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ARIZONA

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ARIZONA

I. INCOME TAX

A. Legislation

1. ***Senate Bill 1046 - Ariz. Rev. Stat. Ann. § 43-1147(B)***

   a. "Multistate service providers" may elect to source sales of services for sales factor purposes based on where the customer received the benefit of the service (market-based sourcing), rather than the state where the greater portion of the income-producing activities were conducted, based on costs of performance.

   b. A "multistate service provider" is a taxpayer that derives more than 85 percent of its sales from services provided to purchasers who receive the benefit of the service outside Arizona in the tax year of the election.

   c. The election is available beginning on or after December 31, 2013, and will be phased in between 2014 and 2017.

      i. The phase-in permits the use of market-based sourcing for 85 percent of service sales in 2014, 90 percent of service sales in 2015, 95 percent of service sales in 2016, and 100 percent of service sales thereafter.

   d. The election must be made on a timely filed original income tax return, and is binding for five consecutive tax years.

      i. The election may be terminated with the Department of Revenue's permission or without its permission on the acquisition or merger of the electing taxpayer.

B. Litigation and Private Letter Rulings

1. ***Harris Corp. v. Ariz. Dep't of Revenue, 233 Ariz. 377 (App. 2013)***
   First Data Corp. v. Ariz. Dep't of Revenue, 233 Ariz. 405 (App. 2013)

   a. The Court of Appeals held in *Harris Corp.* and confirmed in *First Data Corp.* that the definition of apportionable business income for Arizona purposes contains both a transactional and a functional test, and that the business income test does not contain a liquidation exception.

   b. Taxpayers' Petitions for Review to the Arizona Supreme Court were both denied.

2. ***Home Depot USA, Inc. v. Ariz. Dep't of Revenue, 233 Ariz. 449 (App. 2013)***

   a. Home Depot formed a wholly-owned subsidiary to hold all of its trademarks, trade names, and services marks. The subsidiary licensed these intangibles to Home Depot in exchange for royalty fees. The subsidiary engaged in no other business activity.

b. The Court of Appeals held that Home Depot and its subsidiary were engaged in a unitary business and required the subsidiary to be included in Home Depot's combined unitary return.

c. Taxpayer's Petition for Review to the Arizona Supreme Court was denied.

3. ***Arizona Corporate Income Tax Ruling CTR 12-1 – Elective Consolidated Returns***

a. An affiliated group of corporations which files a federal consolidated return may elect to file a consolidated Arizona income tax return. The election to file a consolidated return is binding on all succeeding taxable years, unless the Department of Revenue consents to a change in filing method.

b. Carry forward of net operating losses incurred before consolidation are limited.

i. Net operating losses may be carried forward only to the extent of that portion of the consolidated income related to the business unit which incurred the prior loss.

ii. When a group of corporations files a consolidated return reporting a net operating loss and one or more corporations cease to be a member of the affiliated group, only that portion of the consolidated loss related to the remaining members of the affiliated group may be carried forward against subsequent income of the consolidated group.

c. The $50 minimum tax is imposed on the single return rather than on each corporation in the group.

d. A single apportionment formula is applied against all of the business income of the affiliated group as if it were a single taxpayer. All Arizona property, payroll, and sales of the affiliated corporations will be included in the numerator of the relevant apportionment factors regardless of whether each of the corporations had nexus within the state on a separate basis.

e. Newly acquired subsidiaries included in the consolidated federal return are considered to have waived any objection to filing a consolidated Arizona return by their consent to the filing of a consolidated federal return.

f. When an affiliated group includes an exempt insurance company, the insurance company's income and/or loss and apportionment factors are excluded from the Arizona consolidated return.

4. ***Arizona Corporate Income Tax Ruling CTR 12-2 – Elective Consolidated Returns***

a. All members of the affiliated group, including subsequently sold subsidiaries, who are included in an Arizona consolidated tax return for a given year are jointly and severally liable for tax, penalties, and interest of the affiliated group for that year.

b. A mere change in identity, form, or place of organization of the parent does not create a new affiliated group.

