



2022 ARIZONA TAX UPDATES

2.5% FLAT TAX
TRANSACTION PRIVILEGE TAX UPDATES
PROPERTY TAX UPDATES
INCOME TAX AND MISC.

ARIZONA TO IMPLEMENT 2.5% FLAT TAX AHEAD OF SCHEDULE

Governor Doug Ducey announced that Arizona will implement its new 2.5% flat income tax rate on January 1, 2023, a full year ahead of schedule. According to Gov. Ducey, the accelerated implementation is the result of the state's "continued economic growth and record surplus."

The flat tax was adopted as part of the 2022 fiscal year budget, signed on June 30, 2022, and was originally scheduled to be phased in over three years, beginning January 1, 2024. However, a memo prepared by the Joint Legislative Budget Committee and the Governor's Office of Strategic Planning and Budgeting determined that Arizona's General Fund revenues exceed the statutory threshold required to immediately implement the flat tax.

State income tax rates in Arizona currently range from 2.59% to 4.5%. Come January 1st, the rate will be 2.5%. According to the Tax Foundation, Arizona will join 11 other states with a flat income tax, and will have the lowest rate among these states.

Links to sources:

https://azgovernor.gov/sites/default/files/accelerated_tax_relief_for_arizona_families_letter.pdf

<https://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/>

TRANSACTION PRIVILEGE TAX UPDATES LEGISLATION

Senate Bill 1168, Chapter 343. Short-Term Vacation Rentals. This bill imposes a penalty on online lodging operators who rent or offer for rent lodging without a current transaction privilege tax license number listed on the advertisement, including online lodging marketplace postings. The penalty is \$250 for the first offense and \$1,000 for each subsequent offense. The Department of Revenue is also permitted to suspend the operator's transaction privilege tax license for up to one year in the event of three or more violations relating to the same rental property within a 12-month period.

Senate Bill 1372, Chapter 43. Motor Vehicle Sales to Non-Residents. This bill adds an exemption under the retail classification for sales of motor vehicles to non-residents of Arizona if the vehicle, trailer, or semitrailer has a gross vehicle weight rating of more than 10,000 lbs. and it is used to transport property in furtherance of interstate commerce.

Senate Bill 1579, Chapter 235. Tax Corrections Act of 2022—Defines “Renewable Energy.”

In addition to numerous technical corrections, this bill defines “renewable energy” for purposes of the deduction for proceeds from contracts to construct “mixed waste processing facilities” under the prime contracting classification. A solid waste facility for treating, processing or disposing solid waste and recyclable waste, constructed for the purpose of recycling waste or producing renewable energy. “Renewable energy” means usable energy, including electricity, fuels, gas and heat, produced through the conversion of energy provided by sunlight, water, wind, geothermal, heat, biomass, biogas, landfill gas, or other non-fossil renewable resource.

Senate Bill 1636, Chapter 229. Motor Vehicle Inventory and Use Tax. This bill clarifies that “motor vehicles that are removed from inventory” are subject to monthly use tax at 1/39th of the value of the vehicle if it is returned to inventory within one year and subject to use tax on the entire price if removed from inventory for more than one year. The bill further clarifies that motor vehicle dealers do not owe use tax on vehicles that are available for sale.

House Bill 2871, Chapter 321. Agricultural Equipment and Containment Structures. This bill expands the retail classification deduction for certain new machinery and equipment used for commercial agricultural production to include both new and used equipment and certain off-highway vehicles. The bill also defines the term “containment structure” as used in the deduction for machinery and equipment used in certain industries to comply with certain environmental regulations, and the deduction under the prime contracting classification for the installation of such structures. The bill eliminates the requirement that only leases for two or more years of new agricultural equipment are exempt under the personal property rental classification.

2022 COURT DECISIONS

State v. Tunkey, No. 1 CA-TX 21-0006 (Apr. 19, 2022). Taxpayers personally liable for unpaid transaction privilege taxes even though deficiency notice not issued to Taxpayers first.

