SET NO. 6

COURT OF APPEALS

STATE OF ARIZONA

DIVISION ONE

CALPINE CONSTRUCTION FINANCE COMPANY, a Delaware limited liability partnership, Plaintiff/Appellant, v. ARIZONA DEPARTMENT OF REVENUE, an agency of the State of Arizona, MOHAVE COUNTY, a political subdivision of the State of Arizona, Defendants/Appellees.	No. 1 CA-TX 07-0012 Arizona Tax Court No. TX 2004-000696

REPLY BRIEF OF APPELLANT

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Plaintiff-Appellant Calpine Construction Finance Company will be referred to hereinafter as "Calpine." The Fort Mohave Indian Tribe will be referred to as "the Tribe." Defendant-Appellee the Arizona Department of Revenue will be referred to hereinafter as "the Department." The lease agreement between Calpine and the Tribe will be referred to as "the Lease" and the power plant which is the subject of the Lease will be referred to as "the Facility."

The pleadings and documents filed with the Tax Court will be referenced by the Clerk's Index of Record ("IR"), the item number identifying the document in the Clerk's Index of Record and the particular page or paragraph of the document, if needed.

ARGUMENT

I. AS TO CALPINE, THE FEDERAL JUDGMENT HAS NO COLLATERAL ESTOPPEL EFFECT.

The Tax Court properly rejected the Department's argument that Calpine was collaterally estopped from pursuing this matter. The Department persists in this argument on appeal, however, notwithstanding that none of the elements of collateral estoppel have been satisfied here. The Tax Court rejected the Department's arguments for the following reasons:

The District Court Decision

> As a preliminary matter, the determination of the District Court for the District of Arizona in CIV 02-1212-PCT-MHM that the improvements are Plaintiff's property does not have preclusive effect in this Court. Two elements essential to a claim of collateral estoppel are (1) that there be a final judgment and (2) that the party to be estopped have been a party to that judgment. Neither of those elements is found here.
>
> Under Arizona law, collateral estoppel "attaches only when an issue of fact or law is actually litigated and determined by a valid and final judgment." *In re General Adjudication of All Rights to Use Water in the Gila River System & Source*, 212 Ariz. 64, --, 127 P.3d 882, 888 n.8 (2006). A proceeding stopped for whatever reason before a final judgment on the merits lacks preclusive effect. *Id.* The District Court held that it lacked jurisdiction over the Tribe's claim, and therefore was powerless to issue a judgment at all; the question of ownership of the improvements, while necessary to the District Court's analysis of the statutes governing its jurisdiction, was merely ancillary to the ultimate ruling. Issue preclusion exists only when the action of the first court serves as a bar to action by other courts. RESTATEMENT (2D) OF JUDGMENTS § 27, comment n. The only issue decided by the District Court with

finality was whether it possessed subject matter jurisdiction. Unlike the federal courts, whose jurisdiction is limited by Article III of the United States Constitution and by federal statute, the Superior Court has jurisdiction in all cases which involve the legality of an Arizona tax. A.R.S. Const. Art. 6 § 14(2). No other issue was, or could have been, decided by the District Court. There is therefore no issue preclusion in this action. The Supremacy Clause of the United States Constitution does not obligate this Court to follow the statutory interpretation of the District Court. "[T]here is no dispute that the Arizona courts are the definitive expositors of Arizona state law." *Yniguez v. State of Arizona*, 939 F.2d 727, 736 (9th Cir. 1991). The Court thus applies its own analysis.

Calpine was not a party to the federal action; its petition to intervene had been denied by the District Court, on the ground that its claim was not cognizable in federal court under the Tax Injunction Act. *See* CIV 02-1212-PCT-MHM, Order filed March 31, 2004, at 3:4-5. The only claim before the District Court, then, was that the improvements were exempt from state taxation because they were owned by the sovereign Tribe, a claim with which Calpine plainly was not in privity. Calpine therefore cannot be estopped by the District Court ruling.

Defendants further seek to invoke against Calpine the theory of virtual representation, as set forth in *El Paso Natural Gas Co. v. State of Arizona*, 123 Ariz. 219 (1979). It is true that the same property was at issue in the federal action as in this one. Defendants argue that, because the District Court found that the Tribe did not own the improvements, Calpine *a fortiori* must. However, virtual representation can create *res judicata* only when there is a final judgment rendered on the merits by a court of competent jurisdiction. *Id.* at 222. Here, there was no final judgment on the merits and the District Court itself held that it lacked jurisdiction. The requirements of *El Paso Natural Gas* are thus not met, and the doctrine of virtual representation cannot create *res judicata* against Plaintiff.

