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Arizona Faces Uphill Battle In Stadium Tax Refund Appeal

Law360, New York (September 16, 2015, 1:05 PM ET) -- Last month, the Superior Court of Arizona, Maricopa County, rejected a bid by the Arizona Department of Revenue and the Arizona Sports and Tourism Authority (AzSTA) to only apply prospectively an earlier court ruling that the state's rental car surcharge is unconstitutional. The unconstitutionally imposed taxes are earmarked to fund the special taxing district responsible for operating the University of Phoenix Stadium, home of the Arizona Cardinals, the Grapefruit League, and other tourism-related promotions. This article discusses some of the key state tax principles underlying the decision and highlights points of interest to watch for as the case moves through the Arizona appellate courts.[1]

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Background

In 1999, Arizona faced the possibility of losing its NFL franchise, the Arizona Cardinals, to another city. Former Gov. Jane Dee Hull responded by creating a task force to research and propose alternative funding options for a new football stadium that would serve as home for the Arizona Cardinals, a site for the Fiesta Bowl in College Football's Bowl Championship Series, and a future venue for NFL Super Bowls.

The task force was also charged with addressing other threats to the Arizona tourism tax base, such as the potential move of the minor league baseball Arizona Cactus League, and neighboring cities, like Las Vegas, "stealing" Grand Canyon visitors by outspending Arizona in marketing campaigns. In response to these perceived threats, the task force recommended the creation of the AzSTA.

The legislation establishing the AzSTA also authorized it to issue bonds to fund construction of the multipurpose football stadium. The AzSTA backed its bond issuance with revenue from a variety of sources, including a voter-approved surcharge on car rentals and hotel rooms. Arizona's transaction privilege tax applies to car rentals, but the additional AzSTA surcharge applied to car rentals within Maricopa County and was used specifically to finance construction of the football stadium and promote tourism in the state. The car rental surcharge represents nearly one-third of AzSTA's annual revenue.

Voters approved the car rental surcharge in 2000, and construction of the University of Phoenix Stadium was completed in 2006. Both the Arizona Cardinals football franchise and the Cactus League remained in Arizona. The new football stadium hosted the 2008 and 2015 Super Bowls. It also remains the site of college football's Fiesta Bowl, and despite Las Vegas' marketing efforts, tourists still visit Arizona to see the Grand Canyon.

The Car Rental Surcharge — No Stranger to Controversy

The car rental surcharge used to fund AzSTA has been plagued by controversy despite the relative success of the agency's tourism promotion efforts. In 2004, a class action was brought by an out-of-state car renter challenging the constitutionality of the car rental surcharge. In Karbal v. Arizona Department of Revenue, the Arizona Court of Appeals upheld the Tax Court's dismissal of the class refund claims in 2007 because the plaintiffs lacked standing to challenge the imposition.[2] While Karbal closed the door for consumer refunds, it presented an opportunity for car rental companies.

In 2010, the same Phoenix attorneys that had filed the class action in Karbal filed a new class action challenging the car rental surcharge on behalf of car rental companies. In Saban Rent-A-Car LLC v. Arizona Department of Revenue (Saban I), the Maricopa County Superior Court ruled in 2014 that the car rental surcharge violated Article 9 § 14 of the Arizona Constitution.[3] Article 9 § 14 requires that "[n]o moneys derived from fees, excises, or license taxes relating to the registration, operation, or use of vehicles on the public highways or streets" be used for anything other than "highway and street purposes." The Department of Revenue argued that the car rental surcharge was not a tax on the operation or use of vehicles but an excise tax on car rental companies for the privilege of renting cars within the AzSTA taxing district and therefore did not run afoul of the constitutional restriction. Saban I recognized this distinction but held that the Constitution's use of the phrase "relating to" broadened the reach of the prohibition to include not just taxes whose incidence fell directly on vehicles, but also to taxes imposed upon objects related to the use or operation of vehicles on public highways.

The Saban I court found that a sufficient relationship existed between the use of motor vehicles and the car rental surcharge to require that revenues collected from the surcharge be used for highway-related purposes. Because football stadium financing and tourism promotion fell outside of the constitution's permitted use of surcharge revenues, the Superior Court struck down the surcharge as unconstitutional.

