year. The sales tax simplification bill enacts major changes to Arizona’s sales tax structure, although it falls short of the big, bold ideas its backers initially proposed. Sales tax simplification is effective January 1, 2015.

In May 2012, Governor Brewer signed Executive Order 2012-01, establishing the Transaction Privilege Tax Simplification Task Force (the Task Force). The Task Force was charged with evaluating Arizona’s sales tax system and making recommendations on how to simplify the tax system, improve compliance, and reduce administrative burdens on taxpayers. The Task Force consisted of private sector business representatives, government tax administrators, and interest group leaders. It held hearings and meetings throughout 2012, and issued a final report on December 13, 2012, making numerous recommendations for changes to Arizona’s sales tax system. In early 2013, legislation was introduced to implement and adopt many of the Task Force’s recommendations.

During the course of the legislative session, the proposed sales tax simplification bill took many forms. Many cities in the state intensely opposed key provisions of the bill, and were successful in changing it throughout the session. After making many revisions and amendments to the bill, the Arizona Legislature passed House Bill 2111, a significantly scaled down version of what was originally proposed, with almost unanimous support in the House (58-1) and the Senate (29-0).

Key provisions of the sales tax simplification bill follow:

RETURN FILING, PAYMENT, AND AUDIT STREAMLINING

Online Portal. In 2012, the Arizona Legislature passed House Bill 2446, which required the Arizona Department of Revenue (the Department) to establish a central online portal where taxpayers could elect to report city sales taxes for cities whose sales taxes are not administered and collected by the Department. The portal is scheduled to be up and
...tors. Appeals of all audit assessments. § 42
...o prime contractors or use in a foreign country
...es the order at a business location in
...Spring 2014
...seller receive
...g receipts from retail sales
...Sourcing rules
...SOURCING RULES AND N
...ON REPEALED
...Audits. Under House Bill 2111, taxpayers will be subject to a single audit for state, county, and city sales taxes. In short, all audits will be for state, county, and city taxes, regardless of whether the audit is conducted by the Department or a city. Cities will be permitted to conduct audits of taxpayers engaged in business in only one city, and the Department will conduct audits of taxpayers engaged in business in multiple cities (although the Department may specially authorize a city to audit a multijurisdictional taxpayer on request). All audits will be performed in accordance with the Department’s audit manual, and the Department will train all state and city auditors. Appeals of all audit assessments must be directed to the Department. The Municipal Tax Hearing Office (which previously heard city sales tax cases) will disappear.

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Repeal of exemptions. Current law contains an exemption for sales of tangible personal property to a non-resident of Arizona if the property is shipped or delivered to the purchaser outside Arizona for use outside the state. Ariz. Rev. Stat. § 42-5061(A)(14). Under House Bill 2111, this exemption is limited to sales of motor vehicles. House Bill 2111 also repeals the current exemption for sales of tangible personal property shipped directly to a destination outside of the United States for use in a foreign country (currently, Ariz. Rev. Stat. § 42-5061(A)(35)). Such foreign sales are not taxable under the foreign commerce clause of the US Constitution and evidently the Legislature thought that a separate statutory exemption was unnecessary.

PRIME CONTRACTING CHANGES

General structure unchanged. Under House Bill 2111 as passed by the Legislature and signed by the governor, the general structure of the prime contracting classification remains intact. Prime contractors are still taxable on 65% of their gross receipts, subcontractors are exempt, and sales of building materials to prime contractors or subcontractors are exempt. The initial version of the sales tax simplification bill would have repealed the prime contracting classification entirely and would have simply required contractors to pay sales tax on the purchase of building materials. This proposal met with strong opposition from high-growth cities who wanted the tax revenue from construction within their jurisdiction rather than having all the tax revenue go to cities where material suppliers were located. The second version of the sales tax simplification bill, intended to placate the cities, repealed the prime contracting classification at the state level (except with regards to highway, street, and bridge construction), while still allowing cities to tax commercial and residential construction (as well as highway, street, and bridge construction). Ultimately, neither of these early versions of the bill gained enough traction to get through the legislature.
Service contractor exemption. House Bill 2111 creates a new exemption under the prime contracting classification for “[t]he gross proceeds of sales or gross income derived from a contract with the owner of real property for the maintenance, repair, or replacement of existing property if the contract does not include modification activities.” The bill specifies that each contract or project is independent from other contracts, and that a contractor who has nontaxable contracts under this new exemption is still taxable on any contracts that include modification activities. In addition, building materials sold to service contractors on exempt projects are taxable. A similar city exemption for service contractors is also added.

