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THE SUPERIOR COURT OF THE STATE OF ARIZONA
IN THE ARIZONA TAX COURT

TX 2015-000606 07/24/2017

HONORABLE CHRISTOPHER WHITTEN

CLERK OF THE COURT
T. Cooley
Deputy

BENNETT DORRANCE, et al. PETER C GUILD

v.

STATE OF ARIZONA DEPARTMENT OF REVENUE, et al. BENJAMIN H UPDIKE

RULING

The following motions are fully briefed and pending:

1. Taxpayers' Motion for Summary Judgment, filed February 9, 2017,

2. Defendants' Cross-Motion for Summary Judgment, filed April 13, 2017, and

3. Defendants' Motion for Summary Judgment and Motion for Partial Summary Judgment, filed February 6, 2017.

The Court benefited from oral argument on all the above motions on July 14, 2017.

A.R.S. § 43-1081(A) and § 43-1170(A) identically state, "A credit is allowed against the taxes imposed by this title for expenses that the taxpayer incurred during the taxable year to purchase real or personal property that is used in the taxpayer's trade or business in this state to control or prevent pollution. The amount of the credit is equal to ten per cent of the purchase price."

In 2009 the Court of Appeals has interpreted "in this state" and "to control or prevent pollution," but did not reach the meaning of "used in the taxpayer's trade or business." *Watts v. Arizona Dept. of Revenue*, 221 Ariz. 97 (App. 2009).

Three years later, the Court of Appeals revisited the question, but again did not directly address the words "used in the taxpayer's trade or business"; it was undisputed that the construction of a sewer system by a semiconductor manufacturer for use at its own facilities so qualified. *Microchip Technology Inc. v. State*, 230 Ariz. 303, 306 ¶ 8 (App. 2012).

In this case, the scope of "used in the taxpayer's trade or business" must be squarely faced.

According to the First Amended Complaint, and admitted by the Department in its Answer, Plaintiffs, through their LLC, developed the master-planned community of DC Ranch. The Department denies paragraph 9, that various federal, state, and local laws require the construction of water pollution control facilities (to use a deliberately broad word) for residential developments; the Court takes the denial to mean that, while such laws indisputably exist, the legal requirements do not attach "in connection with the development of such project," as Plaintiffs express it. Plaintiffs respond that, while the facilities were not used in the actual construction of DC Ranch (separate jobsite pollution measures, not at issue here, were used) and were in fact transferred to municipal ownership prior to first occupancy, they were nonetheless "used" by the developer they controlled "in [its] trade or business," for the residences could not be sold in their absence.

Although the appellate courts have not defined "used in the taxpayer's trade or business" in the income tax context, they have discussed similar language in A.R.S. § 42-5061, which carves out exceptions to the imposition of transaction privilege and use taxes on property "used directly" in specified industrial operations; the Court considers the "used directly" test at least as stringent as the bare "used" of the income tax statutes. Beginning with *Duval Sierrita Corp. v. Arizona Dept. of Revenue*, 116 Ariz. 200 (App. 1977), the appellate courts, laying aside the traditional presumption against exemptions, have construed the exemption broadly in the name of stimulating investment and spurring economic development. *Arizona Dept. of Revenue v. Capitol Castings*, 207 Ariz. 445, 448 ¶ 13 (2004). Even in the face of the "used directly" limitation, the Court of Appeals recently held that an item used indirectly qualifies for exemption so long as the "harmonious integrated synchronized system" of which it is part culminates in an exempt item. *Chevron U.S.A. Inc. v Arizona Dept. of Revenue*, 238 Ariz. 519, 523 ¶ 14 (App. 2015) (exemption for lubricants applied to a machine that was used directly in mining). It is no stretch to find legal "use" in the construction of facilities to control water pollution.