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The Tax Court's decision on this point was correct. Collateral estoppel applies when: (i) an issue was actually litigated in a previous proceeding, (ii) there was a full and fair opportunity to litigate the issue; (ii) resolution of the issue was essential to the decision; (iii) a valid and final decision on the merits was entered; and (iv) there is common identity of the parties. *See e.g., Hullett v. Cousin,* 204 Ariz. 63 P.3d 1029 (2003).

Here, none of the required elements are satisfied. First, ownership of the Facility for Arizona property tax purposes was never an issue that was actually litigated or decided on the merits of Calpine's claim in the federal action. The only legal issue adjudicated by the federal court in dismissing Calpine's Complaint-in-Intervention was whether the federal court's jurisdiction over the claim of the Tribe, which was specifically exempted from the Tax Injunction Act, 28 U.S.C. § 1341, allowed the court supplemental jurisdiction pursuant to 28 U.S.C. § 1367(a) over the claim of Calpine, which was not exempt from the Tax Injunction Act. (*See,* Order dated January 29, 2004, Exhibit 7 to IR - 24) The district court ultimately ruled that it lacked supplemental jurisdiction and dismissed Calpine's complaint for lack of jurisdiction under the Tax Injunction Act. *Id.* Accordingly, the federal court never reached the issue presently pending before this Court; namely whether the Facility is taxable to Calpine for Arizona property tax purposes under the terms of the Lease.[1]

Second, Calpine's dismissal from the federal court action under the Tax Injunction Act precluded an opportunity to fully and fairly litigate the question of Calpine's ownership of the Facility for Arizona property tax purposes. Third, resolving who owns the Facility for Arizona property tax purposes was not essential to the federal court's decision to dismiss Calpine's Complaint-in-Intervention for lack of jurisdiction under the Tax Injunction Act. Fourth, there has never been a valid and final decision "on the merits" of Calpine's claim. Fifth, the dismissal judgment, to the extent it is even relevant to the issue presently before this Court, was entered by the federal court against the Tribe only, not Calpine, which is the only party here. *See,* Exhibit 1, IR-24.

The Department also contends that the doctrine of virtual representation and, its claim that the federal judgment is an "in rem" judgment, bar the

[1] The Department cites *Atlantic City Municipal Utilities Authority v. Regional Adm'r*, 803 F.2d 96, 103 (3d Cir. 1986) for the proposition that a dismissal for lack of subject matter jurisdiction is "***conclusive as to matters actually adjudged.***" (Answering Brief at 14, emphasis added). As discussed above, however, the issue of whether Calpine owns the Facility for Arizona property tax purposes was never adjudicated by the federal court.

"relitigation" of the Calpine's claims raised herein. These arguments are also without merit.

The Department's reliance on *El Paso Natural Gas Co. v. State,* 123 Ariz. 219, 599 P.2d 175 (1979) to support its virtual representation argument is misplaced. At issue in that case was the legality of two appropriations passed by the legislature and the consequent effect on the state property tax rate. This court noted in that case, the doctrine of virtual representation must be applied with "utmost caution" *Id.* at 222, 599 P.2d at 178. This theory is commonly encountered in class actions where matters of public interests are involved. As a prerequisite to its application: "The judgment in the prior case must have been a final judgment rendered on the merits by a court of competent jurisdiction. (Citation omitted) There being no question of jurisdiction, we focus on the merits and finality of the judgment." *Id.* Obviously, here, there was a "question of jurisdiction." Indeed, the federal court dismissed *Calpine* because it found it did not have jurisdiction. Thus, it did <u>not</u> reach the merits of Calpine's claims.

Similarly, the Department's *in rem* argument has no merit. The Department claims in conjunction with this argument that "since the federal court action determined the ownership and title to property and was in the nature of an in rem action, the federal judgment will fully bind Calpine . . .."

(Answering Brief at 20) The Department then cites *Mims v. Valley National Bank,* 14 Ariz. App. 190, 481 P.2d 876 (1971), claiming it stands for the proposition that: "An in rem judgment binds the whole world, and specifically persons who have rights or interests in the subject property – whether those persons were parties to the action." (Answering Brief at 20) Respectfully, the *Mims* case has nothing to do with the issues raised in this case and certainly does not defeat Calpine's claims herein.

Mims involved claims brought by the beneficiaries of a testamentary trust against a bank acting as the executor and testamentary trustee of the trust, for breach of fiduciary duty and loss of trust assets. This Court noted that "[t]here is not here any designated property which is the subject of this dispute, but rather an effort by appellants to recover a money judgment against the Bank for its alleged misconduct." *Mims, supra,* 14 Ariz. App. at 194, 481 P.2d at 880. Indeed, the only reference in *Mims* to "in rem" judgments is dictum because the Court there found the claim to be an *in personam* claim.