Project-specific exemption certificates. In order to reign in abuse of exemption certificates, the Department is required under House Bill 2111 to issue project-specific exemption certificates that contractors can use to purchase building materials tax free. To qualify for a project-specific exemption certificate, the contractor must meet the following conditions: (1) the contractor may not work directly for the owner of the real property, but rather must work on a job that is in the control of a taxable prime contractor; (2) the contractor may only use the exemption certificate for material that will be incorporated into a taxable construction project; (3) the contractor may not have a delinquent tax balance; and (4) the contractor must submit documentation to the Department showing that it meets these conditions. It appears that this new exemption certificate requirement applies only to subcontractors.

Pre-construction services exemption modified. Arizona law currently contains an exemption for the gross receipts attributable to a “separate, written design phase services contract or professional services contract.” Ariz. Rev. Stat. § 42-5075(N). This exemption is modified so that design phase services and professional services no longer need to be contained within a separate contract. Rather, the terms, conditions, and pricing for the design phase services or professional services merely need to be separately stated from those for construction phase services in the contract.


EFFECTIVE DATE

The changes made by House Bill 2111 are effective beginning January 1, 2015.

DEPARTMENT OF REVENUE IMPLEMENTATION

The Department is organizing four working groups to implement HB 2111’s reforms. The Administration group, headed by Lynette Nowlan, Assistant Director – Processing, will focus primarily on payment processing and fund distribution. The Audit group, headed by Tom Johnson, Assistant Director – Audit, will focus on implementing “single audit” provisions. The Contracting group, headed by Christie Comanita, Manager Tax Research & Analysis, will focus on implementing the changes to the sales taxation of construction activities. Finally, the Portal group, headed by Cynthia Ramey, Information Technology Specialist III, will focus on the development and implementation of the online portal. Members of the business community, industry groups, and tax practitioners may participate in the working groups.

House Bill 2111 also authorized expedited rulemaking in order for the Department to promulgate regulations to implement the various simplification measures.

LEGISLATURE REPLACES “PERMANENT ATTACHMENT” TEST WITH “INDEPENDENT FUNCTIONAL UTILITY” TEST

TEST USED TO DETERMINE APPLICABILITY OF THE EXEMPTION FOR LABOR TO INSTALL EXEMPT MACHINERY AND EQUIPMENT

Arizona law exempts various types of machinery and equipment from its retail sales tax. For example, it exempts machinery and equipment used directly in
manufacturing, processing, fabricating, job printing, refining, or metallurgical operations. A.R.S. § 42-5061(B). Under the prime contracting classification, Arizona also recognizes an exemption for labor to install exempt machinery and equipment. A.R.S. § 4205075(B)(7). Under prior law, the labor exemption only applied if the exempt machinery and equipment does not become a “permanent attachment” to the real property. “Permanent attachment” means at least one of the following: (1) to be incorporated into real property; (2) to become so affixed to real property that it becomes a part of the real property; or (3) to be so attached to real property that removal would cause substantial damage to the real property from which it is removed. Taxpayers and the Department have been in constant dispute over the application and scope of the “permanent attachment” test for many years, with the Department taking the position that mere bolting of machinery and equipment to the floor of a manufacturing facility to stabilize it during operation rendered the equipment permanently attached.

In order to clarify the installation labor exemption, House Bill 2535 repeals the “permanent attachment” test and replaces it with an “independent functional utility” test. Now, installation labor is exempt if the machinery and equipment “has independent functional utility.” The term “independent functional utility” means that the machinery or equipment “can independently perform its function without attachment to real property” other than attachment for any of the following: (1) assembling the machinery and equipment; (2) connecting items of machinery or equipment together; (3) connecting the machinery or equipment to water, power, gas, communication, or other services; and (4) stabilizing or protecting the machinery or equipment by bolting, burying, or similar non-permanent connections to real property. House Bill 2535 also adds an equivalent municipal tax exemption.

The Legislature made the new “independent functional utility” test retroactive to periods from and after June 30, 1997. However, refund claims based on the retroactive application of the new law had to be filed by December 31, 2013 and were capped at a cumulative $10,000 for all taxpayer filing refund claims.

