

## ARIZONA TRANSACTION PRIVILEGE TAX RULING

### TPR 95-3

(Supersedes and Updates TPR 93-7 for Periods after 7/16/93)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

#### **ISSUE:**

Activities which comprise the business of leasing agricultural real property, and the exclusions available for leasing agricultural property between family members.

#### **APPLICABLE LAW:**

Arizona Revised Statutes (A.R.S.) 42-1301.1 defines "business" as:

[A]ll 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.

A.R.S. 42-1310.09 provides:

A. The commercial lease classification is comprised of the business of leasing for a consideration the use or occupancy of real property.

B. A person who, as a lessor, leases or rents for a consideration under one or more leases or rental agreements the use or occupancy of real property that is used by the lessee for commercial purposes is deemed to be engaged in business and subject to the tax imposed by this article, but this subsection does not include leases or rentals of real property used for residential or agricultural purposes.

C. The commercial lease classification does not include:

\* \* \*

12. Leasing or renting real property used for agricultural purposes under either of the following circumstances:

(a) The lease or rental is between family members, trusts, estates, corporations, partnerships, joint venturers or similar entities, or any combination thereof, if the individuals or at least eighty per cent of the beneficiaries, shareholders, partners or joint venturers share a family relationship as parents or ancestors of parents, children or descendants of children, siblings, cousins of the first degree, aunts, uncles, nieces or nephews of the first degree, spouses of any of the listed relatives and listed relatives by the half-blood or by adoption.

(b) The lessor leases or rents real property used for agricultural purposes under no more than three leases or rental agreements.

\* \* \*

D. The tax base for the commercial lease classification is the gross proceeds of sales or gross income derived from the business, ...

## **DISCUSSION:**

A.R.S. 42-1310.09.A provides that the commercial lease classification is comprised of the business of leasing or renting [commercial] real property. Under A.R.S. 42-1310.09.D, the tax base for the commercial lease classification is the gross income derived from the business.

Exclusions for agricultural leases are limited to leases of real property used for agricultural purposes. Real property used for agricultural purposes means land primarily used for purposes of agronomy, dairy, horticulture or animal husbandry. "Essentially, for property to meet the criteria for agricultural property, it must be used for growing crops or for raising animals." *Central Citrus Company v. Department of Revenue*, 157 Ariz. 562, 760 P.2d 562, 565 (App. 1988).

A lease of more than one parcel of agricultural property, either contiguous or noncontiguous, will be considered to be the lease of one agricultural property if the parcels are managed and operated as one economic unit and each parcel makes a functional contribution to the agricultural use as a single agricultural property.

For periods prior to August 1, 1988, a single lease of real property was considered to be a casual activity if the person had income from any other source and the scope and degree of the rental activity clearly indicated that the rental activity was an investment rather than a

business. Therefore, the person was not considered to be in the business of leasing agricultural real property and was not subject to transaction privilege tax under the commercial lease classification.

Between August 1, 1988 and July 16, 1993, a single lease of agricultural real property or a single lease of residential real property were the only types of leases which maintained the status of a casual activity. All leases of commercial real property constituted being in the business of commercial leasing and were subject to tax.

Please note that until July 17, 1993, a person who leased agricultural real property under one lease in combination with any other commercial leasing activity was engaging in business and was subject to transaction privilege tax under the commercial lease classification.

For leases on or after July 17, 1993, A.R.S. 42-1310.09.C.12(b) provides that the commercial lease classification does not include leasing agricultural real property under three or fewer leases or rental agreements.

Also, pursuant to A.R.S. 42-1310.09.C.12(a) a lease of agricultural property is not included in the commercial lease classification if the lease is a qualifying lease between family members on or after July 17, 1993.

### **Activities which comprise the business of leasing agricultural real property on or after July 17, 1993**

For leases on or after July 17, 1993, A.R.S. 42-1310.09.C.12(b) provides that the commercial lease classification does not include a lessor who leases agricultural real property under no more than three leases or rental agreements. In order to qualify for the exclusion, the lessor cannot lease or rent more than three agricultural properties. The entire gross proceeds of a lessor of more than three agricultural properties will be subject to transaction privilege tax under the commercial lease classification. As noted above, the lease of several parcels of land may constitute one agricultural lease if the separate parcels are managed as one economic unit and each parcel makes a functional contribution to the agricultural use as a single property.

A person may also engage in the lease and rental of other types of commercial property and the rental of agricultural property. If the person is engaged in no more than three agricultural leases, the lease of other types of commercial real property would not disqualify the person from utilizing this exclusion. However, the gross income the person receives from the leases of the other commercial real property would be taxed under the commercial lease classification unless another applicable exclusion would apply to such leases or rentals.

### **Certain leases between family members excluded from tax under the commercial lease classification**

Also effective July 17, 1993, A.R.S. 42-1310.09.C.12(a) provides that the commercial lease classification does not include the lease or rental of agricultural real property between family members or entities in which 80 percent of the entity's members share a family relationship. Family members must share a family relationship as parents or ancestors of parents, children or descendants of children, siblings, cousins of the first degree, aunts, uncles, nieces or nephews of the first degree, spouses of any of the listed relatives and listed relatives by the half-blood or by adoption.