5. ***Taxpayer Information Ruling LR13-004***

Proceeds from a patent infringement lawsuit are business income for Arizona corporate income tax purposes where the regular trade or business operations of the patent holder include developing, acquiring and holding patents, and earning income by using patents in manufacturing products or licensing patents to third parties.

6. ***Arizona Individual Income Tax Ruling ITR 13-2***

a. Nonresident individuals who are partners of a partnership or are shareholders of an S corporation may elect to join in the filing of a composite individual income tax return with other nonresident partners or shareholders under the following circumstances:

i. Individuals must be nonresidents of the state for the full taxable year.

ii. Individuals (and their spouses) may have no income from Arizona sources other than his or her distributive share of S corporation or partnership income allocable to Arizona.

iii. Deceased members may not be included in the composite return.

iv. All members included in the composite return must have the same tax year for income tax purposes.

II. SALES & USE TAX

A. Legislation

1. ***HB 2111, effective January 1, 2015***

a. *Sourcing Rules – Ariz. Rev. Stat. Ann. § 42-5040* – Clarifies that retail sales of tangible personal property are sourced (1) to the seller's business location if the seller receives the order at a business location within Arizona, or (2) to the purchaser's location within Arizona if the seller receives the order at a business location outside Arizona. Gross receipts from leasing or renting tangible personal property are sourced (1) to the lessor's business location if the lessor has a business location within Arizona, or (2) to the lessee's address if the lessor does not have a business location within Arizona.

b. *Repeal of Exemptions – Ariz. Rev. Stat. Ann. § 42-5061(A)(14)* – Eliminates the sales tax exemption for sales of tangible personal property to nonresidents of Arizona for use outside Arizona if the vendor ships or delivers the tangible personal property from Arizona. This exemption is maintained for sales of motor vehicles.

2. ***House Bill 2336 – Cash Equivalents – Ariz. Rev. Stat. Ann. § 42-5061(A)(21)***

a. Exempts the sales of "cash equivalents" from the retail sales tax. Cash equivalents include money orders, traveler's checks, gift certificates, stored value cards, and gift cards. Cash equivalents do not include (1) items or intangibles that are sold to one or more persons, through which a value is not denominated in money, and (2) prepaid calling cards or prepaid authorization numbers for telecommunications service.

b. The exemption applies retroactively to taxable periods beginning on or after December 31, 1998.

c. Any claim for refund based on the retroactive application of HB 2336 must be submitted on or before December 31, 2013, and is capped at $10,000.

3. ***House Bill 2324 – Exemption for commercial leases between affiliated businesses – Ariz. Rev. Stat. Ann. § 42-5069(C)(5)***

Broadens the sales tax exemption for commercial leases between affiliates to include limited liability companies and other business entities that are 80-percent or more commonly owned, either directly or indirectly. Prior law offered the exemption only to affiliated corporations. The exemption is effective September 13, 2013 for state purposes, and July 1, 2013 for municipal purposes.

B. Litigation and Private Letter Rulings

1. ***Home Depot USA, Inc. v. Ariz. Dep't of Revenue, 230 Ariz. 498 (App. 2012)***

Home Depot made sales to certain customers who made purchases with credit cards. A credit card financing company remitted the amount of the sale to Home Depot, less a service fee to cover the cost of potential bad debts. Home Depot argued that because the service fee was to cover the cost of anticipated bad debts, it was entitled to a bad debt deduction in the amount of the service fee. The Court of Appeals rejected this argument, holding that only the vendor who is owed a bad debt—in this case the credit card financing company— may claim a bad debt deduction.