Similarly, the Department cites *Santos v. Simon,* 60 Ariz. 426, 138 P.2d 896 (1943) and *Brophy v. Powell,* 58 Ariz. 543, 121 P.2d 647 (1942) for the proposition that a tax proceeding determining the ownership or title to property is an *in rem* action. First, neither case is a "tax proceeding." Second, the

District Court decision here did not determine title; rather, it ruled only that the Tribe's interest in the Facility was not sufficient to confer statutory federal subject matter jurisdiction. Simply put, the District Court decision involving the Tribe did not reach the merits of the Arizona property tax issue here.

Indeed, there is a perverse irony in the Department's collateral estoppel, virtual representation and "in rem" judgment arguments. Here, Calpine tried to intervene into the federal action to litigate the question of whether the Department could tax its leasehold interest in the Facility under Arizona property tax law, but the Department argued that it should be precluded from doing so. Now, the Department claims that Calpine may not have its day in this Court because the federal court allegedly decided this issue.

The judgment against the Tribe in the federal action was a judgment of dismissal wherein the federal court concluded it did not have subject matter jurisdiction. Hence, it does not apply to Calpine here. Accordingly, the issue of who owns the Facility for Arizona property tax purposes is not barred by the federal judgment involving the Tribe's claim.

II. SECTION 42-14156 DOES <u>NOT</u> ALLOW TAXATION HERE.

The Department next contends that Mohave County may tax the Facility regardless of whether the Tribe or Calpine owns it. (Answering Brief at 21–28)

It claims that the Court need not even address the ownership issue because the Legislature has enacted legislation providing that property **used** for the operation of an electric generation facility – whether leased or owned – is taxable. A.R.S. § 42-14156. From this premise, it then argues that: (1) the statutes providing for the taxation of property used to generate electricity do not tax "possessory interests;" (2) the Department has not valued Calpine's possessory interest; and (3) Calpine has ignored "enabling legislation" passed in 2000. None of these arguments has merit.

First, under the Department's rationale, taxing authorities could impose a property tax on property owned by <u>any</u> governmental entity, including the federal government, which holds tribal lands as Trustee for federally-recognized Indian Tribes, all because the Arizona Legislature has enacted legislation stating that property "used for" electric generation should be taxed. That, of course, would come as news to the federal government, particularly given Arizona's Constitution which exempts from taxation "all federal, state, county and municipal property." Article IX, § 2 Ariz. Constitution. Moreover, the Legislature recognized this exempt status when it enacted A.R.S. § 42-11002, which provides: "All property in this state is subject to taxation **except as provided in article IX, Constitution of Arizona.**" The Facility being taxed by

Mohave County is the electric generation facility operated by Calpine under a Lease with the Tribe. However, because the Tribe is tax exempt, its property—including property it is "deemed" to own by virtue of a lease—cannot be taxed.

Second, the Department's post-hoc rationalization for its present argument is belied by its own conduct. Indeed, the Department does not even believe its own theory. This is demonstrated by the fact that the Department does not tax the land on which the Facility sits, because the Department acknowledges this is the Tribe's property. Nonetheless, the Tribe's land is undeniably **used for** electrical generation purposes because Calpine cannot operate the Facility without it. Hence, if the Department's present theory is valid, the land "leased and used" by Calpine should also be taxable under the Department's present argument.

Third, the notion that centrally-valued leased property is taxable is nothing new and the statutory reference passed in 2000 and cited by the Department certainly does not constitute "enabling legislation" to tax a possessory interest in otherwise tax-exempt tribal property. All property in Arizona is valued by local county assessors, with the exception of certain property which is statutorily required to be valued by the Arizona Department of Revenue. A.R.S. § 42-14001. That property, which includes railroads, utilities, airlines, pipelines, telecommunications and electric generation facilities, is commonly referred to as "centrally-assessed property."

Property **used** in a centrally-assessed industry, and not otherwise exempt from taxation, should be valued under the statutes applicable to such property, regardless of whether it is leased or owned. In fact, centrally-assessed property classifications have always included both leased and owned property. [2] For example, former A.R.S. § 42-14154, the statute which valued electric generation, transmission and distribution property, and the statute out of which A.R.S. § 42-14156 was born, provides the following definition:

> "Plant" means all property that is situated in this state and that is **used or useful** for the generation, transmission, or distribution of electric power or distribution of natural gas. Plant does not include land rights, materials and supplies and licensed vehicles.

