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SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

TX 2010-000517 10/08/2014

HONORABLE CHRISTOPHER WHITTEN

CLERK OF THE COURT
A. Quintana
Deputy

SUN LAKES MARKETING LIMITED PARTNERSHIP, et al.

PATRICK IRVINE

v.

STATE OF ARIZONA

SCOT G TEASDALE

KENDIS K MUSCHEID

UNDER ADVISEMENT RULING

Plaintiff are land developers and utility operators who claim tax credits for tax years 1998 through 2004 under A.R.S. § 43-1170 and A.R.S. § 43-1081. At the relevant time, A.R.S. § 43-1170 read:

A. 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.

B. Property that qualifies for the credit under this section includes that portion of a structure, building, installation, excavation, machine, equipment or device and any attachment or addition to or reconstruction, replacement or improvement of that property that is directly used, constructed or installed in this state for the purpose of meeting or exceeding rules or regulations adopted by the United States environmental protection agency, the department of environmental quality or a political subdivision of this state to prevent, monitor, control or reduce air, water or land pollution. The credit allowed pursuant to this section does not apply to the purchase of any personal property that is attached to a motor vehicle.

The Plaintiffs in this case fall into two groups – land developers and utilities.[1] The property for which Plaintiffs seek credit falls into four basic categories – systems for wastewater or sewage collection, systems that treat the wastewater or sewage, systems that distribute the wastewater after it is treated and systems which manage storm water.

The Department of Revenue ("DOR") challenges whether the Land Developer Plaintiffs qualify for the credit at all. It also argues that most of the property at issue does not qualify for the credit.

Qualifying Entities

Plaintiffs all argue that they qualify as taxpayers, either directly or indirectly, who may claim the credits described in A.R.S. § 43-1170 under either subsection A or subsection B. This argument is unpersuasive.

The relationship between the two parts of this statute was recently described in *Microchip Technology Corp. v. State*, 230 Ariz. 303, 306-07 ¶ 2-3 (App. 2012). The Court explained that the second subsection "describes what property is 'included'" under the first subsection but does not otherwise impose any limit on the first subsection.

Neither does the plain language of the second subsection expand the class of taxpayers who qualify under the first. As the *Microchip* court pointed out, the second section merely illustrates the first.

Only A.R.S. § 43-1170(A) defines the type of taxpayer who qualifies for the credit - one who purchased real or personal property used in their business in Arizona to control or prevent pollution.

A. Utility Plaintiffs

The Utility Plaintiffs are Pima Utility and SaddleBrooke Utility. Both are "owners and operators of sewage collection and treatment systems and effluent distribution systems" on two of the properties which were developed by the Land Development Plaintiffs. The DOR argues that the Utility Plaintiffs do not qualify for the credit because they did not control or prevent pollution *created by them*. Instead, the Utility Plaintiffs treated pollution created by those residents of, and visitors to, the developments they service.

[1] Some of the Plaintiffs are also individuals and entities who receive the pass through benefit of the tax credits claimed by either of these groups.

The distinction the DOR seeks to draw appears nowhere in the statute. Had the legislature intended to limit this tax credit to only those taxpayers who control or prevent pollution *created by them*, it could easily have added those words to the statutes. It did not. This Court will not engraft such a requirement onto the language chosen by the legislature.

The Utility Plaintiffs qualify for the credit under A.R.S. § 43-1170, to the extent that they purchased property used in their business in Arizona to control or prevent pollution.

B. Land Developers

The Land Developer Plaintiffs[2] here build master-planned communities, continuing to own, operate and maintain portions of them even after they begin selling homes. Part of their responsibility in building these communities includes providing water supply and sewage systems to each lot prior to human occupancy.

The DOR contends that these Plaintiffs are similar to the Sunstate Equipment Plaintiffs in *Watts v. Ariz. Dept. of Revenue*, 221 Ariz. 97 (2009). Those plaintiffs were not allowed to claim a credit under A.R.S. § 43-1170 because they did "not use the equipment in their trade or business in this state to control or prevent pollution. Instead, they lease(d) the equipment to others who may or may not use the ... (equipment) ... to prevent pollution." *Id.* at ¶ 16. Indeed, one of Sunstate's executives, Garth Price, testified that "any number of possible uses could come of [the water trailers and trucks], limited only by your imagination." *Id.* at ¶ 10.