Affirming the Tax Court, the Court of Appeals held that the Department of Revenue was not required to assess the taxpayers personally before it could bring a collection action against them for unpaid transaction privilege taxes incurred in the taxpayer's operation of their business. The taxpayer's business, a sandwich shop, had collected taxes from its customers and filed returns with the Department of Revenue, but failed to pay the taxes owed. The Court of Appeals concluded that under the standard set by *Ariz. Dep't of Revenue v. Action Marine, Inc.*, 218 Ariz. 141 (2008), the Department of Revenue could initiate a collections action pursuant to A.R.S. §§ 42-5028 and 42-1108 against corporate officers or directors of a business that collected but did not remit tax without issuing a deficiency notice because the business had admitted collecting and owing the taxed by filing monthly transaction privilege tax returns.

Ute Mountain v. Arizona Department of Revenue, 1 CA-TX 22-0004 (January 10, 2023). Construction on Indian Reservation where contract was with the Federal government is taxable.

Ute Mountain Tribe had a construction company that had contracts with the Federal Government for construction work on the Navajo and Hopi Reservations. Court applied the long-standing *Blaze* Supreme Court case, which held that a contract with the Federal government for work on an Indian reservation is not preempted by *Bracker* and the *Bracker* balancing test is not to be applied. *Bracker* is proper only when the proceeds at issue derive from a nontribal entity's direct transaction with the tribe or tribal members.

2022 DEPARTMENT OF REVENUE GUIDANCE

THE FOLLOWING DEPARTMENT OF REVENUE STATEMENT ACCOMPANIES ALL PRIVATE TAXPAYER RULINGS:

"This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this taxpayer ruling is the present position of the department. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position."

Transaction Privilege Tax Ruling TPR 22-1 (May 10, 2022). Imposition of transaction privilege tax on activities performed on Native American Indian reservations.

This ruling discusses and provides examples for the application of the exemptions in A.R.S. § 42-5122, which apply to certain transactions that involve Native American tribes, tribally owned businesses, tribal entities, or affiliated tribal members. The ruling supersedes and rescinds Arizona Transaction Privilege Tax Ruling TPR 95-11. A.R.S. § 42-5122 was enacted in 2021 and codified the exemption of such transactions as were previously recognized in TPR 95-11.

PROPERTY TAX UPDATES

LEGISLATION

Senate Bill 1093, Chapter 171. Further Reductions to Class One Assessment Ratio. This bill further extends the 0.5% annual reduction in the assessment ratio through 2027. The assessment ratio for Class One property is 17.0% for 2023 and was scheduled to reduce to 16.0% by 2025. Under this bill, the assessment ratio will further reduce to 15.0% by 2027.

Senate Bill 1095, Chapter 341. Property Tax Exemption for Disabled Veterans. This bill establishes a statutory property tax exemption for certain veterans with disabilities.

Senate Bill 1265, Chapter 17. Notice of Property Tax Lien and Foreclosure. Under this bill, purchasers of property tax liens who send a timely notice of intent to file an action to foreclose the owner's right to redeem the lien to the owner's mailing address, the property's address, and the mailing address of the tax bill do not also have to send notice to the county treasurer. The bill also requires that such notices include the county assessor's description of the property rather than the legal description.

Senate Bill 1266, Chapter 228. Electronic Affidavits. This bill allows property owners claiming a tax exemption to file an electronic affidavit with the county assessor. Taxpayers are also permitted to file a notice of claim electronically. County assessors are required to provide electronic receipts for such filings.

Senate Bill 1267, Chapter 300. Change in Use of Residential Property. This bill clarifies that for single-family residences, a change in use for purposes of setting limited property value must be a physical, objectively-verifiable change and not merely a change in occupancy or classification. Reverses the *Qasimyar, et al. v. Maricopa County* case (2021 Court of Appeals) (holding that a change from the rental to owner occupied classification was a change in use that triggered "Rule B")

Senate Bill 2320, Chapter 261. Classification of Veterans' Organization Property. Under this bill, real property and improvements, including furniture and equipment, that are leased to and used exclusively by a U.S. veterans' organization that is a I.R.C. Section 501(c)(3) or 501(c)(19) charitable organization that operates a veterans' post on the premises for the entire valuation year are Class Nine property (1% assessment ratio).