(Emphasis added). Obviously, "plant" included both owned and leased property if used for the stated purpose. There is nothing in this statute which limits its application to property "owned" by the taxpayer or that makes any distinction between "owned" and "leased" property.

The Department places undue emphasis on House Bill 2324, passed in the 2000 legislative session, which created the new valuation statute for electric

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[2] The same is true of locally-assessed property, but that property is usually reported by and taxed directly to the lessor under A.R.S. § 42-15053(A).

generation facilities. A.R.S. § 42-14156. It claims that this concept of valuing leased property used to generate electricity is something new. In fact, the concept has existed as long as the centrally-assessed statutes have been in existence.[3]

Likewise, the amendments to this new valuation statute, made in 2003 through House Bill 2348, did not alter this common method of valuing centrally-assessed property. (Senate Fact Sheets and House Summaries for House Bill 2324 and House Bill 2348 attached as Exhibit 3 to IR - 32) No mention is made of any desire to single-out leased property for special tax treatment. The reason is simple. Leased property used by a centrally-assessed taxpayer has always been subject to valuation, subject to otherwise applicable exemptions, but this does not render leasehold interests in tax-exempt property taxable.

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[3] *See, e.g.,* **Railroads** - A.R.S. § 42-14352(A)(5) – locomotives and cars "owned or leased;" A.R.S. § 42-14354(A) and (B) – "property that a railroad company owns or leases" and "property used;" **Pipelines** - A.R.S. § 42-14204(E) – "noncapitalized leased operating property;" **Private rail car companies** – A.R.S. § 42-14301(2) – includes leased rail cars; **Telecommunication properties** – A.R.S. § 42-14402 (A)(6) – telecommunications companies must report lines "that are controlled or used under lease or otherwise;" **Airport fuel delivery companies** – A.R.S. § 42-14503(A)(4), (B)(5) – "noncapitalized leased property;" **Oil, gas and geothermal properties** – A.R.S. § 42-14101(7) – a producer "means a person who owns, controls or leases; **Mines** – A.R.S. § 42-14051 – "property used" in producing mines. All of these provisions existed both before and since the Legislature enacted and then repealed the taxation of "possessory interests" in government-owned property. *See, e.g.,* A.R.S. §§ 42-681, *et seq.*

The plain language of the new statute to be used for valuing electric generation assets, A.R.S. § 42-14156, is consistent with this valuation treatment. For example, subsection (A)(2) addresses real property improvements **used** in operating the facility, and (A)(3) addresses personal property **used** in operating the facility. This is virtually identical language to the previous statute valuing all electric utility property, as well as and the current statute that values transmission and distribution components.

The Department seems to recognize that its argument falls-apart if the tax at issue here constitutes a possessory interest tax, and thus, it tries to characterize it as anything but such a tax. However, if the Tribe is deemed to be the owner of the Facility for property tax purposes, that is precisely what this tax is. The Department, in essence, contends that the Arizona Legislature created a mini-possessory interest tax on electric generation facilities. A.R.S. § 42-14151. It is obvious that subjecting only one industry to a possessory interest tax would be unconstitutional under the Uniformity Clause, Article IX, § 1, and the prohibition against "special laws" found in Article IV, Pt. 2 § 19(9) of the Arizona Constitution. Clearly, this was not the intent of the Legislature.

Furthermore, the Department's assertion that "the legislature repealed **some** possessory interest statutes in 1995" (Answering Brief at 27, emphasis added) is simply false. As acknowledged in *Airport Properties*, the Legislature repealed **all** taxes on possessory interests in 1995, not just "some" of them. When the Arizona possessory interest tax was repealed by 1995 Session Laws, Chapter 294, § 8, the Legislature made it clear that the state tax collectors were not to undertake to tax possessory interests without clear statutory authorization:

> ...[I]t is the intent of the legislature that by repealing [the possessory interest tax] that possessory interests will not be subject to any ad valorem tax until the legislature enacts a new taxing mechanism.

Chapter 294; § 1.A. Quite clearly, Sections 42-14151 and 42-14156, which do not deal with possessory interests in tribal property, are not the "new taxing mechanism" the Legislature had in mind.

If it was truly the intent of the Legislature to reenact some form of possessory interest tax, after all the furor created by the enactment, litigation and subsequent repeal of the previous possessory interest tax statutes,[4] surely there would have been some mention of that in at least one of the Fact Sheets or Bill Summaries for either H.B. 2324 in 2000 or H.B. 2348 in 2003. The absence of any mention of such intent in the legislative history surrounding these enactments strongly undermines the Department's present argument.