SALES TAX EXEMPTION FOR COMMERCIAL LEASES BROADENED TO INCLUDE LLCS AND OTHER ENTITIES

At long last, the Arizona Legislature has rectified an ongoing problem for business owners who have created a separate entity to hold real property used to house business operations. Arizona imposes a tax under the commercial lease classification on “the business of leasing for a consideration the use or occupancy of real property.” Ariz. Rev. Stat. § 42-5069(A). At the state level, there is no tax on commercial leases, but counties in Arizona (who piggy-back on the state tax classifications) still tax commercial leases. Likewise, municipalities, like counties, tax rentals of real property (note that the state/county tax only applies to commercial leases, but cities also tax residential rentals in addition to commercial leases). Model City Tax Code § 445.

Previous law – exemption limited to leases between affiliated corporations. Under previous law, the commercial lease classification contained an exemption for leases of real property by a “corporation” to an “affiliated corporation.” Ariz. Rev. Stat § 42-5069(C)(5). At the same time, state law also prohibited cities from taxing commercial leases between a “corporation” and an “affiliated corporation.” Ariz. Rev. Stat. § 42-6004(A)(11). Additionally, some cities have elected to exempt gross income for leases of real property to a “corporation” if “the lessor’s aggregate holdings in the lessee corporation amount to at least 80% of the voting stock of the lessee corporation. Model City Tax Code § 445(i). Taxing jurisdictions have taken a narrow and technical read of these exemptions and have taken the position that they only apply to leases between affiliated “corporations” and do not extend to leases between any other types of entities. For example, if a corporation leased commercial real property to an affiliated LLC, taxing jurisdictions took the position that the exemption did not apply. As LLCs are the most common type of business entity, many businesses did not qualify for the exemption.

New law under House Bill 2324 – exemption expanded to cover leases between any type of affiliated company. The Arizona Legislature has now repealed the exemption for leases between affiliated corporations and has replaced it with a much broader exemption for leases between
“affiliated companies, businesses, persons, or reciprocal insurers.” House Bill 2324. For purposes of the new exemption “affiliated” companies include those where: (1) the lessor holds a controlling interest in the lessee; (2) the lessee holds a controlling interest in the lessor; (3) an affiliated entity holds a controlling interest in both the lessor and the lessee; or (4) an unrelated person holds a controlling interest in both the lessor and lessee. In determining if companies are affiliated, a controlling interest is defined as an 80% direct or indirect ownership (based on voting shares for corporations or ownership interests for other entities). Note: House Bill 2324 also adds an identical municipal tax exemption.

Effective date. On July 11, 2013, the Arizona Department of Revenue published guidance on its website addressing the effective date for the new exemption added by House Bill 2324. It instructed taxpayers that the state and county exemption took effect on September 13, 2013, while the municipal exemption took effect on July 1, 2013. The difference in effective dates is attributable to the fact that the Model City Tax Code was formally amended to take House Bill 2324 into account effective July 1, 2013 (while the exemption at the state and county level does not kick in until the normal effective date of House Bill 2324).

ARIZONA’S REAL PROPERTY TAX STRUCTURE CHANGES BEGINNING WITH THE 2015 PROPERTY TAX YEAR

In November 2012, Arizona voters approved Proposition 117, a constitutional amendment that collapses Arizona’s existing two value system applicable to real property taxes for tax year 2015 (the valuation date for the 2015 property tax year is January 1, 2014) and thereafter. Under current law, real property has two values: the “full cash value” and “limited value.” Full cash value is generally synonymous with market value and is used to calculate secondary property taxes. Limited value equals the limited value in the previous year plus the greater of 10% of that value or 25% of the difference between full cash value in the current valuation year and the limited value of the previous valuation year; it is used to compute primary property taxes. Under Proposition 117, “[f]or purposes of taxes levied beginning in tax year 2015, the value of real property and improvements . . . used for all ad valorem taxes shall be the lesser of the full cash value of the property or an amount five percent greater than the value of property determined pursuant to this subsection for the prior year.” In short, annual increases in real property value will be capped at five percent.

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COMPARISON OF PROPERTY TAX CALCULATIONS UNDER NEW STRUCTURE IN 2015

The following chart shows the tax calculation for a commercial property with a full cash and limited values of $1 million under the current system and under the new system effect in 2015. The assessment ratios and the average tax rates for 2013 were used in this calculation.

