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IN THE SUPERIOR COURT OF THE STATE OF ARIZONA

IN AND FOR THE COUNTY OF MARICOPA

DEBORAH McEWEN, et al.,

Plaintiffs,

vs.

BOARD OF DIRECTORS OF THE ARIZONA COMMERCE AUTHORITY, et al.,

Defendants.

Case No. CV2025-001929

DEFENDANT BOARD OF DIRECTORS OF THE ARIZONA COMMERCE AUTHORITY'S REPLY IN SUPPORT OF ITS MOTION TO DISMISS

(Assigned to Honorable Michael Herrod)

(Oral Argument Requested)

I. Introduction

In its Motion, the ACA explained that Plaintiffs' Gift Clause challenge to the Motion Picture Production Program tax credits runs headlong into binding precedent, conflicts with the constitution's text and history, and would upset Arizona tax policy. First, in *Kotterman v. Killian*, 193 Ariz. 273 (1999), the Supreme Court squarely held that tax credits do not implicate the Gift Clause. Second, the Gift Clause's plain text confirms that it does not apply to tax credits. Third, concluding that tax credits implicate the Gift Clause—contrary to *Kotterman* and the clause itself—would raise separation-of-powers concerns. Finally, permitting taxpayers to challenge every tax credit under the Gift Clause would jeopardize Arizona's entire tax system. The ACA thus argued the Court should dismiss Plaintiffs' lawsuit for failure to state a claim or, alternatively, for lack of standing.

None of the arguments in Plaintiffs' Response overcomes these hurdles. Plaintiffs initially try to skirt *Kotterman*, arguing their suit targets a refundable tax credit and *Kotterman* prohibits Gift Clause challenges to non-refundable tax credits only. Yet Plaintiffs then spend the rest of their Response undercutting this position. They argue (at 12) that, under the constitution's text and structure, "even non-refundable tax credits … are subject to Gift Clause scrutiny." And they contend (at 12, 14) that Gift Clause scrutiny should apply to Arizona's entire tax system, including "tax credits, deductions, exemptions, and classifications." These sweeping claims threaten dozens of tax statutes and unmask Plaintiffs' effort to overturn *Kotterman* with a complete assault on Arizona's tax framework.

Plaintiffs' arguments are not just internally inconsistent. They are mistaken. Plaintiffs challenge an entire tax-credit Program and specific tax-credit applications—whether or not any taxpayer receives a refund. *Kotterman* squarely forecloses these claims. Further, the constitution's text, structure, and history confirm that tax credits are one of several legislative enactments to which the Gift Clause does not apply. To find otherwise would upend Arizona's long history of purposeful tax credits, exemptions, deductions, and transaction-privilege classifications for eligible taxpayers.

The Court should dismiss Plaintiffs' claims under Rule 12(b)(6) or, alternatively, under Rule 12(b)(1) for lack of taxpayer standing.

II. Legal Argument

A. The Gift Clause does not apply to tax credits.

Supreme Court precedent and the constitution's text, structure, and history dispense with Plaintiffs' claims. The Court should find that Plaintiffs cannot, as a matter of law, overcome the presumption of constitutionality. "All statutes are presumed to be constitutional and any doubts will be resolved in favor of constitutionality." *Ariz. Downs v. Ariz. Horsemen's Found.*, 130 Ariz. 550, 554 (1981). "It is axiomatic that [courts] must interpret statutes," such as the Program and its tax credit, "whenever possible, to avoid an unconstitutional result." *State ex rel. Ariz. Dep't of Revenue v. Tunkey*, 254 Ariz. 432, 439, ¶ 35 (2023) (Bolick, J. concurring).

1. *Kotterman* bars Gift Clause challenges to tax credits.