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[4] For background, see *Scottsdale Princess Partnership v. Maricopa County*, 185 Ariz. 368, 916 P.2d 1084 (Ct. App. 1995) and *Scottsdale Princess Partnership v. Department of Revenue*, 191 Ariz. 499, 958 P.2d 15 (Ct. App. 1997).

III. CALPINE DOES NOT "OWN" THE FACILITY UNDER ARIZONA LAW.

As discussed in Calpine's Opening Brief, Arizona appellate courts have consistently and repeatedly held that, where an improvement is constructed on land leased from a governmental entity and there are substantial restrictions in the lease on the control and disposition of the improvement by the lessee, the improvement is treated as if owned by the governmental entity for property tax purposes. In its Opening Brief, Calpine discussed in detail six decisions from this Court that directly addressed the issue now before this Court. *Havasu Springs Resort Co. v. La Paz County,* 199 Ariz. 49, 18 P.3d 143 (Ct. App. 2001); *Airport Properties v. Maricopa County*, 195 Ariz. 89, 985 P.2d 574 (Ct. App. 1999); *Cutter Aviation v. Maricopa County*, 191 Ariz. 485, 958 P.2d 1 (Ct. App. 1997); *Maricopa County v. Novasic,* 12 Ariz. App. 551, 473 P.2d 476 (1970); *State of Arizona ex rel., Arizona Dep't of Revenue v. Pima Grande Development II/Vestar*, 1 CA-TX 97-0013 (Ct. App. June 2, 1998); and *Allied-Signal, Inc. v. Arizona Dep't of Revenue,* 1 CA-TX 96-0018 (Ct. App. Aug. 14, 1997).

In its Answering Brief, the Department all but ignores these determinative cases. Its failure to address them in any meaningful way speaks volumes. It knows it cannot distinguish them substantively. Therefore, it claims that they are inapplicable because they did not involve: (1) electric generation facilities; (2) legislation authorizing the taxation of "owned or leased" property; (3) statutory definitions of "personal property" and "real property"; and (4) evidence suggesting that the life of the property at issue was shorter than the lease term. (Answering Brief at 29) However, these "distinctions" do not support the Department's legal position.

The cases referred to above involved a host of different kinds of property, including: a resort, a private air terminal, aircraft maintenance facilities, an office building, a retail mall, and a manufacturing facility. However, the type of property at issue had nothing to do with the legal principles relied upon by Arizona's appellate courts in deciding them. The first two "distinctions" advanced by the Department above have already been addressed and clearly have no merit.

Similarly, the definitions of "personal" and "real" property do nothing to support the Department's position. As the *Cutter* Court observed: "For taxation purposes, 'ownership' has traditionally meant ownership in fee, which includes the rights of control and disposal. [Citations omitted]." *Cutter,* 191 Ariz. at 491, 958 P.2d at 7. This Court prefaced this comment by stating that: "one who has no right to control, handle or dispose of a thing cannot be considered its owner, for the essential attributes of ownership of property, **real and personal**, are the rights in the owner to control, handle and dispose of the thing owned." *Cutter,* 191 Ariz. at 490, 958 P.2d at 6 (emphasis added).

Finally, as to the issue relating to the life of the Facility, the Department ignores the fact that Calpine is expressly prohibited from removing or demolishing any portion of the Facility "without written approval of the Tribe and the Secretary [of the Interior of the United States or his authorized representative]" and that Calpine must maintain the Facility during the term of the Lease and turn-over the Facility to the Tribe at the end of the Lease term "in good repair and in a safe condition." (IR – 20, Exhibit 1, §§ 4.3, 8.2.5, 14.1, 14.2)

Like the Tax Court, the Department ignores that buildings can survive for periods much longer than the lease term here but <u>only</u> if regular repairs and maintenance are performed. For example, the fact that the roof on a building may wear out and have to be replaced before a lease term expires does not affect the ownership analysis. Again, the Lease expressly requires Calpine to turn-over a fully-functioning and well-maintained co-generation power plant when the Lease is over.[5]

The several cases cited by Calpine are on point and they are all applicable here. They stand for the proposition that if the control and disposal of the property is significantly restricted, and there is no express language in the lease indicating an intent by the parties to treat the property as belonging to the lessee (as in *Allied-Signal*), the property is the property of the land owner/lessor – or in this case, the Tribe.