<table>
<thead>
<tr>
<th>Current Property Tax System</th>
<th>Value</th>
<th>Assessment Ratio* (2013)</th>
<th>Assessed Value</th>
<th>Tax Rate (per $100 of assessed value)</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Cash Value</td>
<td>$1,000,000</td>
<td>19.5%</td>
<td>$195,000</td>
<td>4.02%</td>
<td>$7,839</td>
</tr>
<tr>
<td>Limited Value</td>
<td>$1,000,000</td>
<td>19.5%</td>
<td>$195,000</td>
<td>8.52%</td>
<td>$16,614</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>12.54%</td>
<td>$24,453</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Property Tax System Beginning in 2015 Tax Year Under Proposition 117</th>
<th>Value</th>
<th>Assessment Ratio* (2013)</th>
<th>Assessed Value</th>
<th>Tax Rate (per $100 of assessed value)</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Cash Value (only as cap for limited value)</td>
<td>$1,000,000</td>
<td>Not used</td>
<td>Not used</td>
<td>Not used</td>
<td>Not used</td>
</tr>
<tr>
<td>Limited Value (primary rate)</td>
<td>$1,000,000</td>
<td>19.5%</td>
<td>$195,000</td>
<td>8.52%</td>
<td>$16,614</td>
</tr>
<tr>
<td>Limited Value (secondary rate)</td>
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percent over the previous year’s limited value, with the total limited value not exceeding full cash value. This new limited value will be used for purposes of calculating both primary and secondary property taxes. Full cash value will no longer be used for purposes of calculating secondary taxes. It will serve only as a cap to increases in the limited value. This new structure does not apply to personal property (except mobile homes) or centrally valued property (property valued by the Department of Revenue) — rather, for these properties, full cash value will be used for calculating both primary and secondary property taxes.

OTHER TAX DEVELOPMENTS

SALES TAX

2013 LEGISLATION

Sunset of Proposition 100 temporary sales tax rate increase. In May 2010, Arizona voters approved Proposition 100, which temporarily increased Arizona’s sales and use tax rate under most classifications by one percent for three years. On most transactions, the tax rate increased from 5.6% to 6.6% at the state level. The temporary rate increase automatically expired on May 31, 2013 and the state rate reverted to the original 5.6%.

House Bill 2259: Chapter 120. Retail sales tax exemption enacted for orthodontic devices. This bill creates a new exemption under the retail classification for retail sales of orthodontic devices dispensed by a licensed dentist as part of the practice of dentistry. An equivalent city exemption is also created. The exemption is retroactive to taxable periods from and after September 30, 2007.

House Bill 2336: Chapter 233. Sales of cash equivalents such as gift cards are not subject to sales tax. This bill creates a retail sales tax exemption for sales of “cash equivalents.” “Cash equivalents” means “[i]tems or intangibles, whether or not negotiable, that are sold to one or more persons, through which a value denominated in money is purchased in advance and may be redeemed in full or in part for tangible personal property, intangibles or services.” Examples of “cash equivalents” include gift cards, gift certificates, stored valued cards, traveler’s checks, and money orders. “Cash equivalents” do not include items or intangibles through which a value is not denominated in money or prepaid calling cards or prepaid authorization numbers for telecommunications services. This legislation clarifies that the redemption of any cash equivalent for a taxable good or service is subject to tax. House Bill 2336 is retroactive to taxable periods from and after December 31, 1998; refund claims based on retroactive application of House Bill 2336 must be filed by December 31, 2013 and cumulative refunds are capped at $10,000.

Senate Bill 1179: Chapter 236. Exemptions created for ignition interlock devices, destination management companies, and energy drinks. Senate Bill 1179 enacted numerous tax changes and exemptions.

Ignition interlock devices. The bill creates a state and municipal exemption for the leasing or renting of certified ignition interlock devices. The Legislature’s adoption of this new exemption was designed to overturn the Department’s position in LR10-006 in which the Department ruled that income derived from ignition monitoring systems installed in the cars of drivers participating in state-mandated alcohol monitoring programs is subject to transaction privilege tax under the personal property rental classification. This change is retroactive to taxable periods beginning from and after August 31, 2004; refund claims based on the retroactive application of this provision must be filed by December 31, 2013 and are capped at a cumulative $10,000 for all taxpayers filing refund claims.

Destination management companies. By way of Senate Bill 1179, the Arizona Legislature clarified that destination management companies are not taxable on their gross receipts from customers, but rather vendors providing tangible personal property, rentals, or taxable services to destination management companies are taxable. A.R.S. § 42-5039. This legislation was designed to legislatively overrule the Arizona Department of Revenue’s position in LR10-011, in which it took the position that a destination management company is taxable on its gross receipts under various tax classifications.