House Bill 2610, Chapter 287. Affordable Housing Exemption. This bill eliminates the 200-unit cap on affordable housing projects that may qualify for a property tax exemption.

House Bill 2629, Chapter 69. Expiration of Property Tax Liens. This bill extends the time period for county treasurers to notify purchasers of property tax liens that those liens are going to expire. From 30 to 60 days before expiration to within 365 days. The bill also permits county treasurers to send such notifications by e-mail.

House Bill 2822, Chapter 103. 2.5% Full Cash Value for Personal Property. This bill sets the full cash value of specified business and agricultural personal property initially classified during or after tax year 2022 at 2.5% of the property's acquisition cost.

House Bill 2866, Chapter 317. K-12 Equalization Assistance Repeal. This bill repeals the state K-12 education equalization assistance property tax.

Senate Concurrent Resolution 1011. Constitutional Property Tax Exemptions. This resolution consolidates existing property tax exemptions into a single section of the Arizona Constitution and adds a discretionary property tax exemption for the property of honorably discharged disabled veterans who are Arizona residents. The resolution also authorizes the legislature to update the qualifications for and determine the amounts of current discretionary exemptions. The resolution was approved by Arizona voters in the November 2022 election.

COURT CASES

***South Point Energy Center LLC v. Ariz. Dep't of Revenue*, No. CV-21-0130-PR (Apr. 26, 2022).** **Indian Reorganization Act of 1934 does not expressly preempt Mohave County's ad valorem property tax imposed on an on-reservation power plant.** Reversing the Court of Appeals, the Arizona Supreme Court held that an ad valorem property tax imposed on a power plant located on the Fort Mojave Indian Reservation was not expressly preempted by the Indian Reorganization Act of 1934. The Court concluded that the rights included in the federal government's ownership of the reservation land, which were expressly preempted from any state taxation, did not include the real property improvements, which were owned by the non-Indian taxpayer under the terms of the lease. The Court remanded the case to the Court of Appeals for further consideration of whether the ad valorem property tax was nonetheless preempted under the balancing test articulated by the U.S. Supreme Court in *White Mountain Apache Tribe v. Bracker*, 448 U.S. 136 (1980).

***Nayeri v. Mohave County*, 1 CA-TX 21-0001 and 21-0002 (consolidated) (Ct. App. Feb. 3, 2022).** **Award of attorney's fees appropriately granted.** The Court of Appeals affirmed the Tax Court's award of attorneys' fees to the taxpayer following its grant of summary judgment in the taxpayers' favor. The underlying case involved multiple taxpayers, all represented by the same attorney, and the sale of delinquent tax liens. One of the parties subsequently settled its case. The Court of Appeals held that the award of fees was appropriate because the County did not demonstrate that the taxpayer's request for fees included work performed solely for the party who had settled its case.

***Mesquite Power, LLC v. Ariz. Dep't of Revenue*, 1 CA-TX 22-0002 (Dec. 20, 2022).** The Court of Appeals vacated and remanded this case back to the Tax Court, where the Tax Court had reduced the full cash value of the taxpayer's centrally-valued power plant for the 2019 property tax year. Although power plants are valued according to a statutory formula based on cost, the formula's value cannot exceed "market value." The taxpayer argued that the statutory value exceeded the market value and should be reduced by the value of a power purchase agreement, which is a nontaxable intangible. The Taxpayer's appraiser essentially reduced the statutory value by the value of the power purchase agreement. The Court of Appeals held that where intangible assets such as a valid power purchase agreement enhance the value of real and personal property, a competent appraisal must consider the effect of such intangible assets on the property's value. The Court found that the Department of Revenue's appraisal appropriately considered the effect of the power purchase agreement on the plant's value, that the taxpayer had misattributed the value of taxable property to the power purchase agreement, that the power purchase agreement enhanced the value of the plant, and that the taxpayer's expert testimony was incompetent.

