ARIZONA TAX CONFERENCE
STATE AND LOCAL TAX UPDATE
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Arizona Supreme Court

***Mesquite Energy v. Arizona Department of Revenue,* CA 23-0016-PR (7/22/24).**

HELD: All property generated income included in appraisal formula

- Mesquite owns an electric generating power plant in Maricopa County. The Department of Revenue determined a $196 million statutory formula value for the Mesquite plant for the 2019 tax year. Mesquite appealed on the basis that the statutory value may have been calculated correctly, but that the value exceeded the plant's fair market value.
- The case went to trial and Mesquite's appraiser testified that the plant was worth only $105 million because any revenue the plant generated from a long-term power sales contract was excludable in determining value. The Department's appraiser testified the contract income should be included in the value determination, yielding a fair market value of $432 million. The plant sold for $556 million six months after the valuation date.
- The Tax Court accepted Mesquite's argument excluding the contract income and awarded Mesquite substantial expert witness costs and attorney fees. The Court of Appeals reversed ruling that the appraisal was incompetent valuation evidence because whether the plant sold power under a long-term contract or just on the spot market, it would have revenues that would be utilized in determining value under the income approach. The Court of Appeals noted the testimony of the recent plant purchaser that it used all the plant revenues in evaluating whether it would buy the plant (which it did at triple the Department's statutory value).
- The Supreme Court agreed with the Court of Appeals that all income should be included in the income approach to determining fair market value. Therefore, Mesquite's appraisal was incompetent evidence and thus did not overcome the Department's initial calculation of a $196 million value.
- Surprisingly, the Supreme Court remanded the matter back to the Tax Court with the instruction that Mesquite's appraisal was to be updated to include the

contract income, but then the appraiser could reduce from that determined value any value for the contract itself, an intangible asset.

- Finally, the Supreme Court denied an award of attorney fees to Mesquite because Mesquite failed to cite any statute that allowed for a fee award to the prevailing party in its petition for review (ouch).

Dove Mountain v. Arizona Department of Revenue, **CV 23-0176-PR (6/7/24).**

HELD: Gross receipts include payments from rewards program.

- The Ritz Carlton Dove Mountain Hotel participates in the Marriott Rewards Program. The Program allows Program members to accumulate points for many activities including staying at other Marriott affiliated hotels.
- Participating hotels such as the Ritz pay a certain amount to the Program each year, called remittances. When a Program member utilizes points to stay at the Ritz Carlton, the hotel submits a claim to the Program and the Program pays the hotel an amount based on a Program formula, called reimbursements. In some years, Ritz received more in reimbursements than it paid in remittances.
- Ritz considered the amounts received as reimbursement above what it paid in remittances as taxable gross receipts. However, Ritz requested a refund of the tax paid on the amounts of reimbursements below that amount, asserting everything equal to the remittances should be non-taxable.
- The question presented was whether the amount paid to the hotel as reimbursements constituted gross receipts subject to the Arizona transaction privilege tax. The Arizona Tax Court and Court of Appeals decided in favor of the Department.
- The Arizona Supreme Court, distinguishing a precedent involving trading stamp redemption, held that the amounts paid were part of the hotel's gross receipts. The Court reasoned that the tax extended to amounts received from providing transient lodging services, and the statutory definition of gross receipts did not distinguish who was paying for the transient lodging services. The Program paid for the Program member's hotel stay and thus the hotel had gross receipts that were subject to tax. The key distinction with the trading stamp redemption case was that the retailer in that case did not receive any additional payment when it provided merchandise to the customer in exchange for the customer presented trading stamps.

San Diego Gas v. Arizona Department of Revenue, **CA 23-0283-PR.**

Oral argument held 5/14/24, awaiting decision

- San Diego Gas and Electric Company owns an interstate electric transmission line that runs through Arizona to the Palo Verde Nuclear Generating Station in Western Maricopa County. Each year the Department of Revenue utilizes a statutory formula to determine a full cash value for the transmission line.
- For 2020, the company filed its valuation report with the Department and reported more in depreciation expense than it reported in original cost to construct the transmission line, resulting in a negative value.
- Part of the depreciation expense was an amount for future costs to remove the transmission line when it no longer was in service. The Department accepted the original cost and regular depreciation amounts but disallowed as a deducting the unspent future removal expense.
- The Company appealed and the Tax Court ruled in its favor concluding that the future expenses were to be included even if that resulted in a negative plant in service value. The Court of Appeals partially agreed that the future expenses were to be included, but that it could not result in a negative value. The Company petitioned for review arguing that all future expenses had to be included and there was no statutory authority for limiting the expenses at all, meaning the value could be negative (which then offset the value of construction work in process).

Arizona Court of Appeals

City of Tucson v. Orbitz Worldwide, Inc., **1 CA-TX 23-0001 (1/11/24) (Memorandum decision).**

HELD: City of Tucson tax ordinance did not apply to business activity of OTC.

- This case began in 2015 with litigation between numerous cities and several online travel companies, called OTCs. Travelers booking a room through an OTC receive one price that includes the amount paid to the hotel, taxes and fees, and also the OTC mark up.
- Various cities conducted audits of OTCs alleging they were “brokers” under the applicable city privilege tax codes. The cities impose two taxes on transient lodging, one (§444) on any person engaging in business from

operating a hotel and the other (§447) on the business activity of any hotel. The term "person" includes any "broker" in the city tax code.