As the ACA showed in its Motion (at 5), Plaintiffs' claims rest on the flawed premise that a tax credit can be a gift. In *Kotterman*, the Supreme Court rejected this premise, explaining that "a tax credit [does not] amount[] to a 'gift'" because "[o]ne cannot make a gift of something that one does not own." 193 Ariz. at 288, ¶ 52. Put differently, the State does not own future taxable income, so it gives nothing away by forgoing the imposition of taxes on that future income. Under *Kotterman*, prospective tax credits do not implicate the Gift Clause at all. *Kotterman* thus bars Plaintiffs' claims, and each of Plaintiffs' attempts to sidestep *Kotterman* fail.

a. *Neptune Swimming* reaffirms that one cannot give what it does not own.

Plaintiffs argue (at 10) that the "claim that the Gift Clause does not apply because 'the [S]tate cannot own taxable income that taxpayers have not yet earned,' … is foreclosed by *Neptune Swimming*." Quite the opposite. Not only did *Neptune Swimming* distinguish the facts there from tax credits, but the Court reaffirmed *Kotterman*'s holding that one cannot give what it does not own.

There, the City of Scottsdale evaluated bids from two private swim clubs for the exclusive rights to use the City's aquatic centers. *Neptune Swimming Found. v. City of Scottsdale*, 256 Ariz. 551, 555–56, ¶¶ 1–2 (2024). The City awarded the rights to the club that offered "the less profitable arrangement." *Id.* at 556, ¶ 2. The club that offered "the higher bid" sued, arguing the City violated the Gift Clause by forgoing the more profitable bid. *Id.* The City contended its decision to forgo the greater-revenue-generating bid did not violate the Gift Clause because this decision was like the tax credit in *Kotterman*, which allowed the State to forgo the collection of greater taxes. *Id.* at 560, ¶¶ 27–29.

The Court disagreed. It explained that "such arrangements are *not* like the tax credit challenged under the Gift Clause in *Kotterman*." *Id.* at 560, ¶ 29 (emphasis added). Instead, the City "own[ed] the property access rights" to its pools, so giving those rights away implicated the Gift Clause. *Id.* Tax credits are different: "because the [S]tate does not own untaxed taxpayer income, foregoing collecting some of that income by applying the credit could not be a 'gift.'" *Id.* (quoting *Kotterman*, 193 Ariz. at 288, ¶ 52).

Neptune Swimming thus offers Plaintiffs no support. Although the Court reasoned that "foregoing collecting" money could create a gift in some situations, *id.*, the Court limited those situations to when the State forgoes the collection of money related to an interest it owns. As the ACA argued in its Motion (at 6–7), the State does not own an interest in prospective taxpayer income. Plaintiffs do not dispute this. The State's forgoing the collection of prospective taxpayer income thus cannot be a gift.

Further, *Neptune Swimming* eliminates any doubt that *Kotterman* remains binding precedent. The *Neptune Swimming* Court reiterated—without limitation—the reasoning and decision in *Kotterman*: "tax credit[s] … [can]not be a 'gift.'" *Neptune Swimming*, 256 Ariz. at 560, ¶ 29 (quoting *Kotterman*, 193 Ariz. at 288, ¶ 52). Under *Kotterman* and *Neptune Swimming*, Plaintiffs' claims fail as a matter of law.

b. The tax credit in *Kotterman* is like the tax credit here.

Plaintiffs also argue that the tax credit in this case differs materially from the STO tax credit in *Kotterman*. Plaintiffs are wrong. At the outset, the fundamental principle that

the State cannot give what it does not own applies to *all* prospective tax credits, regardless whether it was a donation that triggered the tax credit. The STO tax credit, like the tax credit here, benefited private individuals and entities by reducing tax revenues that would have increased public funds.

Plaintiffs argue (at 3) that *Kotterman* is distinguishable because "no public funds ever changed hands—and no private party received a public benefit." According to Plaintiffs, the STO tax credit "merely gave [taxpayers] a choice of *whom* to pay: either the State or a qualifying charitable entity," so "their financial position remained unchanged," while the Program tax credit, by contrast, "reduces the tax liability of film companies." [Resp. at 10 (emphasis original).]

