Recent Arizona Court and Legislative Actions

By James M. Susa

James Susa gives us a bird's-eye view of Arizona's court and legislative activities of the last year.

Arizona's courts and Legislature have been busy over the past year issuing numerous court decisions and enacting new bills. Here is a summary of the recent matters involving state and local taxes.

Supreme Court

Class 9 property improvements must only exist on the valuation date and be used for specified purposes. Property within Arizona is divided into multiple classes, each with differing assessment ratios, for property taxation purposes. One of the most favorable classifications is Class 9, with a one-percent assessment ratio. CNL Hotels and Resorts entered into a 99-year land lease with the state of Arizona, upon which CNL constructed the Marriott Desert Ridge Resort and Spa and golf course. The lease provided that the improvements will be transferred to the State upon the termination of the lease. CNL applied for the favorable Class 9 assessment ratio, and the Maricopa County Assessor denied the request, reasoning that due to the ability of CNL to remove the improvements, there was no guarantee that there would be any improvements to transfer to the state at the end of the lease. The Arizona Supreme Court ruled that the existence of the improvements upon the land on the valuation date each tax year was sufficient to obtain Class 9 status. However, the court also ruled that the second requirement of the Class 9 statute was that the improvements be used "primarily for athletic, recreational, entertainment, artistic, cultural or convention activities." Because no evidence was submitted in the trial court that the improvements were used primarily for any of those purposes, the

James M. Susa is of counsel with Snell & Wilmer L.L.P. in Tucson, Arizona.

court remanded the case back to the trial court for proceedings on the second requirement.[1]

Court Of Appeals

Alarm system signals are "telecommunications services," and their taxation by cities is prohibited. The cities of Phoenix and Peoria assessed Brink's Home Security privilege tax upon their revenues received from monitoring services for customers located within those cities. Brink's protested, asserting that such services represent "interstate telecommunications service," and state law prohibits cities from levying taxes on such services. The Arizona Supreme Court ruled in March that Brink's services were "interstate," but it remanded back to the Court of Appeals the question of whether such services were "telecommunications services." While both cities assessed Brink's under their tax codes "telecommunication services" category, the cities argued that the term has a different meaning than the state statute prohibiting the taxation of "interstate telecommunications services." The court held that the monitoring services are "telecommunications services" even if they are merely connected with interstate telecommunications services.[2]

The court held that the monitoring services are "telecommunications services" even if they are merely connected with interstate telecommunications services.

Personal property owners may appeal the Assessor's decision directly to the Tax Court. The process for appealing the Assessor's value on personal property is governed by a different set of statutes than the process for appealing real property. Due to these different procedural statutes, the Assessor argued successfully in the Arizona Tax Court that the taxpayer could not directly appeal the Assessor's determination of value on personal property to the court without first appealing the value administratively to either the county or state boards of equalization. The Court of Appeals reversed based upon the broad language of A.R.S. § 42-16201(A) allowing "a property owner" to appeal directly to court. The Court of Appeals reasoned this language unambiguously provided an avenue for a property owner, real or personal, to forego the administrative appeals process and go directly into court.[3]

Department estimating a value based on the property owner's failure to submit an annual report is not an "error." Certain property owners are valued by the Department of Revenue ("DOR"). This process begins with the submitting of an annual statement containing pertinent information. An electric utility in Mohave County refused to submit the statement, citing its location on tribal land. DOR, as required by statute, then estimated the value. The property owner did not appeal that value. Later, the property owner filed a notice of error under the error-correction statute claiming the value was an "error" because DOR had not relied on actual information, but instead upon estimates. The Court of Appeals held that DOR's reliance upon estimates, as required by statute when the property owner fails to submit the annual statement, is not an "error" subject to correction. Acknowledging that DOR's value was higher than would have occurred had the property owner submitted the annual statement, the Court held nevertheless that the property owner's decision to not file the annual statement doomed the owner's ability to challenge DOR's valuation under any statutory mechanism, including the error-correction statute.[4]

Use tax not due when service, not tangible personal property, is dominant purpose of the transaction. The use tax is imposed upon the purchase of tangible personal property from a retailer. In this case, Val-Pak was hired by certain Arizona businesses to create, print, and mail coupons to Arizona residents. Val-Pak is a franchisee of Val-Pak Florida. Val-Pak Florida fulfills the orders by delivering envelopes to the post office, addressed to Arizona residents in certain geographic areas. Val-Pak Florida then bills Val-Pak. The Department of Revenue asserted that Val-Pak was liable for use tax upon the amount it was billed by Val-Pak Florida. The court noted that when there is a mixture of services and property used to fulfill a contract, the court will apply the "dominant purpose" and "common understanding" tests. Under the "dominant purpose" test, the court looks to the purpose of the transaction i.e., was the customer paying for the service provided or the tangible personal property being delivered? Under the "common understanding" test, the court must determine whether the business providing the item is generally in the business of selling products or providing services. The court here held that Val-Pak's desired services,

not paper, from Val-Pak Florida was the dominant purpose, and further, Val-Pak Florida was generally not in the business of selling paper. Rather, Val-Pak Florida was providing advertising services using paper and thus the use tax did not apply.[5]

