

PRIVATE TAXPAYER RULING LR01-005

July 19, 2001

The following private taxpayer ruling is in response to your letter of March 7, 2000. Your letter requests a department ruling regarding the taxation of a sanitary district's gross proceeds of sales or gross income derived from the sale of effluent or reclaimed wastewater.

The following is a restatement of the facts as presented in your request for a private taxpayer ruling on behalf of your client

Statement of Facts:

According to your letter, the ... ("District") operates a wastewater collection and treatment system in northern ... County, Arizona. The District is a Special Taxing District and is invested with the powers of a municipal corporation. Once the wastewater is treated, the District disposes of the treated wastewater ("effluent") in accordance with state and federal environmental laws.

The District can dispose of the effluent in three ways: (1) release the effluent into Arizona waters; (2) provide the effluent free of charge or for reimbursement of delivery fees; or (3) sell the effluent at a profit.

Page two of the "State of Arizona Reclaimed Wastewater Reuse Permit" ("Permit") filed by the District in ... of ..., describes the District's operation as follows:

The ... Wastewater Treatment Plant (WWTP) has a maximum average flow of 1.7 million gallons per day (MGD). The WWTP treatment process includes headworks, denitrification, clarification, sand filtration, UV disinfection, and a solids handling cell. The effluent will be consumptively reused by irrigation on the reuse sites listed above. The permitted effluent reuse category is 'Open Access'. Effluent that cannot be reused will be discharged into the ... tributary to the ... as regulated by the NPDES Permit No. AZ Waste sludge will be disposed of in accordance with the State regulations.

Additionally, the Permit allows the effluent water to be distributed to various golf courses, schools, ranches, parks and several other locations.

The Arizona Department of Environmental Quality (ADEQ), reports that the ... of ... Water Department serves the vast majority of water customers within the city. Over ... individuals and

entities are served by the city. Furthermore, according to ADEQ, the ... Water Department can be considered to be in competition with the District for sales of water to golf courses, schools and parks. Additionally, other water companies serve the area. ... Company serves about ... customers and ... Company approximately ... customers.

Your Position:

The District is mandated by law to dispose of effluent, the District's sales of effluent are not subject to Arizona's transaction privilege tax under the utilities classification of Arizona Revised Statutes (A.R.S.) § 42-5063.

- A government entity may engage in either proprietary or governmental functions. Proprietary functions are those in which the government engages for profit: a commercial activity. *Book-Cellar, Inc. v. City of Phoenix*, 150 Ariz. 42, 44, 721 P.2d 1169 (1986).
- Proprietary sales (i.e., sales of potable water) are subject to transaction privilege tax. *Flowing Wells Irrigation Dist. v. Tucson*, 176 Ariz. 623, 624, 863 P.2d 915 (Ariz. Tax Court 1993).
- Effluent is different from potable water because effluent is not property acquired, held or used by cities for the benefit of the public. Quoting *City of Phoenix v. Long*, 158 Ariz. 59, 63, 761 P.2d 133, effluent "is a noxious by-product of the treatment of sewage which the cities must dispose of without endangering the public health and without violating any federal or state pollution laws."
- The terms effluent; wastewater; sewage; sewerage system; wastewater treatment plant; reclaimed wastewater; and reuse of reclaimed wastewater are defined in Title 18, Chapter 9 of the Arizona Administrative Code.
- Selling potable water and disposing effluent both involve the operation of a utility, yet the activities are different. Providing a "sewerage system" is a service. Revenues derived from such a service are not subject to taxation. Providing a "wastewater treatment plant" and "wastewater reclamation system" are services not subject to taxation. It is not the production and furnishing of water to customers within the meaning of A.R.S. § 42-5063. It is the cleaning for disposal of a 'noxious by-product' of the treatment of sewage, and is exempt from taxation."
- The operation a sewage disposal plant is a governmental function and not a proprietary activity. *Copper Country Mobile Home v. City of Globe*, 131 Ariz. 329, 333, 641 P.2d 243. Establishing rates to be charged for sewage disposal for customers within the corporate limits of a city is a governmental function. *Copper Country*. Governmental functions of a municipal corporation are exempt from taxation. *Flowing Wells*, 176 Ariz. 624; *City of Phoenix v. City of Goodyear*, 174 Ariz. 529, 851 P.2d 154 (Tax Court 1993); *Salt River Project Agric. Improvement and Power Dist. v. City of Phoenix*, 129 Ariz. 398, 631 P.2d 553 (App. 1981).

The District believes that disposal of treated wastewater, even for a fee, is a governmental

activity, as exempt from taxation as are user fees. Taxes are not payable on amounts collected in connection with the disposal of treated wastewater by the District.

Applicable Statutory Provisions and Administrative Rules:

A political subdivision of the state is immune from taxation pursuant to Article XIII, § 7, of the Arizona Constitution which provides that a special district is any entity with substantially the following characteristics:

1. The status of a political subdivision of this state vested with the rights, privileges and immunities of a municipality to the extent consistent with its stated purposes.
2. A limited purpose as stated in its authorizing statutes.
3. An independently elected governing body.
4. Exterior boundaries within or coterminous with a single county.
5. The power to impose and collect taxes.
6. Perpetual succession of its governmental existence, purpose, powers and governing body, subject to a prescribed dissolution procedure.
7. Corporate existence separate and apart from any other unit of government.