INCOME TAX UPDATES LEGISLATION

Senate Bill 1264, Chapter 41. Annual Internal Revenue Code Conformity. This bill provides for conformity to the Internal Revenue Code in effect on January 1, 2022 for tax years beginning on or after January 1, 2022. It also provides for conformity to the PPP Extension Act of 2021 (Public Law 117-6) and the Infrastructure Investment and Jobs Act (Public Law 117-58) for the 2021 tax year.

Senate Bill 1579, Chapter 235. Annual Tax Corrections Act. Among numerous technical changes, this bill also makes the following substantive changes to Arizona income tax laws.

1. Fantasy Sports Prize Winnings Treated as Wages for withholding. The bill requires withholding for payments of prize winnings by fantasy sports contest operators and event wagering operators as though they were the payment of wages.
2. Further Detail for Pass Through Entities Electing to be Taxed at the Entity Level.
3. The bill also requires additional detail regarding taxable income calculations for partnerships and S-corporations that elect to be taxed at the entity level. It clarifies that taxpayers who elect to file Arizona small business income tax returns may not add or subtract certain items on their individual income tax returns that were properly taken on the Arizona small business income tax return.
4. Healthy Forest and Qualifying Environmental Technology Tax Credits Repealed. The bill repeals the individual and corporate income tax credits for net increases in qualified employment positions by a healthy forest enterprise. It also repeals the corporate income tax credit for expenses incurred in building a qualifying environmental technology manufacturing, producing, or processing facility.
5. Partners Cannot Claim Corporate Tax Credit for Pollution Control Equipment. The bill further clarifies that partners in a partnership that is not a corporation cannot claim a portion of the corporate income tax credit for pollution control equipment.
6. Adds Credit Against Estate and Trust Taxes for Taxpayers in a Pass Through Entity Taxable at the Entity Level. Finally, beginning with the 2022 tax year, the bill adds a credit against the taxes applied to estates and trusts for taxpayers that are partners in a partnership or shareholders in an S-corporation that elects to pay Arizona income tax at the entity level.

House Bill 2156, Chapter 387. New Refundable Motion Picture Tax Credits. Effective January 1, 2023, this bill adds a refundable individual and corporate income tax credit against the costs of motion picture production activities in Arizona that are subject to state taxation. The credit starts at 15% - 20% of qualifying production costs based on expenditure thresholds. The percentage increases for companies that hire Arizona residents, use qualifying in-state production facilities, film primarily in Arizona, or produce and film in association with a long-term tenant of a qualifying production facility. The credit requires pre- and post-approval by the Arizona Commerce Authority.

House Bill 2204, Chapter 369. Adds Subtraction for “Airdropped” Virtual Currencies and Non-Fungible Tokens. Effective January 1, 2023, this bill adds a subtraction from Arizona gross income for the value of virtual currencies and non-fungible tokens received via an “airdrop” (i.e., the mass distribution of virtual currency or non-fungible tokens for free to promote widespread usage) at the time of the airdrop, to the extent that such amounts were not already excluded by the Internal Revenue Code. The bill also permits taxpayers to subtract the fees paid for the use of a network to facilitate purchases, sales, or exchanges of virtual currencies and non-fungible tokens (commonly called “gas fees”) when determining the gain or loss on the sales of such virtual currencies and non-fungible tokens.

House Bill 2693, Chapter 385. CPI Adjustments for Tax Credits for Contributions to Charitable Organizations. This bill requires an annual adjustment, starting January 1, 2023, to the maximum amount of the individual income tax credit taxpayers may claim for a contribution to a qualifying charitable organization or qualifying foster care charitable organization, based on a consumer price index. Retroactive to January 1, 2022, the bill also modifies the definitions of “qualifying foster care charitable organization,” “qualified individual,” and “services.”

House Bill 2871, Chapter 321. Distributions by Partnerships and S-Corporations Electing to be Taxed at Entity Level Subject to Tax at Individual Rates. This bill requires that partners and shareholders of businesses that are treated as partnerships or S-corporations for federal income tax purposes and who consent to being taxed at the entity level for Arizona income tax purposes pay Arizona income tax at the same rates as applicable to individual income taxpayers.