Income tax credit for sewer system and storm basin as pollution-control property proper. An income tax credit is provided for expenses to purchase real or personal property used to control or prevent pollution. Microchip constructed a sewer system and storm basins for its semiconductor manufacturing plants in the cities of Tempe and Chandler. Microchip applied for the income tax credit for the expenses attributable to the construction because the system and basins were used, in part, to control or prevent pollution. Microchip's claim was denied by the Department of Revenue on the basis that the property was not constructed to meet or exceed any pollution-control regulations, as required by the statute. The Court of Appeals held the Department's reading of the credit statute was flawed. The statute's first portion provides the credit for pollution-control equipment. The statute's second portion states that pollution-control equipment "includes" property which meets a number of requirements, including its installation to meet federal, state, or local environmental regulations. The court held that the statute's second portion only provided illustrations of what property would qualify, not a limitation on the type of property that would qualify. Had the statute's second portion term "includes" instead been "is limited to," then the Department's argument would have merit. However, the statute's first portion provided the credit for pollution-control equipment, and Microchip's property controlled pollution, and therefore, the credit should have been allowed.[6]

Airline property valued using direct capitalization and stock and debt approach. The Department of Revenue is required to determine the full cash value of airline company property based upon original cost less depreciation. If that value is above market value, the Department is to reduce the value so that it does not exceed market value. The Department determined the value of Southwest Airlines and concluded that value did not exceed market value. Southwest protested that determination and expert witnesses for both parties testified as to their conclusions of value. The Tax Court held in favor of the Department, and Southwest appealed. On appeal, the court held that the two methodologies used by the Department's expert witness, direct capitalization and stock and debt, were more appropriate than the methodologies used by Southwest's expert. The Southwest expert performed a valuation using the cost method, but with significantly more depreciation than the Department's original calculation and a valuation using a yield capitalization method. The court criticized Southwest's depreciation calculation because it presumed a Southwest earnings figure instead of focusing on actual earnings. Similarly, the court criticized Southwest's yield capitalization approach because it used dissimilar companies to select the average cost of capital and improperly chose and inflated the risk premium.[7]

911 telecommunications tax applies to prepaid wireless phone service company. The State of Arizona enacts a special monthly tax of 37 cents per month per activated account on each provider of wire and wireless service for the purpose of financing emergency telecommunication services, commonly called "911 service." Virgin Mobile offers users in Arizona prepaid wireless telephone services. Virgin Mobile provides a phone which is activated with a set number of minutes. Users have the option to purchase more minutes from Virgin Mobile as they exhaust their originally purchased number of minutes. Virgin Mobile paid the tax and sought a refund asserting two main theories. The Court of Appeals rejected both. First it held that even though the statute imposes the tax upon a "provider," and Virgin Mobile is a "wireless provider" the tax imposition statute would render the statute's other language imposing the tax upon "each activated wire and wireless service account" meaningless. The next argument was that because the tax is imposed only on those services that are billed monthly, the tax could not apply to Virgin Mobile because they have prepaid service and thus do not bill monthly. The court held that although the tax amount is computed on a per-month basis, it would be absurd to read the statute to exempt those who choose to bill on some basis other than each month.[8]

Tax Court

Tax exemption from property tax not warranted merely by claim as church. The Church of the Isaiah brought a court action to contest the Assessor's determination that it is not exempt from property tax. The church sought relief under the illegal tax statute. The church asserted that it should be exempt from property tax because the Internal Revenue Service had issued a determination letter under 501(c)(3). The church also

asserted that it was a violation of the constitutional guarantee of free exercise of religion to pay property taxes on church property. The court held that the church could not use the illegal tax statute to contest the exemption determination because the statute is only applicable to the recovery of illegally collected taxes, and the church actually never paid any of the property tax that had been assessed. Thus, the church could not sue to recover taxes never paid. Next, the court held that the Assessor may require documentation beyond that requested by the federal government in order to prove property is exempt. Finally, the court held that there was no violation of the exercise clause because the imposition of the property tax was not done because the property is owned by a church, but rather because the property owner has not proven that the property should be exempt.[9]