The Land Development Plaintiffs here are not like the *Watts* plaintiffs. These plaintiffs have a much more intimate relationship to the land upon which the pollution controlling equipment is built and used. They do not own the equipment and simply rent it out to others, free from any control over how or where it is used. Instead, they are required to install this pollution controlling or preventing equipment when they build their master-planned communities and they continue to operate their business upon the very land where they have built it.

The Land Development Plaintiffs use of the claimed property in this case is also very unlike the plaintiffs' use of the claimed property in *Watts*. There, the equipment had multiple purposes and the taxpayer had absolutely no control over how it was used – to control pollution or to make muddy volleyball courts. The property these taxpayers claim a credit for is affixed to the land on which it is designed to control pollution. It is not used for other purposes than to control pollution on that property.

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[2] The Land Development Plaintiffs include Sun Lakes Marketing Limited Partnership, Saddlebrooke Development Company, PebbleCreek Properties Limited Partnership, Robson Ranch Quail Creek, LLC, Sun Lakes-Casa Grande Development LLC, and Robson Ranch Mountains, LLC.

The Land Development Plaintiffs also qualify for the credit under A.R.S. § 43-1170, to the extent that they purchased property used in their business in Arizona to control or prevent pollution.

Qualifying Property

A.R.S. § 43-1170(A) describes generally the types of property which qualify for a tax credit: property "used in the taxpayer's trade or business in this state to control or prevent pollution."

Microchip makes two things clear. In order to qualify for the credit the primary purpose or function of the property need not be pollution control, and all property which is part of an "integrated system" designed for pollution control qualifies for the credit.

In *Microchip* the court approved of outlays which included:

> expenses in dedicating real property to use for storm-water basins, in making improvements required for the installation of storm-water basins and their integrated components, and in making improvements required for the installation of sewer systems. Other property expenses included storm sewers, sanitary sewers, retaining walls, fencing footings, a block wall, a fence, a sprinkler system, a garage roof, floor drains and drains on the office roof. Taxpayer's application also claimed expenses for various construction activities: compaction, surveying, underground detection, geotechnical work, excavation and landscaping.

Microchip Technology Corp. v. State, 230 Ariz. 303 at ¶ 2.

Using only the plain language of A.R.S. § 43-1170(A), the Court analyzes the four categories of property claimed in this case.

1. Wastewater or Sewage Collection Systems

The wastewater collection systems claimed here are "a series of sewer lines and lift stations for the collection of raw sewage from residences and other buildings." Defendant's Response brief at 14:4-5.

Only the Utility Plaintiffs claim credit for their purchase and operation of the property making up these systems, including "pipes, pumps, installation work, electrical work, lift station repairs, manhole and cleanout projects, radio and computer costs, an antenna, sewer laterals,

service laterals, receiving wells, plan review fees, right of way permits, sewer tax and a contract with a lawn sprinkler company." Id at 14:14-20.

Microchip expressly approved of almost identical property being claimed under A.R.S. § 43-1170(A).

Expenditures for wastewater collection systems qualify for the credit.

2. Systems that Treat the Wastewater

The Utility Plaintiffs claim a credit for the purchase of property related to two wastewater treatment facilities, including computers and related equipment, various motors, pumps, turbines, screens, filters, piping, valves, a compressor, crane repair, a stair tower, professional and consulting services, engineering services, electrical services, and software and software support services. See DSOF at ¶ 30.

It is difficult to imagine property which more fully meets the requirement that it be used for the control or prevention of pollution.

Expenditures related to wastewater treatment facilities qualify for the credit.

3. Systems that Distribute the Wastewater After it is Treated

The Utility Plaintiffs claim a credit for "property used for the distribution of treated sewage, also referred to as reclaimed water (also called effluent), from a wastewater treatment plant to a point of recharge, reuse or disposal." See DSOF at ¶ 32.

Microchip made clear that property which is part of an "integrated system" designed for pollution control qualifies for the credit. In doing so, the *Microchip* court analyzed the requirement in A.R.S. § 43-1170(B) that the property be "directly used" for pollution control. Citing *Duval Sierrita Corp. v. ADOR*, 116 Ariz. 207 (App. 1977),[3] the Court found that the proper focus is determining whether property is "directly used" should be on the ultimate function of the property.

