



Douglas A. Ducey
Governor

PRIVATER TAXPAYER RULING LR16-007

David Briant
Director

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Thank you for your letter dated February 11, 2015 requesting a private taxpayer ruling ("PTR") on behalf of your clients, *** and ***. That letter, originally addressed to the Unified Audit Committee, was forwarded to the Arizona Department of Revenue ("Department") on April 27, 2016 for a response. Specifically, you requested a determination on whether a prior ruling issued to *** and *** in 2011 is still valid notwithstanding recent changes to Article 3 of the Model City Tax Code ("MCTC").

Pursuant to Arizona Revised Statutes (A.R.S.) § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request. A.R.S. § 42-6001(A) authorizes the Department to collect and administer any transaction privilege and affiliated excise taxes imposed by any city or town in Arizona. Under A.R.S. § 42-6002(A) state statutes govern the administration of the municipal privilege taxes levied by a city or town. Pursuant to A.R.S. § 42-6005(B) the Department's guidance is binding on cities and towns when the state statutes and model city tax code are the same. This letter accordingly provides a joint response to your request which has tax implications within several Arizona cities and towns.¹

ISSUES:

Whether *** is subject to city privilege taxes with respect to rental properties it manages on behalf of their owners *** and ***?

Whether *** is exempt from city sales tax on rentals or leases of units it owns because it qualifies for the federally exempt organization exemption contained in MCTC § 270 (c)?

RULING:

*** is not subject to city privilege taxes with respect to the rental properties it manages on behalf of *** and other *** because the legal incidence of the tax is on the landlord property owners as the parties conducting the business of leasing real property. See *Tower Plaza Investments Ltd. v. DeWitt*, 508 P.2d 324, 326, 109 Ariz. 248, 250 (Ariz. 1973) and MCTC § 310(e) discussed below. *** is acting as the *** property manager or broker and oversees the *** leasing activity.

¹ For the purposes of this ruling, the state transaction privilege tax is not under consideration.

MCTC § 270 provides an exclusion for gross income earned by certain persons deemed not engaged in business. That section includes an exemption for persons classified as federally exempt organizations that have obtained federal determination of exempt status. *** is a *** as a result of being classified as a *** and so at first glance it appears that *** would qualify for the exemption under the terms of MCTC § 270.

However, MCTC § 270 adds an additional qualification before the exemption can be claimed. MCTC § 270(c) provides that “transactions which, if conducted by any other person, would produce gross income subject to the tax ... shall not be subject to the imposition of such tax if *conducted entirely* by a federally exempt organization or proprietary club ...” The ordinary meaning of the phrase *entirely conduct* indicates that *** must completely or solely manage or carry on the business of leasing real property to tenants in actual possession. It does not do so and therefore it does not qualify for the exemption under MCTC § 270(c).

MCTC Reg. §100.1 specifically provides that there are no deductions allowed for any commissions or fees retained by a broker acting on behalf of its principal. *** is responsible for the city privilege taxes as a result of its leasing activity as outlined and its tax base includes all the gross income it receives including any commission income retained by its broker, ***.

SUMMARY OF FACTS:

The following is a summary of the relevant facts based on your letter dated February 11, 2015 and subsequent correspondence with the Department dated June 10, 2016:

*** is a *** entity doing business as *** (“****”). *** is 100% owned by ***, a ***. *** was created to manage rental properties for both *** and *** groups. *** provides a full spectrum of standard property management services such as rent collection, coordinating maintenance services, paying property-related bills, etc.

*** manages landlord-owned single family residences (1-4 rental units), multi-family residences, apartment complexes, commercial properties and home owner associations. The rental income derived from these properties is passed on to the owners of the rental properties.

You provided sample copies of contracts used by *** in the conduct of its business of property management. Those sample contracts include:

- A sample lease agreement for property owned by a non-profit principal (including ***)(hereafter “Occupancy Agreement”);
- A sample lease agreement for property owned by a for-profit principal;²

² This is the typical residential lease agreement used when *** is managing rental units on behalf of for-profit companies. As such, it is not under consideration.