As noted in Calpine's Opening Brief, here, the Lease must be read as a whole and "each part must be read in light of all other parts of the lease." *Novasic*, 12 Ariz. App. at 553; 473 P.2d at 478. A careful reading of the Lease leads to only one conclusion – "that the parties intended that the title acquired by the tenant in the [improvements] was of a leasehold interest only rather than total ownership of the [improvements]." *Id.* at 554; 473 P.2d at 479. Several

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[5] As the Lease makes clear (and the photograph of the Facility shows), the Facility is comprised of buildings as well as machinery and equipment. The Lease requires Calpine to turn-over the <u>entire</u> Facility to the Tribe at the end of the Lease term. The Tax Court's baseless speculation about Calpine's ability to turn-over a "husk" devoid of economic value to the Tribe at the end of the Lease term is not only lacking in evidentiary support, it is contrary to the covenant of good faith that is implied into the Lease by Arizona law. For example, if one of the turbines used to generate power at the Facility wears out even one week before the Lease ends, Calpine is obligated to replace it for the benefit of the Tribe which is the ultimate owner of the Facility under the terms of the Lease.

Lease provisions, similar to those in the cases cited above, establish that the Tribe owns the Facility. Those provisions include:

- The Lease requires that Calpine construct specified improvements on the Tribe's land. (IR – 20, Exhibit 1, §§ 8.1, 5.1)
- The Lease specifies the use of the leased property. (*Id.* at § 5.1)
- Calpine is required to post a performance bond. (*Id.* at § 6.4)
- Calpine is required to maintain insurance on the leasehold improvements and both the Tribe and Calpine are required to be named as insureds. (*Id.* at §§ 12.1. 12.1.2)
- Calpine cannot sublease the improvement without the Tribe's approval. (*Id.* at § 26.4)
- The Tribe has the right to approve any building plans. (*Id.* at § 8.2.3)
- Calpine cannot transfer any interest in the leasehold, including improvements, without the Tribe's consent. (*Id.* at § 26.4)

Significantly, the Lease here also requires Calpine to maintain and repair the Facility <u>throughout the term</u> of the Lease to assure that it remains in good working condition:

> 14.1 <u>Calpine's Duty to Maintain.</u> Throughout the term of this Lease, Calpine shall, at Calpine's sole cost and expense, maintain the Property and all Improvements thereon in proper working condition and repair (including landscaping and parking), <u>making all necessary substitutions and replacements</u>.
>
> 14.2 <u>Calpine's Duty to Repair.</u> If any Improvements on the Leased Land shall be damaged or destroyed

> by any cause whatsoever during the term of this Lease, Calpine shall, subject to Section 8 hereof, with reasonable promptness rebuild, repair or restore the same, to at least substantially the condition existing immediately prior to such damage or destruction.

IR – 20, Exhibit 1, § 14.1, 14.2 (emphasis added).

Calpine may not remove or demolish any of the Facility "without written approval of the Tribe and the Secretary [of the Interior of the United States or his authorized representative.]" (*Id.* § 8.2.5) Most importantly, like the leases in the multiple cases relied upon by Calpine, it must turn over the Facility to the Tribe at the end of the term of the Lease:

> 4.3 Surrender of Premises. Upon the expiration or earlier termination of the Lease Term, **Calpine shall leave all Improvements in place on the Leased Land in good repair and in a safe condition; provided**, however, that Calpine shall remove equipment, supplies and other personal property, including trade fixtures, which have no economic value to the Tribe from the Leased Land within sixty (60) days after the expiration or termination of the Lease Term upon the written request of the Tribe given any time prior to the expiration or termination of the Lease Term.

(*Id.*, § 4.3) The capitalized term "Improvements" in this section of the Lease makes it clear that the items of "equipment, supplies and other personal property" that Calpine has the right to remove are not those assets that constitute the power-generation equipment and structures that house it, because those are the items that give "economic value" to the Tribe.

The Department's reliance upon *Offutt Housing Co. v. County of Sarpy,* 351 U.S. 253 (1956) to support its claim that the Facility is taxable to Calpine is misplaced. Indeed, both the facts and the law at issue in *Offutt* are quite different from this case. Factually, *Offutt,* involved a complicated situation where the U.S. Air Force leased its land for construction of on-base housing. A private company contracted to build residential housing for military and civilian personnel.

Unlike this case, however, there is nothing in *Offutt* to indicate that the contractor there was required to turn-over virtually new buildings at the expiration of the lease term. In fact, there was nothing to indicate that the contractor even had to maintain the buildings. It is not illogical to assume that the Air Force, which used the buildings to house military and civilian personnel at the Base, would maintain the property because, at the expiration of 75 years, the government received whatever was left standing. However, unlike the Lease here, there was no requirement as to the condition of the buildings at the expiration of the lease.