But this mischaracterizes the STO tax credit in *Kotterman*, which facilitated the "encouragement of private schools," 193 Ariz. at 278, ¶ 8, and could "reimburse parents for expenses incurred in schooling their children," *id.* at 283, ¶ 25. The STO tax credit, for instance, allowed parents to donate $500 to an STO, receive a $500 scholarship from an STO for their child, and receive a $500 reduction in prospective tax liability. The STO tax credit thus improved the financial position of private schools (by helping STOs pay private school tuition) and parent taxpayers (by reducing their prospective tax liability)—clear benefits to private schools and taxpayers alike, facilitated by a reduction in tax revenue and public funds.

Here, the Program tax credit likewise improves eligible film companies' financial position without implicating the Gift Clause. Like parent taxpayers who claim an STO credit and private schools that receive tuition from STOs, companies that produce films in Arizona receive financial benefits that reduce public tax revenues. *Kotterman* confirms that such benefits, implemented through tax credits, do not implicate the Gift Clause.

For these reasons, Plaintiffs are wrong when they argue (at 6) that the State's providing "*anything* of value to a private entity for non-public reasons … violates the Gift Clause," and (at 8) that "laws that eliminate people's financial obligations to the [S]tate are unconstitutional gifts." The tax credit in *Kotterman* is an example of a law that gives

something of value to private actors (i.e., STOs, private schools, and parent taxpayers) while eliminating a prospective financial tax obligation to the State. But the Gift Clause did not apply, and the Court did not need to analyze whether there was a public purpose or adequate consideration. 193 Ariz. at 288, ¶ 51.

c. The tax credit's refundability does not change the *Kotterman* analysis.

Plaintiffs argue (at 10) that *Kotterman* is distinguishable because the tax credit there was non-refundable, whereas the tax credit here is refundable. This argument fails for at least three reasons: the majority in *Kotterman* rejected concerns about refundability, a refundable tax credit is still a reduction in prospective tax liability not owned by the State, and refundability is immaterial to Plaintiffs' facial and as-applied challenges.

First, Justice Feldman's dissent in *Kotterman*, like Plaintiffs, argued that taxpayers "may well make a profit" and receive "a dollar-for-dollar refund" from the tax credit. *Kotterman*, at 309–10, ¶ 148, n.17 (Feldman, J., dissenting). Yet, in addressing whether the tax credit was a religious "appropriation" prohibited under article II, § 12 (an analysis similar to whether a tax credit is a "grant" or "subsidy"), the majority rejected concerns about refunds. *Kotterman*, at 287–88, ¶ 48. The majority reasoned that the tax credit was not an appropriation; whether taxpayers could receive a refund was "a policy matter for the legislature and the taxing authorities to address, rather than this court"; and the refundability of the STO tax credit "in no way change[d] [the Court's] constitutional analysis." *Id.* Whether the Program tax credit here may result in a refund is a policy matter for "the other branches of government," and in no way should it change this Court's constitutional analysis. *See id.*

Second, refundable tax credits—like all tax credits, deductions, and exemptions and transaction-privilege tax deductions and exemptions—still reduce prospective tax liability. A tax credit may result in a positive tax liability (taxpayer still owes taxes), zero taxes (no tax liability or refund), or a negative tax liability (taxpayer receives a refund or credit voucher). In any case, the credit remains a reduction in prospective tax liability,

which the State does not own and cannot give away, *id.* at 288, ¶ 52, subject to a host of other factors, including the application of other credits and withholdings or estimated tax payments previously paid by taxpayers.

Third, the refundability of the Program tax credit is inconsequential to Plaintiffs' facial and as-applied challenges as pleaded in the Complaint. To prevail on their facial challenge, Plaintiffs must prove "no circumstances exist" under which the Program would be found constitutional. *State v. Burke*, 238 Ariz. 322, 325, ¶ 4 (App. 2015). Plaintiffs do not (and cannot) allege the Program will provide *all* applicant taxpayers with a refund. The refundability of the tax credit is thus irrelevant to Plaintiffs' facial challenge. The only allegation material to the facial challenge, and which would apply to all circumstances, is that the State's "foregoing the collection of income taxes" implicates the Gift Clause. [Complaint ¶ 144.] *Kotterman*, however, squarely forecloses such a claim.