- A sample property management agreement which is used for both for-profit and non-profit principals.

Under the Occupancy Agreement, rental facilities are provided on a month to month basis to an occupant. It also provides that *** is acting as the “Housing Provider” as agent for a “sponsor.” Section 1 of the agreement provides that “*** will enter into leases with owners and make rental payments on behalf of the occupants towards rents to the owners...” In addition, it provides that the occupant will pay 40% of his/her salary as rent and that the rent does not exceed the allowable rent limitations as established.³

DISCUSSION & LEGAL ANALYSIS:

General

The League of Arizona Cities and Towns created the MCTC in order to impose and administer city privilege taxes. City privilege taxes are imposed “upon persons on account of their business activities”. See MCTC § 400(a)(1). All Arizona cities generally follow the MCTC in their imposition of their privilege tax based upon their local ordinances. However, certain options exist, allowing each city to alter or qualify the imposition of its privilege tax.⁴

MCTC § 445 imposes a tax on the gross income upon every person engaging or continuing in the business of leasing or renting real property located within the City for consideration to the tenant in actual possession.

MCTC § 100 defines a business as follows:

Business: All activities or acts, personal or corporate, engaged in and caused to be engaged in with the object of gain, benefit, or advantage, either direct or indirect, but not casual activities or sales.

The tax base for the real property leasing classification is the gross proceeds of sales or gross income derived from the business, subject only to certain expressly allowed deductions.

The Legal Incidence of the Tax is on the Landlord, Not the Landlord’s Agent

MCTC § 445 imposes the city privilege tax on persons conducting the business of leasing real property. However, the statute isn’t clear in situations where a property manager is engaged who the legal incidence of the falls upon. Thus, the first question raised here is who is conducting the rental/leasing activity? The non-profit corporation, *** who owns the

³ These leases *may* qualify for a deduction under MCTC 445(r) as rental income received from a “low-income unit.” However, the Department does not make this determination as this question was not requested to be specifically addressed.

⁴ As earlier indicated, this ruling only addresses applicable city privilege taxes.

property, or its subsidiary, ***, who manages the properties for *** as a result of the leases it enters into with the occupants of those properties? This question may be answered by looking at the history and cases related to the privilege tax on the real property leasing classification.

When the Arizona transaction privilege tax (“TPT”) statutes were amended to impose the TPT on the business of leasing or renting real property in 1967,⁵ owners of real property with already existing leases petitioned the court arguing that because the tax may affect leases entered into prior to the enactment, a new, improper obligation was created in respect to past transactions. The petitioners in *Tower Plaza Investments Ltd. v. DeWitt*, 508 P.2d 324, 326, 109 Ariz. 248, 250 (Ariz. 1973) which dealt with that issue argued that the tax violated the Arizona and Federal Constitutions in that it had retroactive application. The Supreme Court of Arizona described the situation this way:

Collectively, petitioners are the owners of real property herein described as shopping centers. As landlords, they have entered into written leases, some as long as fifty years ...They argue that ... the actual incidence of the tax is the lease entered into prior to the enactment... The word ‘incidence,’ as it relates to taxation, is defined by Webster’s Third International Dictionary as ‘: the falling of a tax upon a person who is unable to shift it onto someone else and who therefore bears the money burden of the tax.’ ... The incidence of the tax in the present case is upon petitioners, as landlords, and not upon the transactions out of which they acquire their gross receipts or income, the leases...In the instant case, it is the receipt of rentals by the taxpayer, not the leases out of which the rentals arise, which is the taxable event ...⁶

Thus, the TPT imposed was not unconstitutional since it was a tax imposed on the receipt of income from the rental by the landlords. This interpretation is consistent with the recent amendments to MCTC § 310 dealing with special licensing requirements. MCTC § 310(e) provides that:

In all cases the Transaction Privilege and Use Tax License shall be issued only to the owner of the real property regardless of the owner engaging a property manager or other broker to oversee the owner’s business activity including filing tax returns on behalf of the owner. Each rental property that can be independently sold or transferred is deemed to be a separate

⁵ The specific section (Section 42—1314, as amended by Laws of 1966, Ch. 23, s 1, and Laws of 1967, Third Special Session, Ch. 3, s 1) provided as follows ‘A. The tax imposed ... shall be levied and collected at an amount equal to two per cent of the gross proceeds of sales or gross income from the business upon every person engaging or continuing within this state in the following businesses:3. Leasing or renting for a consideration the use or occupancy of real property ...’ See *Tower Plaza Investments Ltd. v. DeWitt*, 508 P.2d 324, 326, 109 Ariz. 248, 250 (Ariz. 1973).