A.R.S. § 42-5001(1) defines "business" to include activities or acts which produce a direct or indirect gain, benefit or advantage.

A.R.S. § 42-5001(8) provides that "person" or "company" includes an individual, firm, partnership, joint venture, association, corporation, and many other entities.

A.R.S. § 42-5001(13) defines "sale" to mean any transfer of title or possession of tangible personal property or other activities taxable under this chapter, for a consideration.

A.R.S. § 42-5001(16) defines "tangible personal property" to mean personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses.

A.R.S. § 42-5008 levies the transaction privilege tax upon the gross proceeds of sales or gross income of persons conducting business activities in Arizona.

A.R.S. § 42-5061 imposes the transaction privilege tax on the business of selling tangible personal property at retail. All sales of tangible personal property are subject to tax unless specifically exempted by statute.

A.R.S. § 42-5063 provides that the utilities classification is comprised of the business of producing and furnishing or furnishing to consumers electricity, natural or artificial gas and water.

A.R.S. § 48-2001(D) provides that a sanitary district established under this chapter is a body corporate with the powers, privileges and immunities generally granted to municipal corporations by the constitution and laws of this state for the purposes prescribed by this chapter.

Environmental quality is addressed by Title 18 of the Arizona Administrative Code ("A.A.C."). The specific topic of water pollution control is found in Chapter 9 of Title 18. Article 1 deals with aquifer protection permits. A.A.C. R18-9-101. Article 7 regulates the reuse of wastewater. A.A.C. R18-9-701.

A.A.C. R18-9-101 provides the following definitions:

24. "Sewage" means untreated wastes from toilets, baths, sinks, lavatories, laundries, and other plumbing fixtures in places of human habitation, employment, or recreation.

25. "Sewage collection system" means a system of pipelines, conduits, manholes, pumping stations, force mains, and all other structures, devices, and appurtenances that collect, contain, and conduct sewage from its sources to the entry of a sewage treatment facility or onsite wastewater treatment facility serving sources other than a single residence.

26. "Sewage treatment facility" means a plant or system for sewage treatment and disposal, except an onsite wastewater treatment facility, that consists of treatment works, disposal works, and appurtenant pipelines, conduits, pumping stations, and related subsystems and devices.

A.A.C. R18-9-701 provides the following definitions:

2. "Effluent" means wastewater that has completed its passage through a wastewater treatment plant.

...

8. "Open access" means that access to the reuse site by the general public is uncontrolled.

...

11. "Reclaimed wastewater" is effluent which meets the standards for the specific reuses contained in R18-9-703.

...

16. "Wastewater" means sanitary wastes of human origin, sewage, gray water, and industrial wastes that contain sanitary wastes or are used in the production or processing of any crop or substance which may be used as human or animal food.

17. "Wastewater reclamation system" means the wastewater treatment plant and the entire reuse and distribution system for the reclaimed wastewater.

18. "Wastewater treatment plant"

encompasses all of the processes, devices, structures, and earth-works which are used for treating wastewater for disposal and reuse but does not include septic tanks, wastewater treatment plants serving single family residences, industrial unit processes, or industrial impoundments for process waters within the industrial property.

Discussion:

The District is a political subdivision of the state and immune from taxation pursuant to Article XIII, § 7, of the Arizona Constitution. It is also a municipal corporation by virtue of A.R.S. § 48-2001(D). A sanitary district may be formed for purposes of regulating, purchasing, establishing, constructing and operating a sewerage system or a sewage sludge or by-product processing and disposal system. The system may include the collection, transportation, pumping, treatment and disposal of sewage, processing, treating and disposing of sewage sludge and other by-products of sewage treatment. A.R.S. § 48-2001(B).

Governmental and Proprietary Functions

The District, as a political subdivision of the state, is not subject to transaction privilege tax when performing governmental functions. A governmental function is generally recognized as one undertaken because of a duty imposed on the entity for the welfare or protection of its citizens or a function that is fundamentally inherent in or encompassed within the basic nature of government. *Flowing Wells Irrigation District v. City of Tucson*, 176 Ariz. 623, 624, 863 P.2d 915 (Tax 1993) citing *Copper Country Mobile Home v. City of Globe*, 131 Ariz. 329, 333, 641 P.2d 243, 247 (App. 1982); *Book-Cellar, Inc. v. City of Phoenix*, 150 Ariz. 42, 44, 721 P.2d 1169, 1171 (App. 1986).

Proprietary activities of a government, however, are taxable. A proprietary function is "more a commercial activity which directly competes with other commercial activities...." *Flowing Wells Irrigation District v. City of Tucson*, 176 Ariz. 624, 863 P.2d 915 (Tax 1993) citing *Book-Cellar, Inc. v. City of Phoenix*, 150 Ariz. at 44, 721 P.2d at 1171 (App. 1986).