House Concurrent Memorial 2004. Opposing Burdensome Reporting Requirements for Peer to Peer Payment Apps, etc. Exceeding \$600. The Arizona House passed a memorial urging the U.S. Congress to “oppose the burdensome reporting requirements included in the Biden administration’s tax increase proposal for fiscal year 2022.” The memorial is targeted at the requirement that peer-to-peer payment transaction apps, banks, and other financial institutions annually report data to the Internal Revenue Service on all aggregate inflows and outflows exceeding \$600.

ARIZONA DEPARTMENT OF REVENUE RULINGS, DECISIONS, ETC.

Decisions of Hearing Officer Case No. 202100028-I and Case No. 202100029-I (Jan. 27, 2022). Hearing Officer Upheld DOR Income Tax Assessment Based on Bankruptcy Court’s Validation of IRS Proofs of Claim. In these two related cases, the Department issued proposed adjustments to two Taxpayers that resulted from adjustments made by the Internal Revenue Service to the Taxpayers’ federal returns. The Taxpayers each timely protested the Arizona assessments, arguing that (1) their due process rights were violated; (2) the assessments improperly combined the Taxpayers’ personal tax liability with an LLC they operated; (3) the returns omitted certain deductions and credits to which the Taxpayers were entitled; (4) both Taxpayers (who were spouses) filed personal bankruptcy petitions, and that these were relevant to the assessments and not yet resolved; and (5) the IRS abated the federal liability. The Hearing Officer concluded that the Taxpayers failed to provide evidence to support his first three claims. The Hearing Officer further concluded that it was clear that the Federal Bankruptcy Court reviewed and validated the IRS proofs of claim in its order dated February 7, 2019, and that the Arizona Department of Revenue used this same liability in the assessments it issued. The Hearing Officer then upheld the assessment.

APPELLATE CASES

There were no income tax cases in 2022.

MISCELLANEOUS TAX UPDATES LEGISLATION

House Bill 2871, Chapter 321. Aircraft License Tax Annual Increases Limited to CPI; Tax System Modernization Project Established; Increases State Payment for Public Infrastructure for New Manufacturing Facilities. This bill limits the annual percentage change in the average fair market value used for purposes of determining the annual aircraft license tax to the annual percentage change in the consumer price index. The change is retroactive to July 1, 2021. For fiscal year 2021-2022, the bill sets an aircraft's value to the average fair market value of the aircraft in 2019 and allows a credit towards future registration fees for fees paid in 2021-2022 before the change went into effect.

The bill also establishes the Tax System Modernization Project Advisory Committee and allocates funds from Arizona's transaction privilege tax for education to the Integrated Tax System Project Fund. It requires counties, municipalities, government councils, and regional transportation authorities to contribute to the Fund.

Finally, the bill increases the maximum amount that the state may pay to help finance public infrastructure improvements made to support new manufacturing facilities from \$50 million to \$100 million

ARIZONA DEPARTMENT OF REVENUE RULINGS, DECISIONS, ETC.

Arizona Luxury Tax Notice Joint TPN 22-1/LTN 22-1 (Aug. 23, 2022). Reminder for Remote Sellers of Luxury Products. This notice serves to remind all out-of-state sellers of products subject to luxury tax (i.e., alcohol and tobacco products) of the following:

- Remote sales of tobacco products, other than cigars and pipe tobacco, can only be made to licensed tobacco distributors or retailers.
- Economic nexus thresholds apply to the retail sale of tobacco products into Arizona for TPT purposes. While vape and CBD products do not generally contain tobacco and are generally not subject to luxury tax, economic nexus thresholds still apply to the retail sale of vape and CBD products into Arizona for TPT purposes.
- If a remote seller of tobacco, CBD, or vaping products exceeds the economic threshold requirements, it will be required to file and remit TPT on those sales.
- A remote seller remains restricted to tobacco delivery sales of pipe tobacco and cigars when made directly to Arizona retail customers.
- Without exception, five types of Arizona liquor licenses are permitted to take orders via the internet and ship liquor to a private residence or non-liquor licensed business in Arizona. Each of these license types require the seller to obtain a standard TPT license and remit applicable TPT to Arizona without regard to economic nexus. As such, all sellers of liquor into Arizona will be deemed to have nexus with Arizona and will not be considered remote sellers.