Offutt also dealt with static property, residential buildings. An electric generation facility, which can be operated 24 hours a day, 7 days a week, with many moving parts, not the least of which are the large gas-fired turbines which have components that wear-out and must be replaced on a regular basis, is physically quite different from a house or apartment building. Constant maintenance and repair is necessary for a generation plant to continue to function, a fact that was clearly contemplated by the parties in the Lease. Such a high degree of maintenance and replacement is not required for a house.[6]

Legally, *Offutt* raised the issue of whether Congress had authorized the taxation of these improvements through a combination of the Military Leasing Act of 1947 and the Wherry Military Housing Act of 1949. The Supreme Court, with four justices dissenting, held that these Acts effectively constituted consent by the federal government to the imposition of Nebraska's property tax. The *Offutt* case involved a unique confluence of two congressional enactments that were held to allow states to tax housing located on military bases in limited circumstances that are simply not present here. Thus, *Offutt* has no application to the instant case.

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[6] To compare a house with an electric generation facility, for property tax purposes, is inappropriate under Arizona law. This distinction is emphasized in the Arizona property tax statutes. A residential building is assessed in Legal Class Three by the local county assessor at 10% of its full cash value. A.R.S. § 42-12003. An electric generation facility is assessed in Legal Class One by the Department at 25% (now 23%) of its full cash value. A.R.S. § 42-12001. In addition, the methodology for valuation of electric generation facilities is set forth by statute, A.R.S. § 42-14156, while the methodology for valuation of a residential structure is based on standard appraisal methods and techniques.

Finally, there was no indication in *Offutt* of long-standing state precedents in Nebraska addressing the taxation of leasehold improvements on tax-exempt land. Therefore, not only are the facts in *Offutt* distinguishable, the interpretation of the unique federal legislation at issue in that case as it related to Nebraska's *ad valorem* tax laws limits its applicability here.

In contrast to *Offutt,* according to the terms of the Lease at issue here, Calpine is required to maintain the Facility in virtually new condition. The Lease term is irrelevant other than defining for Calpine the length of time that it has the beneficial use of the Facility and the requirement to maintain and upgrade it so the Tribe receives a fully-functioning power plant at the end of that period. In light of the foregoing, and based on the principles established in the cases discussed at length in Calpine's Opening Brief, the only possible conclusion is that the Facility at issue here is <u>not</u> subject to Arizona property tax. Simply put, the Tribe is deemed to be the "owner" of the Facility under the terms of the Lease when read in its <u>entirety</u> as required by settled Arizona case law.

The Department, recognizing that the Lease does not support its position, seeks to avoid its terms. It contends that the Court should go beyond the Lease terms and conclude that Calpine owns the Facility because: (1) the federal judgment bars re-litigation of the ownership issue; (2) the Lease term exceeds the useful life of the Facility; (3) a "sale-leaseback" transaction suggests the Tribe does not really own the improvements; and (4) financial records and Calpine's website suggest that Calpine is the owner.[7]

The Department's position is without merit because the Lease defines the relationship of the parties to it, and <u>none</u> of the factors relied upon by the Department support its position. The first two factors relied upon by the Department are addressed above and in Calpine's Opening Brief. To reiterate, the federal judgment does not bar "re-litigation" of the ownership issue, and the term of the Lease is not controlling given the requirements imposed on Calpine to maintain, report and turn-over a functioning power plant at the end of that term.

The Lease must be read as a whole and "each part must be read in light of all other parts of the lease." *Novasic*, 12 Ariz. App. at 553; 473 P.2d at 478. A careful reading of the Lease here leads to only one conclusion – "that the parties intended that the title acquired by the tenant in the [improvements] was of a

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[7] Ironically, the Department cites to Calpine's website as support for its argument that Calpine is the owner of the Facility, but simultaneously objects to the use of a photograph of the Facility that was down-loaded from Calpine's website.

leasehold interest only rather than total ownership of the [improvements]." *Id.* at 554; 473 P.2d at 479.

As for the "sale-leaseback" transaction, which was, in essence, a financing transaction, the Department ignores the fact that the refinancing required the Tribe's consent. This required consent is simply one more factor consistent with the degree of control outlined in the *Cutter* cases. The Department's conclusory statement that this transaction proves that Calpine owns the Facility, without more, does nothing to support the Department's position.