In *Duval Sierrita* the property at issue included conveyor belts which carried rock for five miles to the taxpayer's mining operation, steel pipes carrying water nine miles to the operations and steel pipes carrying the used water away from the same operations. Noting that some might

[3] *Duval Sierrita* dealt with a separate tax exemption statute, not related to A.R.S. § 43-1170. Its discussion of the meaning of "used directly," was nonetheless helpful in *Microchip*. It is also helpful here.

draw a distinction between pipes carrying water to the operations and pipes carrying used water away from the operations, the court held "both types of pipes are part of the integrated system of recovering copper from native rock and as such are essential to that operation."

Similarly, in this case, both the systems used to carry sewage and water to the treatment plants and systems used to carry treated water, or effluent, from the treatment plant to a point of recharge, reuse or disposal are essential to that operation and qualify as integrated systems which are directly used for pollution control.

Distribution systems for treated wastewater, or effluent, qualify for the credit.

4. Storm Water Management Systems

The Developer Plaintiffs claim a credit for expenses predominantly related to "engineering for drainage plans and for review and plan approval by local regulatory agencies" which included "storm drains, gutters, storm water retention areas, temporary barriers made from hay or straw bales as well as for cleaning up the straw, and basins, lakes and a drainage line underneath a golf course." See DSOF at ¶ 32.

This category of property is the most troubling, largely because it requires the Court to draw a line which, by its nature, is somewhat arbitrary (exactly what the *Microchip* court frowned upon) in order to determine where pollution controlling property ends and a country club (in this case) starts.[4]

Because, however, the *Microchip* court expressly approved of expenses related to building storm basins, expenses which are practically indistinguishable from the types of expenses claimed by the taxpayer here, the Court finds that the storm water management expenses claimed by the taxpayers in this case also qualify for the tax credit.

[4] For example, some of the expenses claimed here are related to building lakes on golf courses which are used, among other things, to retain storm water. While these expenses qualify, there is little inherent logic in drawing the line for what expenses at the edge of the lake. If the golf course lakes qualify why doesn't the landscaping around the lake qualify as part of the "integrated system" for storm water retention? And if the landscaping around the lake qualifies, why doesn't the grass around it (the golf course)? Taken to an illogical conclusion, why wouldn't the clubhouse be part of the system?

Timeliness of Claims

The final issue is whether some of Plaintiffs' claims for credit are time barred. The statute of limitations has expired on the items not brought in Plaintiffs' original refund claims. Plaintiffs argue that AAC R15-10-108(A) permit a claim to be supplemented or amended at any time before the conclusion of the hearing. But this must be read consistently with A.R.S. § 42-1106(A), which provides that a taxpayer has four years from the date his return is, filed to bring a claim. As the higher courts have in recent years emphasized, the amount of the claim is an essential, perhaps the most essential, element of it. To allow that amount to be increased long after the original claim is brought would defeat the purpose of the statute of limitations.

Conclusion

Based upon the foregoing, Plaintiffs' Motion for Summary Judgment, filed March 31, 2014 is granted in part. It is not granted in whole only because there are questions of fact regarding whether certain expenses claimed by Plaintiffs are supported by documentation sufficient to allow the claim.

By agreement of the parties, these factual disputes will be resolved, either by the parties or by the Court, consistently with the above ruling.

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Beginning September 29, 2011, the Clerk of the Superior Court will be accepting post-initiation electronic filings in the tax (TX) case type. eFiling will be available only to TX cases at this time and is optional. The current paper filing method remains available. All ST cases must continue to be filed on paper. Tax cases must be initiated using the traditional paper filing method. Once the case has been initiated and assigned a TX case number, subsequent filings can be submitted electronically through the Clerk's eFiling Online website at http://www.clerkofcourt.maricopa.gov/

NOTE: Counsel who choose eFiling are strongly encouraged to upload and e-file all proposed orders in Word format to allow for possible modifications by the Court. Orders submitted in .pdf format cannot be easily modified and may result in a delay in ruling.