⁶ *Tower Plaza Investments Ltd. v. DeWitt*, 508 P.2d 324, 326-327, 109 Ariz. 248, 250-251 (Ariz. 1973).

business establishment...

Thus, the party responsible for the taxes is the landlord or lessor even though that landlord/lessor may engage a property manager, broker or other person to oversee the lessor's business activity of leasing real property to a tenant in actual possession.⁷ In this case, the responsible party is ***, not ***.

Exemption for Non-profit Organizations under MCTC § 270

MCTC § 270 provides an exclusion for gross income earned by certain persons deemed not to be engaged in business. One such 'person' is a federally exempt organization described in MCTC § 270(a) as an organization which has received a determination of exemption, or qualifies for such exemption, under 26 U.S.C. Section 501(c) and rules and regulations of the Commissioner of Internal Revenue pertaining to same, but not including a "governmental entity", "non-licensed business", or "public educational entity".

MCTC § 100 defines a person as follows:

Person: An individual, firm, partnership, joint venture, association, corporation, estate, trust, receiver, syndicate, broker, the federal government, this State, or any political subdivision or agency of the State. For purposes of this Chapter, a person shall be considered a distinct and separate person from any general or limited partnership or joint venture or other association with which such person is affiliated. A subsidiary corporation shall be considered a separate person from its parent corporation for purposes of taxation of transactions with its parent corporation.

In the context of MCTC § 270, a person engaged in the business of leasing real property may be exempt from city privilege taxes where that person is deemed to *not* be engaged in a business. *** is a non-profit corporation since it possess the 501(c)(3) designation authorized by the Internal Revenue Service contemplated by MCTC § 270. It is deemed a separate taxable person under MCTC § 100. In addition, it owns the rental properties and therefore the legal incidence of the tax falls on it. So at first glance it appears that it would qualify under the terms of MCTC § 270.

However, MCTC § 270 adds an additional qualification before any person can claim an exemption under its terms. MCTC § 270(c) provides that "transactions which, if conducted by any other person, would produce gross income subject to the tax under this Chapter shall not be subject to the imposition of such tax if *conducted entirely* by a federally exempt organization or proprietary club ..." (emphasis added). Thus, any 'person' seeking to benefit from this exemption must be able to show that not only are they a federally exempt

⁷ Please see the discussion below related to the statutory obligation imposed by the MCTC on brokers to pay the city privilege taxes on behalf of their principals including brokers acting as property managers on behalf of the owners. That notwithstanding, the legal incidence of the tax is on the lessor.

organization but that they also *entirely conduct* the potentially taxable activity. As the owner and landlord of the rental properties being leased, the *** may be deemed to be a person not engaged in business and would be exempt from the city privilege tax if it 'conducted entirely' its leasing activity.

The MCTC does not provide a specific definition of what is meant by the phrase 'conducted entirely'. Where the legislature has not defined terms and it does not appear from the context that a special meaning was intended, the ordinary meaning of the words should be used. *State Board of Dispensing Opticians v. Schwab*, 93 Ariz. 328, 380 P.2d 784 (1963); *Arizona State Tax Commission v. First Bank Building Corp.*, 5 Ariz. App. 594, 429 P.2d 481 (1967). In addition to looking at the ordinary meaning of words those words must be strictly construed against the taxpayer. Statutes are interpreted liberally in favor of taxpayers, but any exemptions from taxation are strictly construed. *Brink Elec. Const. Co. v. Arizona Dept. of Revenue*, 909 P.2d 421, 425, 184 Ariz. 354, 358 (Ariz. App. Div. 1,1995)

The Merriam-Webster online dictionary defines the verb *conduct*⁸ as

- to plan and do (something, such as an activity);
- to direct the performance of (musicians or singers);
- to guide or lead (someone) through or around a place.