This exclusion applies if:

1. a lease is between family members;
2. a lease is between family members and a qualifying entity or entities; or,
3. a lease is between two or more qualifying entities.

A qualifying entity is one in which family members comprise at least 80 percent of the membership of the legal entity. The family members may be involved in several different types of legal entities including trusts, estates, corporations, partnerships, and joint ventures. The 80 percent threshold is determined from the family members' membership in the legal entity, not from each family member's share of control of the legal entity.

**Example:**

Brother, sister, sister's husband and an unrelated party form a partnership. The brother, sister and sister's husband each control 30 percent of the partnership. The unrelated party controls the remaining 10 percent. Although the brother, sister and sister's husband are family members and control 90 percent of the partnership, they comprise only 75 percent of the partnership. Thus, the partnership would not be a qualifying entity for purposes of this exclusion.

Further, a lease transaction is excluded from tax under the commercial lease classification if the lease is between qualifying entities. In order to qualify, the family members in each entity must comprise at least 80 percent of each entity and a family relationship must be shared between individuals in each of the qualified entities.

**Example:**

One entity qualifies because it is a trust composed of two siblings. Another entity qualifies because it is a partnership composed of two first cousins and their spouses. The siblings share a family relationship with the cousins and their wives.

Therefore, if the partnership leases the agricultural property to the trust, the partnership would not be subject to tax on this lease.

## **RULING:**

### **Leasing agricultural real property prior to August 1, 1988**

Prior to August 1, 1988, a person was not engaged in the commercial leasing business if the person leased only one unit of real property, had any other income source and if the scope and degree of the activity indicated the property was held for investment. The gross income received by such a person was not subject to tax under the commercial lease classification.

### **Leasing agricultural real property commencing August 1, 1988 through July 16, 1993**

Between August 1, 1988 and July 17, 1993, a person was not engaged in the business of leasing if:

1. the person leased agricultural property under one lease;
2. the person did not rent nonresidential real property;
3. the person had income from any other source; and,
4. the scope and degree of rental income generated from the lease clearly indicated it was an investment rather than a business.

The gross income from such a lease of agricultural real property was not subject to transaction privilege tax under the commercial lease classification.

A person who leased one piece of agricultural property in combination with any other commercial leasing activity was "engaging in business" and was subject to transaction privilege tax under the commercial lease classification.

### **Example:**

Tom Jones leased a farm and an office building to the same lessee. All gross proceeds from both leases were subject to the tax under the commercial lease classification.

### **Leasing agricultural real property under no more than three leases commencing July 17, 1993**

On or after July 17, 1993, the commercial lease classification does not include a lessor engaged in the rental of agricultural property under no more than three leases or rental agreements. When a person leases no more than three agricultural real properties and also leases other commercial real property, the lease of the agricultural properties is excluded from the commercial lease classification. However, a lessor engaged in the rental of agricultural real property under more than three leases cannot utilize this exclusion for any lease of agricultural real property.

### **Examples:**

Jose owns four separate agricultural properties. Jose leases one property to Jim and one property to Susan. The other two properties are leased to Hector. Hector does not use the two properties as a single unit of agricultural property. Jose is subject to tax on the gross proceeds received from all four leases.

R. Jay leases a farm and an office building to the same lessee under separate leases. The gross proceeds from the agricultural lease are exempt from the tax under the commercial lease classification; however, the gross proceeds from the office building lease are subject to the tax under the commercial lease classification.

Bob owns 12 parcels of land which are leased for agricultural purposes. He also owns five commercial properties which he leases to various individuals. Under one lease, BigAgCorp leases 10 of the agricultural parcels for use as a single farm. Marge leases another parcel and Sally leases the final parcel. Bob's lease of the 10 parcels to BigAgCorp would constitute the leasing of one agricultural property. Bob's lease of the three agricultural properties are excluded from taxation under the commercial lease classification. However, Bob's gross income from the lease of the five other properties is subject to transaction privilege tax under the commercial lease classification.

### **Leasing agricultural real property between family members on or after July 17, 1993**

The commercial lease classification does not include the lease of property used for agricultural purposes if the lease is between family members, between family members and an qualifying entity, or between qualifying entities. The entity is a qualifying entity if 80 percent of the individuals comprising the entity share a family relationship.

### **Examples:**

Steve Gray leases agricultural properties under eight separate lease agreements. Five are leases between family members. The five leases to family members are

excluded from the commercial lease classification. The other three leases are subject to transaction privilege tax under the commercial lease classification.

Grandfather established Family Trust for the benefit of his five grandchildren. The Trust owns agricultural property. The Trust leases the property to one of the grandchildren. The Trust is a qualifying entity and the grandchild is a qualifying individual. Therefore, Trust, as lessor, would not be engaged in a taxable activity under the commercial lease classification.

For further discussion regarding leases prior to July 17, 1993, see Arizona Transaction Privilege Tax Ruling *TPR 93-7, Levy of Transaction Privilege Tax on the Gross Income from the Leasing of Agricultural Real Property.*

Harold Scott, Director  
Signed: April 11, 1995

#### Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law which are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement which provides interpretation, details or supplementary information concerning the application of the law. **Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling.** See GTP 92-1 for more detailed information regarding documents issued by the Department of Revenue.