A destination management company is a business that acts as an event coordinator and trip planner for its customers, for example a business wanting to hold a corporate event or conference in Arizona. A destination management company might secure a venue for the event, arrange transportation, hire caterers, rent equipment, or purchase tangible personal property in order to coordinate the
conference or event. Most destination management companies treated themselves as a final consumer and user of the tangible personal property, rentals, or taxable services that they arranged and accordingly paid tax to vendors or supplies of such items or services. However, the Department took the position in letter ruling, LR10-011, issued on August 10, 2010, that destination management companies are themselves liable for tax on their gross receipts under various tax classifications for the tangible personal property, rentals, and services they arrange for their customers. Senate Bill 1179 overturns LR10-011, and provides as follows:

(A) A qualified destination management company is not subject to transaction privilege tax under this chapter on the gross proceeds of sale or gross income derived from a qualified contract for destination management services.

(B) A qualified destination management company is a final consumer and user of any tangible personal property, activity, or service subject to transaction privilege tax under Article 2 of this chapter that the qualified destination management company arranges pursuant to a qualified contract for destination management services.

(C) For the purposes of this section:

(1) “Destination management services” means the business of coordinating, designing and implementing the delivery by a third party of four or more of the following: (a) transportation; (b) entertainment; (c) food or beverage; (d) recreational or amusement activity; (e) tours; (f) event venue; or (g) theme décor.

(2) “Qualified contract” means a contract for the provision of destination management services by a qualified destination management company where both of the following apply: (a) the qualified destination management company receives payment from or on behalf of the qualified destination management company’s client for the cost of the destination management services arranged by the qualified destination management company; (b) the qualified destination management company pays the vendor supplying the destination management services arranged by the qualified destination management company including any applicable transaction privilege tax or collection of use tax charged by the vendor to the qualified destination management company.

(3) “Qualified destination management company” means a person that receives on an annual basis at least 80% of its gross proceeds of sales or gross income derived from destination management services.

Energy drinks. Senate Bill 1179 also provides that “[a]ny ready-to-drink, nonalcoholic beverage that is contained in a closed or sealed bottle, can or carton, that is intended for human consumption and that is intended for home consumption is deemed to be food” and is exempt under Arizona’s food exemption. This legislation was designed to clarify the taxability of energy drinks and clear up confusion caused by conflicting positions the Department had taken on whether or not such drinks were taxable. Senate Bill 1179 also specifies that medicines or dietary supplements, such as vitamins and protein supplements are not considered to be exempt food unless otherwise exempt by statute.

House Bill 2009: Chapter 9. Data center incentive added. House Bill 2009 creates an exemption for certain computer data center equipment purchased by the owner, operator, or qualified colocation tenant of a computer data center for use in a data center certified by the Arizona commerce authority under § 41-1519. In order to qualify for the exemption, the taxpayer must comply with certification requirements and must meet certain investment requirements in Arizona.

2013 COURT DECISIONS

City of Chandler v. Whitewing II, LLC, 1 CA-TX 12-0008 (Ariz. Ct. App. Oct. 22, 2013). The sale of real property on which existing improvements have been removed to make way for future residential development is subject to city speculative builder tax. The taxpayer acquired land that had previously been used as a hog farm for development into a residential subdivision. The taxpayer cleared and graded the land, removed tangible personal property, removed a septic tank, and removed a 4800 square foot concrete slab with associated footings and stem wall from the property. The taxpayer then subdivided the land and sold the vacant lots.

Cities in Arizona impose a speculative builder sales tax on sales of “improved real property.” Model City
Tax Code § 416. “Improved real property” is defined by statute to include any real property “[w]here improvements have been made to land containing no structure (such as paving or landscaping). MCTC § 416(a)(2). The issue in the case was whether the taxpayer had sold “improved real property.” The taxpayer argued that by removing tangible personal property and other improvements it had not improved the real property because, unlike paving and landscaping (the examples contained in the statute), it had not done anything to add to the land; it had only removed existing improvements. The Court rejected the taxpayer’s argument and ruled that “the question is whether substantial alterations have added value to the property so as to constitute an ‘improvement’ for tax purposes.” Under this standard, the Court found that the taxpayer’s efforts to get the property ready to subdivide by removing existing improvements were sufficient to render the real property improved and subject to the speculative builder tax.