Regular dispute on valuation is not "illegal tax." The property owner filed suit claiming that the assessed value of its property was excessive, and, thus, any tax to be paid upon that property amounted to an "illegal tax." Property owners are provided the opportunity to contest the valuation and classification of their property each year by following clearly delineated appeals procedures. If those procedures are not followed, property owners do not obtain a second opportunity to contest value and classification by bringing an action under the "illegal tax" statute. That statute is only applicable to seeking a refund of already-paid taxes based upon some irregularity in the tax itself, not the value or classification of the property that was subjected to tax. Because the property owner's lawsuit was filed long after the time for contesting value and classification had passed, the property owner's lawsuit was dismissed.[10]

> The Court of Appeals held that DOR's reliance upon estimates, as required by statute when the property owner fails to submit the annual statement, is not an "error" subject to correction.

Deadline for filing of protest of sales tax assessment strictly enforced. Arizona law provides 45 days from the taxpayer's receipt of a notice of proposed assessment of transaction privilege (sales) tax to file a written protest with the Department of Revenue. If a protest is not filed by that time, the assessment becomes final, due, and collectible by the Department. The taxpayer received the notice by certified mail. The issue for the court was whether the certified mail receipt signed by the taxpayer was signed on August 5 (in which case the taxpayer's appeal would be untimely) or August 6 (in which case the taxpayer's appeal would be timely). The court reviewed the actual receipt and determined that the figure appeared to be a "5" rather than a "6," and, thus, the taxpayer had missed their opportunity to appeal. The taxpayer did, however, retain the opportunity to contest the merits of the assessment, but only after paying the assessment in full and requesting a refund.[11]

Improved real property need not have additions under city tax code. The Model City Tax Code imposes a tax upon those who sell improved real property. Improved real property is defined as real property where improvements have been made to land containing no structure (such as paving or landscaping). Here, the taxpayer "improved" the real property by removing a 4,800-square-foot concrete slab, a septic tank, and grading the land after removal. The court held that the code did not require the actual addition of tangible personal property to the land, but could also mean subtracting from the land as long as the subtractions constituted a "valuable betterment" to the land.[12]

Appeal to court from assessor decision must follow strict timeline. A property owner has a number of options when contesting the value or classification of their property each year. However, once the property owner chooses which path to follow, it must carefully follow that path, including meeting all timelines. Here the property owner chose to appeal to the Assessor, who reviewed the appeal and rendered a decision. From that decision, the property owner could either appeal to the State Board of Equalization or directly to the Arizona Tax Court, each with different timelines for filing the appeal. The property owner did not file an appeal with the state board and instead filed an appeal with the court. However, the appeal was filed almost three months after it should have been filed with the court. The property owner asserted that the filing was timely, as it was the successor-in-interest to the entity which filed the original Assessor's appeal. The court held that even if that were true, the appeal still should have been filed earlier than it was filed, meaning the appeal to court was still untimely.[13]

Lack of administrative rule for valuing member-owned nonprofit electric distribution cooperative does not invalidate value. Each year the Department of Revenue must determine a full cash value for utility property. It uses standard appraisal methods and techniques if no specific valuation formula is found in statute. There is no statutory method for determining the value of a nonprofit electric distribution cooperative. The taxpayer asserted that the Department's methodology for determining value was invalid because it had not established an administrative rule codifying the methodology. The court held that the lack of a rule detailing how the value was to be computed was not fatal to the Department's valuation. The Department must still compute a value, and the taxpayer is free to contest that determination as all other property owners may contest the value determined for their property.[14]

Legislature[15]

SB 1046: Corporate tax allocation; Sales factor. Laws 2012, Chapter 2. Allows multistate corporate income taxpayers the option to apportion sales from services based on the destination of their customers (market approach), rather than to the state where the greater portion of their income-producing activity occurred (income approach) based on costs of performance.

SB 1047: School tuition organizations; credits; administration. Laws 2012, Chapter 4. Establishes a new individual income tax credit for contributions to certified school tuition organizations, effectively doubling the amount of credit that individuals may take for contributions to school tuition organizations. Changes some of the definitions used in the existing individual and corporate income tax credits for contributions to school tuition organizations.

HB 2713: Long-term care insurance premiums; deduction. Laws 2012, Chapter 351. Provides that individuals who do not itemize their deductions may subtract long-term care insurance premium costs from their Arizona gross income and that, effective January 1, 2013, individuals may subtract certain amounts contributed to long-term health care savings accounts to the extent that the contributions are included in their federal adjusted gross income.

HB 2727: Public school tax refund check off. Laws 2012, Chapter 77. Allows individuals to designate any portion (rather than just all) of their Arizona income tax refund as a voluntary contribution for state aid to public schools.