For their as-applied challenges, Plaintiffs do not allege that *any* taxpayer application, including MoPic-2023-008 and MoPic-2024-004, has resulted or will result in a refund. [*Id.* ¶¶ 145–58.] Whether these applications will result in a refund turns on many unknown variables, including taxpayer income, claimed credits and deductions, and resultant tax liability. Plaintiffs allege no facts from which the Court could reasonably infer that these applications would result in a refund. And even if the Court could infer this, it is still possible that no refund would ever occur. Plaintiffs allege that the credit may be "[1] paid to the taxpayer …, [2] issued as a credit voucher to be carried forward and applied against future tax liabilities, or [3] [disbursed as] a combination of a refund and a credit voucher." [*Id.* ¶ 93.] If a refund were disbursed as a credit voucher, the State would not have paid a refund to any taxpayer. The fact that the Program tax credit could be refundable, under certain unalleged circumstances, is thus immaterial to Plaintiffs' as-applied challenges.

To avoid these issues, Plaintiffs could have challenged only the refundability of the Program tax credit. They did not. Instead, Plaintiffs' facial and as-applied challenges,

as pleaded in their Complaint, attack only the Program tax credit. Plaintiffs' claims therefore boil down to whether the State's "foregoing the collection of income taxes" implicates the Gift Clause. [Complaint ¶ 144.] *Kotterman* has already decided that tax credits do not implicate the Gift Clause. Plaintiffs' claims are therefore barred.

2. The Gift Clause's text proves it does not apply to tax credits.

As the ACA showed in its Motion (at 6–7), the Gift Clause's text does not implicate or even mention tax credits. Rather, it states that neither the State nor any subdivision of the State "shall ever give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any individual, association, or corporation." Ariz. Const. art. IX, § 7. Plaintiffs' attempts to stretch the text to include tax credits fail.

Plaintiffs argue (at 6) that the Program tax credits fall under the phrase "by subsidy or otherwise." But tax credits, exemptions, and deductions are neither subsidies nor forms of government sponsorship. *See Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 590 (1997) ("[T]here is a constitutionally significant difference between subsidies and tax exemptions."); *Walz v. Tax Comm'n of City of N.Y.*, 397 U.S. 664, 675 (1970) ("The grant of a tax exemption is not sponsorship."); *Kotterman*, 193 Ariz. at 288, ¶ 50 (there is "no constitutional difference between a [tax] credit and a deduction").

Kotterman likewise rejects the notion that a tax credit gives "public money" in violation of article II, § 12, and article IX, § 10 of the Arizona Constitution. *Kotterman*, 193 Ariz. at 284–85, ¶¶ 33–37. "[U]nder such reasoning all taxpayer income could be viewed as belonging to the [S]tate"—an "expansive interpretation … fraught with problems." *Id.* at 285, ¶ 37. A tax credit is not a gift or subsidy of public money based on "any common understanding of the[se] words." *Id.* at 285, ¶¶ 36–37.

Inviting this Court to expand the Gift Clause to include tax credits, Plaintiffs contend (at 7, 12) that "courts have always applied meaningful [Gift Clause] scrutiny to taxing and spending actions by the government," "regardless of whether they involve a direct 'grant of money.'" Not so; courts have approached the Gift Clause with more nuance than Plaintiffs acknowledge. The State's spending actions related to pension

benefits, for example, are categorically excluded from Gift Clause scrutiny. *See Yeazell v. Copins*, 98 Ariz. 109, 113 (1965); *Burke v. Arizona State Ret. Sys.*, 152 Ariz. 323, 326 (App. 1986); *McClead v. Pima Cnty.*, 174 Ariz. 348, 358 (App. 1992).