CCI Europe Inc. v. Ariz. Dep’t of Revenue, TX 2010-000404 (Ariz. Tax Ct. April 17, 2013). Newspaper publishers are manufacturers and sales of newspaper production software used to create newspapers are exempt. In this case, the taxpayer sold newspaper production software to the publisher of a newspaper in Arizona. The taxpayer took the position that its software sale qualified for Arizona’s exemption for “machinery and equipment used directly in manufacturing [or] processing.” A.R.S. § 42-5061(B)(1).

The Department disallowed the claimed exemption and asserted that (1) sales to a newspaper publisher are ineligible for the A.R.S. § 42-5061(B)(1) exemption because a newspaper publisher is not a “manufacturer”; and (2) even if a newspaper publisher were a manufacturer, the newspaper production software at issue was not “used directly” in manufacturing. The Arizona Tax Court ruled in favor of the taxpayer and against the Department. It held that the process of creating a physical item (a newspaper) out of paper and ink fell within the ordinary meaning of the term “manufacturing” and that sales to a newspaper publisher were eligible for the machinery and equipment deduction contained in A.R.S. § 42-5061(B)(1).

In addition, the Tax Court held that the production software at issued was “used directly” in the newspaper publisher’s manufacturing process because it told the printing presses where and how to apply ink to the paper, and thereby helped to maintain a harmonious, integrated, and synchronized manufacturing process. The Department appealed and the case is pending before the Arizona Court of Appeals.

PROPERTY TAX

2013 LEGISLATION

House Bill 2344: Chapter 9. County treasurer may waive certain penalties. The county treasurer, in consultation with the board of supervisors may waive penalties imposed on homeowners who failed to respond to information requests about the classification of residential property as a qualifying primary residence or qualifying residence of a family member for good cause.

Senate Bill 1169: Chapter 66. Technical changes to implement Proposition 117. This bill makes technical and language changes to Arizona statutes to conform to voter’s approval of Proposition 117 in November 2012, which capped valuation increases on locally assessed real property to five percent, not to exceed fair market value.

House Bill 2346: Chapter 226. Valuation of distribution and transmission of electric distribution cooperatives. This bill sets out a statutory method of valuing the distribution and transmission property of electric distribution cooperatives. An electric distribution cooperative is a member owned, non-profit electric utility. The statutory value is based on the original plant in service cost as adjusted by ARS § 42-14154(B) and then multiplying that value by a “standard market value factor” as defined in the bill.

Senate Bill 1179: Chapter 236. Incentive for real and personal property used to manufacture motor vehicle biofuel. Under current law, real and personal property used specifically and solely to manufacture 100% biodiesel fuel and its by-products after December 31, 2006 and through December 31, 2016 is treated as Class 6 property. This bill amends the current law such that Class 6 treatment is extended to include real and personal property used to manufacture motor vehicle biofuel and its by-products. This favorable treatment is extended through December 31, 2023.

2013 COURT DECISIONS
**SHR Scottsdale X, LLC. v. Maricopa County, CA-TX 12-0004 (Ariz. Ct. App. Jan. 3, 2013).** A successor could not re-litigate the issue of who owned improvements when its predecessor had already litigated that issue. The taxpayer was a successor in interest to Scottsdale Princess Partnership and operated a resort on land leased from the City of Scottsdale. The taxpayer sought a refund of taxes paid for prior years, arguing that the resort improvements were owned by the City of Scottsdale. Scottsdale Princess Partnership had previously litigated the issue of who owned the improvements, with the Arizona Court of Appeals ruling in 1995 that the Partnership owned the improvements. The Court in this case held that the doctrine of collateral estoppel precluded the taxpayer from re-litigating the issue of who owned the improvements, when its predecessor had already litigated that question.

**Cable One, Inc. v. Ariz. Department of Revenue, 232 Ariz. 275 (App. 2013).** The Arizona Court of Appeals held that a Voice over Internet Protocol (VoIP) provider was subject to central valuation by the Arizona Department of Revenue as a telecommunications company. Cable One was a cable and Internet provider, whose property had been locally assessed by each county. Cable One began offering VoIP telephone service to its customers, including unlimited local and long-distance calling in the continental United States. As a result of the VoIP offering, taxing authorities took the position that Cable One was a telecommunications company subject to central valuation of all of its property, which resulted in a dramatic increase in the value of its property for property tax purposes. A “telecommunications company” subject to central valuation includes “any person that owns communications transmission facilities and that provides public telephone or telecommunications exchange or inter-exchange access for compensation to effect two-way communications to, from, through, or within this state.” ARS § 42-14401.