2. ***City of Chandler v. Whitewing II, LLC, 1 CA-TX 12-0008 (App. 2013)***

a. Taxpayer was assessed a city speculative builder sales tax on the sale of subdivided land used to develop residential property. Taxpayer acquired land and removed existing tangible personal property, then subdivided the land and sold the individual vacant lots.

b. The taxpayer argued that he did not sell improved real property subject to the speculative builder sales tax because taxpayer only removed existing improvements, and did not add new improvements to the land.

c. The court held that by preparing the land for subdivision, sufficient improvements were made to subject the taxpayer to the tax.

d. This is an unpublished memorandum decision. Taxpayer's Petition for Review to the Arizona Supreme Court was denied.

3. ***Private Taxpayer Ruling LR13-002***

Computer backup and restoration offerings were subject to tax as the rental of tangible personal property. The computer backup and restoration involved the use of software, which was tangible personal property, and the customers had sufficient control over the software to be considered renting the software.

4. ***Private Taxpayer Ruling LR13-005***

Online employment application and employee selection offerings involved renting tangible personal property in the form of prewritten software. The taxpayer provided its customers with a customized internet web portal which displayed the employment opportunities for its customer's prospective employees. The customers had the ability to edit and modify job descriptions, and select certain behavioral assessment questions posed to applicants. The taxpayer automatically produced on-line reports which summarized and analyzed the applicant's responses to such questions. Since the customers exercised sufficient possession and control of the software to constitute a rental of the software, the rental was subject to tax.

5. ***Private Taxpayer Ruling LR13-006***

a. Cloud computing business offerings were rentals of tangible personal property because the software used was tangible personal property. The customer's possession and control over the software was sufficient to constitute a taxable rental.

b. Online data storage business offerings were nontaxable services because they involved only the provision of storage capacity, and did not provide customers sufficient control or possession of the software to constitute a rental.

c. The Department noted that because the taxpayer engaged in the rental of tangible personal property as a result of its cloud computing offerings, the taxpayer must demonstrate that its data storage activities exist as a separate line of business from the cloud computing business to be excluded from taxable gross receipts of the cloud computing business.

III. PROPERTY TAX

A. Legislation

1. ***Proposition 117 – Cap on Increases of Real Property Valuation***

a. By constitutional amendment, annual increases in property value are capped at 5 percent over the previous year's value.

b. The total value may not exceed full cash value.

c. Effective beginning in 2015.

B. Litigation

1. ***SHR Scottsdale X, LLC v. Maricopa County, 1 CA-TX 12-0004 (App. 2013)***

a. The Court of Appeals held that a taxpayer that acquired real property from a partnership was collaterally estopped from re-litigating who was the owner of certain improvements to the land because that issue was previously litigated by the partnership prior to the sale.

b. In 1985, a partnership leased land from the City of Scottsdale and subsequently made improvements to the leased land. In 1992, the partnership filed a lawsuit that challenged property tax assessments for the improvements on the land claiming that the improvements were owned by the City of Scottsdale, and that the partnership merely held a nontaxable possessory interest in the improvements.

c. In 1995, the Arizona Tax Court entered final judgment against the partnership, ruling that the partnership owned the improvements and was therefore liable for the taxes at issue.

d. In 2006, the taxpayer purchased the land and improvements from the partnership and subsequently sought a refund for the 2006 tax year on the theory that the City owned the improvements. The taxpayer was collaterally estopped from litigating the same issue argued by the partnership unsuccessfully at the Arizona Tax Court.

e. This is an unpublished memorandum decision. Taxpayer has filed a Petition for Review with the Arizona Supreme Court.

2. ***Cable One, Inc. v. Ariz. Dep't of Revenue, 232 Ariz. 275 (App. 2013)***

a. The Court of Appeal held that Cable One, Inc. was a telecommunications company subject to central assessment because it was providing telephone services to its subscribers through its Voice over Internet Protocol service.

b. 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 communication to, from, through or within this state." (Ariz. Rev. Stat. Ann. § 42-14401.)

c. The Court of Appeals held that although Cable One did not own a telephone network, it provided its customers with access to the network for a fee, which was sufficient to be considered a "telecommunications company" for purposes of central assessment.

d. Taxpayer's Petition for Review to the Arizona Supreme Court was denied.