The Department selectively discusses a few – very few – Lease provisions it claims support its position. (Answering Brief at 33, 34) For example, the Lease provides that during the lease term, the Facility belongs to Calpine. This, however, is no different than the lease terms in the cases relied upon by Calpine. For example, in *Novasic*, *supra,* 12 Ariz. App. at 553-555, 473 P.2d at 478-480, the government owned the property at issue even though the tenant had built the building and had control over the building during the lease term, and, as in this case, the improvements "became" the property of the lessor only upon termination of the lease. *Id.* This Court rejected the notion that the lessee "owned" the improvements simply because the lease provided that at the end of the lease, the improvements "become" the property of the lessor. *Id.*

The same was true in *Cutter, supra,* 191 Ariz. at 491, 958 P.2d at 7. In fact, a provision nearly identical to the one cited by the Department was relied upon by the Department in *Pima Grande;* however, following *Cutter,* this Court held that such a provision did not mean the lessee owned the improvements for property tax purposes. *State of Arizona ex rel., Arizona Dep't of Revenue v. Pima Grande Development II/Vestar, supra,* at 9. In short, these cases all make it clear that the provisions cited by the Department do not confer ownership of the Facility upon Calpine, and they do not alter the legal analysis that applies to taxation of possessory interests under settled Arizona law.

The Department also cites the provisions in the Lease that provide that if the Tribe condemns the Facility, it will compensate Calpine and if another entity condemns the property, Calpine will also receive a portion of the condemnation proceeds. These provisions are not surprising, nor do they suggest that Calpine owns the Facility for property tax purposes. More importantly, they do not negate the factors relied upon by this Court in determining the ownership issue in the multiple Arizona cases relied upon by Calpine.

Finally, the same is true of the last provision cited by the Department; namely, that Calpine can remove damaged and obsolete property. This term, of course, demonstrates the erroneous nature of the Tax Court's suggestion that Calpine can turn-over to the Tribe a worthless electrical generation plant. Indeed, this provision is consistent with Calpine's obligation to "maintain and repair" the Facility throughout the term of the Lease to assure that it remains in "good working condition" and to turn over the Facility to the Tribe at the end of the lease term as a fully-functioning power plant, no matter what that requires.

IV. THE TAX COURT ERRED IN STRIKING THE PRIOR MEMORANDUM DECISIONS OF THIS COURT.

The Department devotes nearly a third of the argument in its Answering Brief to the issue of whether the Tax Court properly struck the Memorandum Decisions of this Court; *State of Arizona ex rel., Arizona Dep't of Revenue v. Pima Grande Development II/Vestar*, 1 CA-TX 97-0013 (June 2, 1998) and *Allied-Signal, Inc. v. Arizona Dep't of Revenue*, 1 CA-TX 96-0018 (Aug. 14, 1997). Contrary to the Department's protestations, Calpine properly submitted those decisions to the Tax Court and it erred in striking them.

In its Opening Brief, Calpine demonstrated that it met the requirements of Rule 28(c), Arizona Rules of Civil Appellate Procedure for citing these cases. Calpine established the elements of collateral estoppel; namely, that the ownership issue was litigated in both cases, that there was a full and fair opportunity to litigate the issue in both cases, that resolution of the issue was essential to both decisions, that a final decision on the merits was entered and that there was a common identity of the parties sought to be bound by those rulings; namely, the Arizona Department of Revenue.

Perhaps what is most important, however, is the fact that neither unpublished decision created any new law. To the contrary, in *Pima Grande,* this Court noted in rendering its decision, that it was relying on the law recently (at the time) pronounced in *Cutter*. It stated: "As we held in *Cutter AviationError! **Bookmark not defined.**,* a lessee whose lease substantially restricts his right to control and dispose of the leasehold improvements is not considered the owner." *Pima Grande, supra,* at 9. Hence, there is no reason to ignore these cases here.

CONCLUSION

The Tax Court's decision is incorrect. The undisputed facts in this case and the terms of the Lease between Calpine and the Tribe, when viewed in light of the well-established legal principles in the *Novasic* line of cases, establish that Calpine does not own the Facility for Arizona property tax purposes. Accordingly, the summary judgment rendered by the Tax Court in the

Department's favor should be reversed and the Court should grant summary judgment in Calpine's favor as a matter of law.

RESPECTFULLY SUBMITTED this 12th day of May, 2008.

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CERTIFICATE OF SERVICE

Paul J. Mooney, being first duly sworn upon his oath, states that on May 12, 2008, he caused the original and six copies of the foregoing Reply Brief of Appellant to be mailed via the United States Postal Service, with proper postage prepaid, for filing to:

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Pursuant to Rule 14, Arizona Rules of Civil Appellate Procedure, the undersigned counsel certifies that this brief uses a proportionately spaced typeface of Times New Roman at 14 points. According to the Microsoft Word word count function, this brief contains 6,504 words excluding the Tables of Contents, Table of Authorities, Abbreviations and Citations to the Record, Certificate of Service, this Certificate of Compliance, and any Appendix.

RESPECTFULLY SUBMITTED: May 12, 2008.

Paul J. Mooney