Cable One disputed that it was a telecommunications company, because it was predominantly a cable and Internet company, and VoIP was a very small part of its business and because it did not itself own communications transmission facilities (it contracted with a third party to connect to the public switched telephone network). However, the Court of Appeals ruled that Cable One was a telecommunications provider subject to central valuation. The Court reasoned that Cable One owned a broadband network that was used to transmit telecommunications; therefore it owned communications transmission facilities and met the definition of a “telecommunications company.” Although Cable One did not own a telephone network, it provided customers with access to a telephone network for a fee. Finally, the Court ruled that the Arizona law does not require that property be used predominantly for telecommunications purposes for it to be centrally valued, so it did not matter that VoIP was a minor component of Cable One’s business.

**Church of the Isaiah 58 Project of Arizona, Inc. v. La Paz County, 2013 WL 4857951 (Ariz. App. Sept. 12, 2013).** A church purchased real property in August 2006 and held church services and Bible study programs at the property. The taxpayer requested a tax exemption from the County Assessor for 2006 because the property was used primarily for religious worship under ARS § 42-11109(A), but did so after the deadline for requesting an exemption for 2006 had expired and did not pay property tax on the property. The Court held that exempt taxpayers acquiring property after the deadline for seeking a tax exemption are not entitled to the exemption for that year.

The taxpayer did file an exemption request for 2007, which the County did not grant or deny. Rather, the County responded by requesting documentation that the taxpayer was an exempt entity and specifically asking the taxpayer to provide a Letter of Determination from the IRS to verify that the taxpayer was a 501(c)(3) exempt organization. The taxpayer replied by letter, explaining that it did not organize as a 501(c)(3) exempt organization, and was not required to do so for purposes of Arizona’s property tax exemption for property used for religious worship. The taxpayer then sought to enjoin the County from imposing its property tax for tax year 2007. The Court held that Arizona’s anti-injunction statute precluded the taxpayer from asserting such an action for 2007, and additionally held that the taxpayer’s action was improper because it had not paid the property taxes for 2007, which is a prerequisite for challenging the tax under ARS § 42-11004.

For 2008, the taxpayer failed to file an exemption request so the court ruled that the taxpayer had waived any claim to an exemption for that year. For tax year 2009, the taxpayer requested an exemption and documented entitlement to the exemption by submitting a letter it had received from the Arizona
Department of Revenue recognizing it as exempt from state income tax and stating that its property used or held primarily for religious worship was also exempt. The County Assessor accepted this documentation and began treating the property as exempt for 2009, so that year was not at issue in the case.

CORPORATE INCOME TAX

2013 LEGISLATION

Senate Bill 1179: Chapter 236. The subtraction for contributions to § 529 plans is increased; a new charitable contribution credit is authorized; rules for apportioning university income are revised. This bill makes the following changes:

§ 529 plan subtraction. The Arizona Legislature has increased the subtraction from taxable income for contributions to § 529 college savings plans. Previously, single filers could take a subtraction of $750 and married couples filing jointly could claim a subtraction of $1,500. Senate Bill 1179 increases the subtraction to $2,000 for single filers and $4,000 for married couples filing jointly.

Charitable donation credit. The Legislature has authorized individuals to claim tax credit - $200 for single filers and $400 for married couples filing jointly – for donations to charitable organizations even if they do not itemize their deductions.

Apportionment of university income. Qualifying universities (for profit) with multistate income may elect to source sales of educational services such as tuition and fees required for enrollment to the destination of the students rather than sourcing using the traditional costs of performance test. This creates an optional market sourcing approach for apportioning university income.

Senate Bill 1168: Chapter 65. Annual Internal Revenue Code conformity bill. This legislation is Arizona’s annual conformity bill and conforms Arizona’s income tax laws to the Internal Revenue Code in effect as of January 3, 2013. However, Arizona did not conform to the retroactive provision of the Federal Aviation Administration Modernization and Reform Act. Rather, Arizona created a refundable tax credit for tax year 2013 in lieu of conforming. The credit equals the amount of the reduction in Arizona income tax that would have occurred in tax years 2002 through 2011 if Arizona had conformed.

House Bill 2531: Chapter 256. $25,000 cap of I.R.C. § 179 deductions lifted. Under prior law, Arizona required that amounts over $25,000 for which an expense deduction had been claimed under I.R.C. § 179 be added back to Arizona gross income for purposes of calculating Arizona adjusted gross income. (I.R.C. § 179 allows a deduction in the current year for the purchase price of certain financed or leased equipment placed in service during the year up to $500,000 in 2013). House Bill 2531 lifts the $25,000 cap and no longer requires that the add-back for amounts over that limit.