- The OTCs litigated whether either tax applied leading to an Arizona Supreme Court decision in 2019 determining that §444 applied, but §447 did not apply to the OTCs business. The Court held §444 applied to "any person" engaged in the business of operating a hotel, but §447 didn't apply because it only applied to the business activity of the hotel itself – which is providing transient lodging. OTCs did not provide transient lodging.
- Tucson had assessed tax under §444 (which had a zero percent tax rate) and the city code 19-66, which had a six percent tax rate and applied to "every person who operates or causes to be operated a hotel." This was Tucson's alternative to §§444 and 447.
- The issue in the Court of Appeals was whether the language of city code 19-66 applied to the OTCs business activity. The Court found that the Supreme Court's reasoning did not apply to 19-66 because the language used in the ordinance deviated in important aspects from either §444 or §447.
- The Court held that the ordinance only applied to persons who operate or cause to be operated a hotel. Missing from the ordinance are the terms "business activity" or "business of," key ingredients in the Supreme Court's analysis of §§444 and 447.
- OTCs do not operate hotels or cause hotels to be operated. As a result, ordinance 19-66 does not apply to the OTCs activities.
- Tucson's Petition for Review denied by Arizona Supreme Court 6/25/24.

South Point Energy v. ADOR, **1 CA-TX 20-0004 (3/19/24) (OA 2/9/23)**

HELD: Privately owned power plant on reservation land subject to local property tax.

- South Point Energy filed eight tax year lawsuits contesting the ability of Mohave County to levy a property tax against the electric generating equipment South Point owns located on reservation land in Mohave County. South Point claimed it was categorically immune from taxation due to its reservation land location.
- The Court of Appeals agreed to categorial immunity in a 2021 decision, but that decision was vacated in part by the Supreme Court in 2022. On remand the Court of Appeals was to determine if the property was immune after applying a balancing test – called *Bracker* interest balancing. The test focuses

on the federal, tribal and state interest to determine if a proposed tax cannot be applied to an activity occurring on reservation lands.

- The Court of Appeals cited numerous United States Court of Appeals for the Ninth Circuit decisions regarding Arizona taxes have applied *Bracker* to conclude that a state tax was valid.
- The Court of Appeals concluded that neither the federal nor tribal interests outweighed the state's interest in property taxation of non-tribal owned property located on reservation land. The Court noted there is no legal principle that would authorize Indian tribes to market an exemption from state taxation to persons who would normally do their business elsewhere.
- Southpoint filed a Petition for Review in the Arizona Supreme Court 5/20/24.

RockAuto, LLC v. ADOR, **1-CA-TX23-0002(4/2/24) (Memorandum Decision)**

HELD: Online auto parts retailer had sufficient contact for taxation.

- RockAuto is an online automotive parts dealer based in Wisconsin. RockAuto fulfills orders through several suppliers located throughout the United States, including six suppliers located in Arizona. RockAuto maintained no inventory, but instead directed its suppliers to send parts to customers after receiving online orders.
- A RockAuto customer went to the Town of Gilbert tax department with a RockAuto package and complained that they were not being charged sales tax!
- The Department of Revenue then audited assessed $8 million in transaction privilege tax, interest and penalty for sales made to Arizona residents.
- The sole issue on appeal was whether RockAuto had sufficient connection to the State of Arizona for the State to have the authority to impose tax. The period involved in the assessment predates the U.S. Supreme Court's 2018 decision in *Wayfair*. Thus, the Court applied the substantial nexus test, requiring physical presence in the state.
- The Court focused on whether the suppliers' in-state activities were significantly associated with RockAuto's ability to establish and maintain an Arizona market. The Court concluded that the test was met because RockAuto utilized the suppliers to fulfill contractual obligations (provide auto parts to customers). Additionally, RockAuto sent employees to Arizona to meet with suppliers on a routine basis.
- RockAuto filed a Petition for Review in the Arizona Supreme Court on 5/2/24.

Agua Caliente Solar v. Department of Revenue, **CA-TX 20-0007 (5/14/24).**

HELD: Federal income tax credits not yet utilized are still deducted in solar equipment valuation formula.

- Agua Caliente Solar operates a solar-electricity power-generation facility. The facility is valued by the Department of Revenue utilizing a statutory formula. The formula utilizes taxable original cost, a term that takes solar equipment's original cost and subtracts the value of any federal income tax credits earned.
- Agua obtained federal income tax credits for building the facility. The Department only utilized in its taxable original cost calculation the tax credits that were applied to a federal income tax liability by one of Agua's owners. The issue decided by the Court of Appeals was whether the tax credits that had yet to be applied, because the other Agua owner did not have any federal income tax liability, should also be counted in the formula.
- The Court's analysis was that the statutory language says "value" of the tax credits, which was a set sum whether the credits had been utilized by Agua's owners or not. This rationale also recognized that the tax credits are determined at a fixed point in time, in a set amount, depending on the solar company's investment in constructing a facility. Nothing in the valuation formula suggests that the "value" was dependent on any other circumstances, like whether there was a federal income tax liability to be offset.
- No Petition for Review was filed in the Arizona Supreme Court.