Retroactivity — Arizona is an "Honorable Government"

In last month's Saban Rent-A-Car LLC v. Arizona Department of Revenue decision (Saban II), the court rejected the department's and AzSTA's request for prospective application of last year's order that eliminated the surcharge.[4] Saban II appeared reluctant to provide refunds to the car rental companies because the tax was passed onto their customers. However, the court held that two decisions by the Arizona Court of Appeals construing McKesson v. Division of Alcoholic Beverages & Tobacco[5] mandated that Saban I be applied retroactively. The court said that "prospective-only relief [under McKesson] is appropriate in a case where a tax is illegally collected, but the taxpayer is otherwise made whole by having passed the illegal tax on to its customers."[6] But the court's concern ignores Arizona case law that likely requires car rental surcharge refunds.

Arizona courts rarely apply prospective-only relief where tax has been improperly imposed.[7] In fact, the Arizona Supreme Court has declared that "[a]n honorable government would not keep taxes to which it is not entitled, and the legislative scheme supports" refunds of taxes erroneously collected.[8] In civil cases, courts presume that their opinions will apply retroactively.[9]

Arizona courts have utilized the following three-part test to determine whether a decision declaring a tax to be illegal should be applied prospectively only: (1) whether the decision establishes a new legal precedent or establishes a rule that could not have been foreseen; (2) whether retroactive application will further or impede the court's new rule; and (3) whether retroactive application will produce substantially inequitable results.[10]

Under the third prong of this test, inequitable results may include required refunds that

place a taxing authority under financial duress.[11] Balancing the above factors could justify prospective-only relief where "great economic hardship" could threaten the "financial stability of the taxing body."[12] Voters approved the car rental surcharge to finance the AzSTA nearly 15 years ago, with two subsequent judicial decisions, at least tangentially, validating the tax. Further, retail classification of the transaction privilege tax applies to car rentals in the same manner, funds that presumably are not specifically allocated for highway-related purposes. Finally, an estimated $160 million in potential refunds, in addition to a one-third reduction of its annual revenue, could create a substantial financial hardship for AzSTA, the taxing authority, suggesting that prospective application of Saban I's directive might have been appropriate. Saban II did not analyze the department's request for prospective-only relief under this test, but instead declared that Arizona case law mandates the refund of illegal taxes.

However, even under the three-part test discussed above, AzSTA's appeal for prospective-only relief is an uphill battle. The AzSTA must rebut the presumption that judicial opinions in civil cases apply retroactively. It must also convince Arizona appellate courts that they should deviate from their "common practice" of requiring refunds of taxes that have been improperly imposed. Furthermore, as Saban II observes, the court of appeals has indicated that the three-part test for prospective-only relief outlined above may apply to nontax cases, but McKesson generally mandates retroactive relief from illegal taxes in order to comply with federal due process requirements.[13]

Takeaways

State constitutional provisions earmarking revenue for specific purposes should be considered when challenging a tax. Given the propensity of legislatures to "juggle" their finances, certain taxes may be vulnerable to attack.

The decision also serves as a reminder to consider whether a win in a tax case may be limited to prospective-only relief and whether a vendor seeking a refund of sales tax (or similar excise tax) is entitled to retain the refunds or is required to return the refund to its customers.

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[1] Representatives from both the AzSTA and the department have publicly indicated that each agency will likely seek appellate review.

[2] Karbal v. Ariz. Dep't of Revenue, 215 Ariz. 114, 117, 158 P.3d 243, 246 (Ariz. Ct. App. 2007).

[3] TX 2010-001089 (Ariz. Sup. Ct., Maricopa Cnty., June 16, 2014) (Saban I).

[4] TX 2010-001089 (Ariz. Sup. Ct., Maricopa Cnty., July 28, 2015) (Saban II).

[5] 496 U.S. 18 (1990).

[6] Saban II, TX 2010-001089 at *2.

[7] See e.g., Wilderness World Inc. v. Ariz. Dep't of Revenue, 182 Ariz. 196, 201, 895 P.2d 108, 113 (Ariz. 1995); Pittsburgh & Midway Coal Mining Co. v. Ariz. Dep't of Revenue, 161 Ariz. 135, 138-39, 776 P.2d 1061, 1064-65 (Ariz. 1989).

[8] Pittsburgh & Midway Coal, 161 Ariz. at 138-39.

[9] Fain Land & Cattle Co. v. Hassell, 163 Ariz. 587, 596, 790 P.2d 242, 251 (Ariz. 1990).

[10] Wilderness World, 182 Ariz. at 201 citing Fain Land & Cattle, 163 Ariz. at 596.

[11] Id.

[12] Id.

[13] See Tucson Elec. Power Co. v. Apache Cnty., 185 Ariz. 5, 21, 912 P.2d 9, 25 (Ariz. Ct. App. 1995).