The Merriam-Webster online dictionary defines the adverb *entirely*⁹ as

- to the full or entire extent; completely;
- to the exclusion of others; solely.

Thus, to qualify for the exclusion, *** must show that it *completely or solely manages* or carries on its business of leasing real property to tenants in actual possession. From the information provided, *** manages landlord-owned rental properties on behalf of the landlord owners. The income derived from these properties is passed on to the owners of the rental properties, *** and other federally exempt organizations. *** is not completely or solely managing any of its properties, or to put it in the language of the statute, it is not *entirely conducting* its leasing activities itself. Thus, *** does not qualify for the MCTC § 270(a) exemption.

Amounts Included in the Tax Base

MCTC §§ 445(a)(1) and (2) provide that the tax base for leasing activity includes payments made by the lessee to, or on behalf of, the lessor for property taxes, repairs, or improvements

⁸ "Conduct." Merriam-Webster.com. Merriam-Webster, n.d. Web. 1 July 2016.

⁹ "Entirely." Merriam-Webster.com. Merriam-Webster, n.d. Web. 1 July 2016.

and additionally includes charges for such items as telecommunications,¹⁰ utilities, pet fees, or maintenance.

MCTC § 310(e) provides that in all cases the TPT License shall be issued only to the owner of the real property regardless of the owner engaging a property manager or other broker to oversee the owner's business activity including filing tax returns on behalf of the owner.

MCTC § 100 provides that the term "broker" means any person engaged or continuing in business who acts for another for a consideration in the conduct of a taxable business activity, *and* who receives for his principal all or part of the gross income from the taxable activity.

Additionally, MCTC Reg. §100.1 provides special rules for brokers. MCTC Reg. §100.1(a) provides that for the purposes of proper administration and to prevent evasion of taxes imposed, brokers shall be wherever necessary treated as taxpayers for all purposes,¹¹ and shall file a return and remit the tax imposed on the activity on behalf of the principal. In addition, it provides that no deduction shall be allowed for any commissions or fees retained by such broker.¹²

Under MCTC Reg. §100.1 (d), the liability of a broker does not relieve the *principal* of liability except upon presentation to the Tax Collector of proof of payment of the tax, and only to the extent of the correct payment. The broker shall be relieved of the responsibility to file and pay taxes upon the filing and correct payment of such taxes by the principal.

The tax base for real property leasing activity includes the gross income derived from the business including any payments a lessee may make on behalf of a lessor. See MCTC §§ 445(a)(1) and (2). In addition, under the terms of MCTC §§ 310(e) and 100 it is clear that *** is a broker acting on behalf of *** and other federally exempt organizations in its property management activities. However, MCTC § 310(e) and the case of *Tower Plaza Investments Ltd. v. DeWitt*¹³ make it clear that the legal incidence of privilege taxing on real property leasing activity is on the landlord as a result of the receipt of rental income and not the property manager as a result of lease agreements. Finally, MCTC Reg. §100.1 specifically provides that there are no deductions allowed for any commissions or fees retained by a broker acting on behalf of its principal. Thus, these sections make it clear that *** is responsible for the city privilege taxes as a result of its leasing activity. In addition, its tax base includes all the gross income it receives including any commission income retained by its broker, ***.

¹⁰ However, if individual metering equipment is installed and there and each tenant based upon actual usage then the income from that activity is taxable under the telecommunications classification. See MCTC § 445(a)(3).

¹¹ This section is pre-empted by MCTC §310(e) which specifically requires only the property owner to obtain a license and pay the tax.

¹² An except is provided in MCTC §405 for advertising commissions.

¹³ 508 P.2d 324.

*** will have to obtain a separate license for each property and the tax is reported to the cities in which each property is located. MCTC § 310.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence. The determinations are 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 private 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.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.