Thus, the District is a governmental entity whose function it is to regulate, purchase, establish, construct and operating a sewerage system or a sewage sludge or by-product processing and disposal system. Once it fulfills that function, it may incidentally supply or sell effluent and other by-products of sewage treatment. How the district disposes of the sewage treatment by-

products is left to the discretion of the District. The District can release the effluent into Arizona waters; provide the effluent free of charge or for reimbursement of delivery fees; or sell the effluent at a profit. The sale of effluent is the focus of this ruling.

The sale of effluent for reuse by the public is not an inherently governmental function. It is more in the nature of a commercial activity competing directly with other services that provide water. The operation of a sewage disposal plant is a governmental function, but supplying for compensation reclaimed wastewater to potential *water* users is a proprietary function subject to the transaction privilege tax.

The Sale of Effluent

Arizona imposes a transaction privilege tax on the privilege of conducting *business* in the State of Arizona. This tax is levied on the seller, not the purchaser. The seller may pass the burden of the tax on to the purchaser. However, the seller is the taxpayer and is ultimately liable to Arizona for the tax.

The transaction privilege tax is imposed on the business of producing and furnishing or furnishing to consumers electricity, natural or artificial gas and water under the utilities classification. It is agreed that the District is not in the business of producing or furnishing to consumers *water*.

The District operates a waste treatment plant. Wastewater treatment entails a number of steps and operations. A "wastewater treatment plant" encompasses all of the processes, devices, structures, and earth-works that are used for treating wastewater. The WWTP treatment process includes headworks, denitrification, clarification, sand filtration, UV disinfection, and a solids handling cell. Its effluent will be consumptively reused by irrigation on specific reuse sites.

"Effluent" means wastewater that has completed its passage through a wastewater treatment plant.

"Tangible personal property" is defined in the transaction privilege tax statutes as personal property which may be seen, weighed, measured, felt or touched or is in any manner perceptible to the senses.

Effluent is personal property that can be seen, weighed, measured, felt or touched and is perceptible to the senses. Therefore, effluent is tangible personal property.

"Sale" is defined in the transaction privilege tax statutes as any transfer of title or possession, or both, in any manner or by any means whatsoever of tangible personal property for a consideration.

The transaction privilege tax is imposed on the business of selling tangible personal property at retail. The tax base for the retail classification is the gross proceeds of sales or gross income derived from the business. All retail sales are subject to tax unless specifically exempted by statute.

When the District transports the effluent to the various reuse sites, a transfer of title and possession of tangible personal property has taken place. Consideration is realized when the reuse sites reimburse the District for the effluent. Therefore, the District makes sales of tangible personal property at retail.

The term "business" is defined in the transaction privilege tax statutes to include all activities or acts, personal or corporate, engaged in or caused to be engaged in with the object of gain, benefit or advantage, either directly or indirectly, but not casual activities or sales.

According to the information provided, the District does not make a profit on the sale of the effluent. Any revenue derived is an offset to the overall operation and maintenance costs of the wastewater treatment plant and a charge for a share of the cost of treatment performed in order to meet the discharge standards required by permit for the act of discharging effluent.

However it is not necessary for a business to make a profit for an activity to be deemed a business which is subject to tax under the transaction privilege tax statutes. Any activity carried on by a corporation which benefits its organizers or members constitutes a business. *O'Neil v. United Producers and Consumers Cooperative*, 57 Ariz. 295, 113 P.2d 645 (1941).

For instance, the District is paid by a golf course for effluent to meet its watering needs. If the golf course were not willing to pay the District for the disposal of the effluent, the District would release the effluent or provide it for free. Therefore, the District receives a benefit from the sale of the effluent to the golf course. If the golf course were not able to obtain the effluent, it might contract with the ...of ... Water Department or one of the other local water companies to provide for its water usage. Consequently, the sale of effluent is in competition with the sale of potable water or water from other vendors. Therefore, the sale of effluent by the District is subject to transaction privilege tax.

Conclusion:

The District, as a political subdivision of the state, is not subject to transaction privilege tax when performing governmental functions. Proprietary activities of the District, however, are taxable.

The District is a governmental entity whose function it is to regulate, purchase, establish, construct and operating a sewerage system or a sewage sludge or by-product processing and disposal system. Once it fulfills that function, it may incidentally supply or sell effluent and other by-products of sewage treatment.

It is not necessary for the District to make a profit for an activity to be deemed a business subject to tax under the transaction privilege tax statutes. The District receives a benefit from the sale of effluent. The sale of effluent for reuse by the public is a commercial activity competing directly with other services that provide water. Consequently, the gross income derived from the sale of effluent by the District is a proprietary activity subject to transaction privilege tax under the retail classification.

The conclusions in this private taxpayer ruling do not extend beyond the facts as presented in the request for a private taxpayer ruling dated March 7, 2000.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this taxpayer ruling is the present position of the department. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.