To further the stimulatory effect of the statute, *Duval Sierrita* refused to limit the exemption to property that was exempt at the time the tax became attached to it, instead looking at the item's "ultimate function in the … process." *supra* at 204-05. The same principle applies here. The water pollution control facilities did not fulfill the requirement of being "used in the taxpayer's trade or business." The business was manufacturing houses, and the facilities played no part in controlling the resultant pollution. But Plaintiffs were not building houses for the fun of it. Their entire business rationale was that, as the final step in the process, the houses would be sold at a profit. For the houses to be legally sold, they had to have facilities compliant with, among other things, the legally-imposed standards governing water pollution. Thus, the "ultimate function" of the facilities was to allow the completion of the process, the sale of the houses. Plaintiffs qualify under the statute.

The Court does not see the materiality of the Department's defense that the credit should be denied because Plaintiffs failed to adjust the basis of the property as required by § 43-1081(D). Assuming that to be true, the Department has not shown that it matters at this point. The credit is not conditioned on the property having any particular basis; subsection D states that an allowable credit must be "includible" (future) in the taxpayer's adjusted basis, not "included" (past). The adjustment to the basis must certainly be done, but the statute does not require that it be done prior to grant of the credit.

Section 43-1081(E) states, "Co-owners of a business … may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed a sole owner," which at the time was $500,000. (The Court does not address the effect of the current, reworded § 1081(G).) Plaintiffs attempt to recover more than four times that sum by arguing that "the amount that would have been allowed" is recalculated annually, in other words, as long as the co-owners collectively sought no more than $500,000 in any one year, they could keep claiming portions of the exemption until they recovered the entire expenditure. But the statutory language spoke of the maximum allowed credit, not that portion of a credit allowable to any particular taxpayer or in any one year. The $500,000 is the maximum that can be exempted for any one year's expenditures on qualified property, however long full realization of the exemption takes.

A.R.S. § 42-1106 limits the time within which "a claim for credit or refund" and "an action for refund or credit" may be filed. To the extent that either remedy will achieve the desired purpose – if the credit, by force of the rules of arithmetic, results in an overpayment necessitating a refund or the refund is based on allowance of the credit – filing a claim for either is sufficient.

The doctrine of exhaustion of administrative remedies was discussed in *Medina v. Arizona Dept. of Transportation*, 185 Ariz. 414, 417-18 (App. 1995). "[T]he doctrine is similar to other judicial gate-keeping devices, such as mootness, ripeness and standing, which courts have established to limit the cases over which they take jurisdiction. This does not mean, however, that the exhaustion doctrine is simply a matter of judicial discretion. Indeed, our supreme court has held that, when the exhaustion doctrine is properly invoked in timely response to an action seeking judicial review of an administrative determination, the trial court may not exercise jurisdiction of the action." *Id.* at 417-18 (internal citations omitted). As a rule, the doctrine will be scrupulously applied in the Tax Court. *See Estate of Bohn v. Waddell*, 174 Ariz. 239, 245-46 (App. 1992). But an exception to the exhaustion doctrine has been recognized where the pursuit of administrative remedies would be futile. *Stagecoach Trails MHC, L.L.C. v. City of Benson*, 231 Ariz. 366, 370 ¶ 16 (2013). To decide whether the doctrine or the exception is to be applied in any given case requires "an understanding of [the doctrine's] purposes and of the particular administrative scheme involved." *Falcone Brothers & Associates, Inc. v. City of Tucson*, 240 Ariz. 482, 491 ¶ 27 (App. 2016). In this case, the position of the Department was known and firm at the time plaintiffs would have had to initiate proceedings; *compare Stagecoach Trails MHC*, *supra*. The dispute was over a question of statutory interpretation, one which the courts alone are empowered to resolve. Under these particular facts, the Court finds that exhaustion of administrative remedies would have been futile.

The Department's motion is denied. The Taxpayers' motion is granted, except with respect to the limit on the amount of credit that may be taken pursuant to A.R.S. § 43-1081(E).