Further, even when courts have applied the Gift Clause, they do not (and need not) always closely scrutinize benefits that are not direct grants of money. Consider *Town of Gila Bend v. Walled Lake Door Co.*, where the Supreme Court evaluated a government-funded, 6,000-foot water line to a private company facility. 107 Ariz. 545, 547 (1971). Even though the water line "would presently benefit only the [c]ompany," the Court held that the government paying for the construction and installation of the water line would not violate the Gift Clause. *Id.* at 549; *see also Humphrey v. City of Phx.*, 55 Ariz. 374, 387 (1940) (government subsidized low-income housing was "not a gift or loan to anyone"); *S. Side Dist. Hosp. v. Hartman*, 62 Ariz. 67, 69, 74 (1944) (government's "loose arrangement" for one-dollar annual lease to hospital did not violate Gift Clause).

Plaintiffs also misconstrue (at 6) two decisions from the Court of Appeals, *Maricopa Cnty. v. State*, 187 Ariz. 275 (App. 1996), and *Pimalco, Inc. v. Maricopa Cnty.*, 188 Ariz. 550 (App. 1997), claiming they show that "[c]ertain kinds of taxation-based subsidies can also be unconstitutional gifts." Not only did the courts in these cases uphold the challenged tax actions as constitutional, but neither case involved a reduction in future tax liability (like the Program tax credit). In fact, "[b]oth cases took care to distinguish retrospective laws that eliminate *existing* tax obligations from laws that simply cut taxes prospectively." Sandefur, *The Arizona Gift Clause in the Twenty-First Century*, 16 Drexel L. Rev. 299, 352 (2024) (emphasis original). Even if the pre-*Kotterman* decisions in *Maricopa County* or *Pimalco* had suggested that prospective reductions in tax liability could implicate the Gift Clause, *Kotterman* now precludes that result.

Finally, Plaintiffs argue (at 8) the Program tax credit requires Gift Clause scrutiny because "Arizonans obtain no specific public good" or "proportionate consideration" from the Program. That is, Plaintiffs argue the Gift Clause must apply because if it did, the Program tax credit would fail scrutiny. "This type of inference is an example of affirming

the consequent, a classic form of invalid reasoning." *In re Stewart Foods, Inc.*, 64 F.3d 141, 145 n.3 (4th Cir. 1995) (describing the logical fallacy of affirming the consequent: "(1) If A is true, then B is true. (2) B is true. (3) Therefore, A is also true."). Whether the Program tax credit would survive Gift Clause scrutiny is irrelevant to whether the Gift Clause applies in the first instance. And as shown by its plain text, it does not.

3. Applying the Gift Clause to tax credits would conflict with the Arizona Constitution's structure and history.

The ACA showed in its Motion (at 7–9) that the Constitution permits only the Legislature, not the courts, to set tax policy. Article III divides "[t]he powers of the government of the [S]tate of Arizona … into three separate departments, the legislative, the executive, and the judicial," and specifies that, "except as provided in this constitution, … no one of such departments shall exercise the powers properly belonging to either of the others." Ariz. Const., art. III. The authority to decide tax policy belongs exclusively to the Legislature.

Ignoring the Constitution's separation of powers, Plaintiffs argue (at 9, 12–13) that Gift Clause scrutiny applies to tax credits just as it would to any other law. They are wrong. Tax-policy decisions are "a legislative function," which courts "usurp" by "substituting [their] concept of public policy for that of the legislative body." *Tanque Verde Enters. v. City of Tucson*, 142 Ariz. 536, 542 (1984). Under this "well-settled constitutional standard," the Legislature has the "unlimited discretion to set the rate of taxation," including to increase prospective taxes or, like here, forgo the collection of prospective "revenue raising tax." *Id.* at 539.