2013 COURT DECISIONS

The Harris and First Data cases: The Arizona Court of Appeals ruled that the definition of apportionable “business income” encompasses both a “transactional” and a “functional” test and rejected the almost universally recognized “liquidation exception.” In November 2013, the Arizona Court of Appeals issued decisions in two companion cases, First Data Corp. v. Ariz. Dep’t of Revenue, 313 P.3d 548 (Ariz. App. 2013) and Harris Corp. v. Ariz. Dep’t of Revenue, 312 P.3d 1143 (Ariz. App. 2013) that interpreted Arizona’s definition of apportionable “business income.” In 1983, Arizona adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), which apportions “business income” amongst the states in which a multistate taxpayer engages in business, but allocated “non-business income” to a single state (generally, the state of the taxpayer’s domicile). Under UDITPA, Arizona defines business income as follows:

Business income means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations. A.R.S. § 43-1131(1).

Conversely, “non-business income” is defined as “all income other than business income.” A.R.S. § 43-1131(4)

The Court interprets the definition of business income expansively to include both a “transactional” and a “functional” test. The first
clause of the definition states that “business income” will include the “transactions and activity” that produce income in the “regular course of the taxpayer’s trade or business” A.R.S. § 43-1131(1). Many courts that have interpreted the UDITPA definition have held that this language creates a single “transactional” test, with the second clause (starting after “and includes”) merely illustrating the application of the general principle. Under the transactional test, gain constitutes business income if it is produced by the transactions and activities in the regular course of the taxpayer’s trade or business. Transactions and activity that are extraordinary and infrequent are not business income under this test.

Other courts have interpreted the second clause of the definition to be a completely separate and independent “functional” test. “The functional test describes business income as income from property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” Harris, 312 P.3d at 1146. Thus, courts adopting the functional test have found that it captures additional gain that would not satisfy the transactional test.

In its Harris and First Data decisions, the Arizona Court of Appeals interpreted Arizona’s definition of “business income” to encompass both the transactional and functional tests.

The Arizona Court of Appeals rejects the liquidation exception. Courts across the country have almost unanimously held that the liquidation or sale of a complete business segment does not constitute business income even under the functional test. The second clause of the “business income” definition from which some courts derive a functional test only categorizes gain as business income “if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” A.R.S. § 43-1131(1). Interpreting this language, courts have come to a near-consensus that the proceeds from the disposition of property in a liquidation cannot constitute business income under the functional test because liquidating dispositions are not “integral parts of the regular course of trade or business operations”; rather, they are a means of ending business operations. Courts and commentators have sometimes referred to this treatment as the “liquidation exception” to the functional test (although that is a bit of a misnomer, because it is not an exemption but merely the application of the statutory language).

The Court in Harris and First Data rejected the liquidation exception in reliance upon a lone California case, which was the only decision to reject the liquidation exception under the UDOTPA definition of business income. Jim Beam Brands Co. v. Franchise Tax Bd., 34 Cal. Rptr. 3d 874 (App. 2005). In reliance upon Jim Beam, the Court held that the sale of property will constitute business income if the “control and use” – rather than the “acquisition, management and disposition” – of the property is “closely related to the taxpayer’s regular trade or business. Harris, 312 P.3d at 1148. In so holding, the Court essentially ignored the language of the statute by reading the “and disposition” requirement entirely out of the “business income” definition and by treating “and” as if it were “or.”

Home Depot USA, Inc. v. Ariz. Dep’t of Revenue 314 P.3d (Ariz. App. 2013). Intangible holding company must be included in its parent company’s combined unitary return. Home Depot created a wholly owned subsidiary to hold all of its trademarks, trade names, and service marks. The subsidiary then licensed these intangibles to Home Depot, for which it received a sizable royalty. Home Depot excluded the subsidiary from its combined unitary return taking the position that it was not unitary. On audit, the Arizona Department of Revenue challenged this approach. On review, the Arizona Court of Appeals held that the operations of Home Depot and its subsidiary were “substantially interrelated” and therefore they engaged in a unitary business.
STATE AND LOCAL TAX GROUP

The foregoing summaries are not intended as legal advice on any particular question of law. If you have any questions or concerns about these or related developments, please contact our State and Local Tax lawyers.

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