SB 1214: Use tax declaration; repeal. Laws 2012, Chapter 143. Eliminates the requirement that individuals report their use tax liability on their Arizona individual income tax returns. Retroactive to January 1, 2012.

HB 2094: Prepaid wireless E911 excise tax. Laws 2012, Chapter 198. Levies a prepaid wireless telecommunications E911 excise tax at the rate of 0.8 percent of each vendor's gross income from the retail sale of prepaid wireless telecommunications service. The tax is to be administered by the Department using the same rules that govern the administration of sales taxes. Effective January 1, 2014.

SB 1229: Tax exemption; residential solar electricity. Laws 2012, Chapter 232. Establishes exemptions from the retail and utility classifications of Arizona's sales tax for income from sales or other transfers of renewable energy credits and a corresponding exemption from Arizona's use tax. Adds an exemption from the utility classification of Arizona's sales tax for income attributable to transfers of electricity by any retail electric customer owning a solar photovoltaic energy generating system to an electric distribution system if the electricity transferred is generated by the customer's system. Retroactive to January 1, 2007.

HB 2466: Local sales tax; payments; DOR. Laws 2012, Chapter 332. Allows taxpayers who are required to pay municipal sales taxes that are not collected by the Department to report and pay the taxes using a central online portal. The portal must be fully operational on or before January 1, 2015.

HB 1442: Prime contracting; manufacturing facilities; infrastructure. Laws 2012, Chapter 328. Requires the state to pay up to 80 percent of the cost of public infrastructure improvements constructed for the benefit of a new manufacturing facility that agrees to make a minimum capital of investment of $500 million in a county with a population of 800,000 persons or more or a minimum investment of $50 million in a county with a population of less than 800,000 persons.

SB 1279: Personal property tax; computer software. Laws 2012, Chapter 324. Clarifies that, while operating system software is considered part of the computer on which it is installed and, therefore, is subject to personal property tax, no other software shall be valued as personal property. Includes an intent clause, which provides that this provision is not intended to constitute a change in the law and shall not be used as a basis for a refund claim.

HB 2526: Skilled nursing home provider assessments. Laws 2012, Chapter 213. Imposes a "quality assessment" (tax) on healthcare items and services provided by nursing facilities in order to obtain additional federal funding for Arizona's Medicaid program, the Arizona Health Care Cost Containment System. The funds generated will be used to finance supplemental payments to nursing facilities for expenses covered by Medicaid. The tax may not exceed 3.5 percent of net patient service revenue and is calculated on a per resident-day basis.

HB 2486: Homeowners' rebate affidavit. Laws 2012, Chapter 350. Eliminates the requirement that homeowners sign an affidavit every other year declaring whether their home is their primary residence or leased to a relative and used as the relative's primary residence in order to maintain class three owner-occupied property tax status. Requires taxing authorities to create a separate form with simplified instructions for appeals involving the value of owner-occupied residential properties.

Endnotes

[1] *CNL Hotels and Resort, Inc. v. Maricopa County*, CV-11-0072-PR (7/3/12).
[2] *City of Peoria v. Brink's Home Security, Inc.*, 1 CA-TX 09-0001 (8/9/11).
[3] *Burlingame Industries, Inc. v. Maricopa County*, 1 CA-TX 10-0003 (8/23/11).
[4] *ADOR v. South Point Energy Center, LLC*, 1 CA-TX 10-0007 (12/13/11).
[5] *Val-Pak East Valley, Inc. v. ADOR*, 1CA-TX 10-0005 (3/13/12).
[6] *Microchip Technology Inc. v. State*, 1 CA-TX 11-0001 (5/31/12).
[7] *Southwest Airlines Co. v. Arizona Department of Revenue*, 1 CA-TX 11-0007 (7/26/12).
[8] *Virgin Mobile USA v. ADOR*, 1 CA-TX 11-0005 (8/2/12).
[9] *Church of the Isaiah 58 Project of Arizona Inc. v. La Paz County*, TX2011-000063 (8/8/11).
[10] *Ronald A. Yunis v. Maricopa County*, TX 2011-000048 (8/16/11).
[11] *Stainless Fixtures Inc. v. Arizona Department of Revenue*, TX2010-001171 (3/15/12).
[12] *City of Chandler v. Whitewing II, LLC*, TX2010-000828 (4/2/12).
[13] *3550 North Central Avenue LLC v. Maricopa County*, TX2011-000628 (4/19/12).
[14] *Sulphur Springs Valley Electric Cooperative Inc v. Arizona Department of Revenue*, TX2010-00398 (4/19/12).
[15] From "Summary of 2012 Arizona Tax Legislation" prepared by James G. Busby, Jr., Gallagher & Kennedy, P.A., used with written permission of the author.