Whether the Legislature has decreased a tax obligation retrospectively or prospectively is key. The latter is well within the Legislature's "sovereign authority to set taxes" because "it would be absurd to hold that laws that cut taxes qualify as unconstitutional gifts." Sandefur, *The Arizona Gift Clause in the Twenty-First Century*, 16 Drexel L. Rev. at 352. Credits and cuts to prospective taxes, like the Program tax credit, cannot implicate the Gift Clause, and to hold otherwise would be an "absurd"

encroachment of legislative authority. *See id.*

Plaintiffs also argue (at 9) that the Program tax credit does not fall under the Legislature's broad discretion to enact tax policy because "[t]he Program is not a general incentive available to all; it's a targeted subsidy for a chosen few." But nearly every tax credit, deduction, exemption, and transaction-privilege classification targets certain taxpayers with eligibility criteria. The *Kotterman* tax credit, for instance, targeted taxpayers who donated to STOs. And neither the constitutional text nor its structure and history give reason to distinguish between tax-policy decisions that benefit all or a targeted few.

On the contrary, the framers discussed at the Constitutional Convention whether to prohibit tax credits and exemptions that benefited private corporations. [Mot. at 8–9.] They chose not to prohibit such targeted benefits. [*Id.*] In fact, from early statehood on, the Legislature has made tax policy that favors some taxpayers over others. In 1912, for example, the Legislature provided private car companies with a special property tax in lieu of the General Property Tax. 1912 Ariz. Sess. Laws ch. 39. Twenty years later, the Legislature provided certain private industries with transaction-privilege tax exemptions and lower transaction-privilege tax rates: most businesses would be taxed at 2.0%; oil, gas, and railroad companies would be taxed at 0.5%; and insurance, banking, and certain mining businesses would be fully exempt. 1933 Ariz. Sess. Laws ch. 90.

The Legislature's decision to set prospective tax policies and provide certain taxpayers with tax benefits has never been held to implicate the Gift Clause. The Court should resist Plaintiffs' invitation to usurp this constitutional authority and second guess the Legislature's policy decisions. *Tanque Verde Enters.*, 142 Ariz. at 542.

4. Applying the Gift Clause to tax credits would upend Arizona's tax framework.

Accepting Plaintiffs' invitation would upend Arizona tax policy. By Plaintiffs' lights, every Arizona tax credit, deduction, exemption, and transaction-privilege classification, deduction, and exemption should be subject to Gift Clause scrutiny. They

argue (at 12) that "the question of whether … aid to a private entity violates the Gift Clause 'is ultimately the province of the judiciary,'" and (at 14) that "tax credits, deductions, exemptions, and classifications are subject to" Gift Clause challenges. As already explained, Plaintiffs are wrong.

But if Plaintiffs were correct, then litigants could drag into courts the millions of applications of each one of the State's dozens of tax credits and transaction-privilege classifications. [Mot. at 11 n.3; 12 n.4.] Plaintiffs could challenge, for instance, the government's decision to provide targeted tax benefits to retail stores but not law firms, or to farmers but not food trucks. Fortunately, these policy decisions related to tax credits and transaction-privilege classifications do not implicate the Gift Clause. And the Court need not "make judgments about the overall wisdom of the tax credit," as that "obligation falls to the other branches of government." *Kotterman*, 193 Ariz. at 288, ¶ 48.

Plaintiffs also argue (at 14) that this Court "need not wade into complex policy questions about tax relief" and can instead address only "the tax credit provided by this Program." But Plaintiffs' arguments, resting on their sweeping and unprecedented interpretation of the Gift Clause, are not nearly so limited. On the contrary, they would place in the Gift Clause's sights *all* "tax credits, deductions, exemptions, and classifications" [Resp. at 14]—which necessarily would include those for donations to STOs and religious and charitable institutions. The Court should avoid that morass.

B. Plaintiffs lack standing.

As the ACA showed in its Motion (at 12–14), Plaintiffs lack taxpayer standing because tax credits are not government expenditures or appropriations, and Plaintiffs' alleged incidental harm turns on hypothetical facts (the issuance of a refund) that may not arise in the future. Plaintiffs did not overcome either argument in their Response. And although standing is a prudential doctrine, there are no prudential concerns here, where binding precedent and the plain text of the Gift Clause foreclose Plaintiffs' claims.

III. Conclusion

The Court should dismiss Plaintiffs' claims with prejudice.

DATED this 15th day of July, 2025.

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