APPELLATE CASES

State of Ariz. E.S.A. Tax Unit v. On-Auk-Mor Trade Center, LLC, No. 1 CA-TX 21-0005 (Apr. 28-2022). **Arizona limited liability company owned by tribal member and doing business on-reservation subject to Arizona’s unemployment insurance tax.** On-Auk-Mor, LLC (“OAM”) was a limited liability company, organized under Arizona law, whose sole member was a trust whose sole beneficiary was an enrolled member of the Salt River Pima-Maricopa Indian River Community. OAM conducted business solely within the Community’s reservation, and its sole member/beneficiary lived on the reservation. After a former employee of OAM filed an unemployment insurance claim with the Arizona Department of Economic Security, the Department found OAM was liable for Arizona unemployment insurance taxes. Affirming the tax court, the Arizona Court of Appeals held that because OAM is an LLC organized under Arizona law, is taxed as a corporation for unemployment insurance tax purposes, and is not an enrolled member of the Community, it is subject to Arizona’s unemployment insurance tax.

TAX PRACTICE

As tax laws continue to evolve, individuals and companies face greater obligations for enforcement and transparency – with higher stakes than ever before. Our deep bench of tax lawyers provide practical, comprehensive counsel across the full spectrum of tax-related matters, helping to minimize risk and ensure optimal accounting, forecasting, and profitability.

The firm's tax lawyers provide counseling across the full range of state and local tax implications for business transactions, including multistate income tax responsibilities as well as sales and use tax collection obligations. Our experienced litigators represent clients in all aspects of tax controversy and disputes before state and local administrative agencies, the IRS, state tax or superior courts, the courts of appeals, and the United States Supreme Court. We also structure, negotiate, and provide tax analysis and guidance in connection with a wide variety of corporate and individual transactions.

STATE AND LOCAL TAXATION

The firm's tax lawyers provide counseling across the full range of state and local tax implications for business transactions, including multistate income tax responsibilities as well as sales and use tax collection obligations. Our experienced litigators represent clients in all aspects of tax controversy and disputes before state and local administrative agencies, the IRS, state tax or superior courts, the courts of appeals, and the United States Supreme Court. We also structure, negotiate, and provide tax analysis and guidance in connection with a wide variety of corporate and individual transactions.

STATE AND LOCAL TAX LITIGATION

Our experienced tax litigators represent clients in all aspects of tax controversy and litigation before state and local administrative agencies, the Internal Revenue Service, state tax or superior court, the courts of appeals and the Supreme Court. Our tax litigators have broad commercial litigation and tax litigation experience. Pat Derdenger, served in the tax division of the US Department of Justice and has more than 35 years of tax litigation experience, including property tax, sales and use tax and income tax litigation. The combination of our trial litigation skills and up-to-date tax experience allows us to take on the most challenging cases and achieve results for our clients.

We have experience in all aspects of tax controversy and litigation, including:

- 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 originals actions in court
- Negotiating litigation settlements
- Trying cases in court
- Arguing appeals in state appellate courts

In addition to our litigation experience - our lawyers 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 - our tax department has diverse and extensive experience, including:

- Constitutional tax matters
- Corporate tax, partnership tax
- Combined and consolidated state returns
- Multistate income tax issues
- Nexus issues
- Property tax matters
- Sales and use tax
- Tax-exempt organizations

CONSTRUCTION AND HOMEBUILDER TAX ISSUES

Our lawyers represent construction contractors, both general and subcontractors, and homebuilders on a wide array of federal, state and local tax issues, including construction manager tax issues, hospital construction projects and issues dealing with the installation of exempt machinery and equipment. We also advise and work with homebuilders on the marketing arm-contracting arm structure used in Arizona for state transaction privilege tax purposes, as well as assist real estate developers with the Arizona “speculative builder” tax.