

PRIVATE TAXPAYER RULING LR96-002

February 7, 1996

The following private taxpayer ruling is in response to your letter of August 28, 1995, requesting the department to rule that the income received by ... from the sale of water to ..., a qualified environmental manufacturer, producer and processor, is exempt from Arizona's transaction privilege tax.

The following is a restatement of the facts presented in your letter.

Statement of Facts:

... owns certain real property improved with four water producing wells. ... holds a transaction privilege tax license and derives income from transactions with

... is a qualified environmental technology manufacturer, producer and processor and the first manufacturing, processing and production equipment will soon be placed in service.

... and ... have entered into an agreement, the intent of which is that two of the four existing wells on the ... property will be transferred for pumping operation by is to construct, at its sole expense, water lines from the wells and is to install the necessary pumps, electrical equipment to power the pumps and all related equipment necessary to make the pumps operable for ... intended purpose.

... shall be solely responsible for the operation and maintenance of all equipment and the wells. ... shall have the right, at its expense, to enlarge, deepen or otherwise improve the wells. ... shall be responsible for all utility costs and personal property taxes related to the well equipment. ... shall have the right to drill and equip at its expense, four additional producing wells. Upon termination of the agreement, ... shall have the right to remove all pumps, lines and other equipment which it installed. The wells and well casing shall be left intact.

... shall be entitled to the use of the wells, and the water from the wells, and the right of access thereto. ... is granted an exclusive easement of 400 square feet surrounding each well site, including any future wells drilled, and a non-exclusive easement upon which the pipeline to the ... facility will run, and reasonable access across the property to the wells, and reasonable space beyond the 400 square feet necessary to operate, maintain and improve the wells and to provide utilities. Additionally, ... agrees to give ... the continuing 30 day written right of first refusal in the event ... is offered, or is offering, for sale any portion or whole of the real property which is subject to the easements surrounding the existing well sites and the easements for pipelines and utilities.

... shall pay to ..., a pumpage fee for each 1,000 gallons of water pumped and transported by ... to its plant site area, but in any event not less than a stated minimum fee per month for each well which is capable of producing a stated minimum gallons per minute.

The term of the agreement is for 30 years, subject to earlier termination for cause.

Your Position:

The transaction privilege tax statutes provide a deduction from the tax base under the utilities classification for income derived from sales to an environmental technology manufacturer, producer or processor. Because ... qualifies as an environmental producer, and because the 15 year period of deduction of sales from the tax base begins on the date the first manufacturing, processing or production equipment is placed in service, transaction privilege tax from sales to ... will not be owed, commencing on the date ... places its production equipment in service.

Applicable Statutory Provisions:

Arizona Revised Statutes (A.R.S.) § 42-1310.03 provides that the business of producing and furnishing or furnishing water to consumers is taxable under the utilities classification of the transaction privilege tax. The tax base is the gross proceeds of sales or gross income derived from the business.

A.R.S. § 42-1310.03.B.4 provides a deduction from the tax base for the utilities classification for income derived from sales to a qualified environmental technology manufacturer, producer or processor that are used directly in environmental technology manufacturing, producing or processing. The deduction applies for 15 full consecutive calendar or fiscal years from the date the first manufacturing, processing or production equipment is placed in service.

A.R.S. § 42-1310.09 provides that the business of leasing for a consideration the use or occupancy of real property is taxable under the commercial lease classification of the transaction privilege tax. 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 is subject to tax. The tax base is the gross proceeds of sales or gross income derived from the business.

Discussion:

Arizona's transaction privilege tax is a tax imposed on the privilege or right to engage in certain specifically identified business activities. It is a tax on the seller, not on the purchaser. The seller may pass the burden of the tax on to the purchaser; however, the seller is ultimately

liable to Arizona for the tax.

The tax is imposed under the particular business classification that applies to the person's business. The particular business classification under which ... is conducting business must be determined by the terms of the agreement and from the language of the statute.

Persons engaged in the business of producing and furnishing water to consumers are subject to transaction privilege tax under the utilities classification. The tax base is the gross proceeds of sales or gross income derived from the business. However, income derived from sales to a qualified environmental technology manufacturer, producer or processor shall be deducted from the tax base. (A.R.S. § 42-1310.03)

The agreement between ... and ... provides that ... shall be entitled to the use of the wells, and the water from the wells, and the right of access thereto. ... is to install water lines, pumps, electrical equipment to power the pumps and all equipment necessary to make the pumps operable. ... is responsible for the operation and maintenance of all equipment and the wells. ... has the right to enlarge, deepen or otherwise improve the wells and has the right to drill and equip four additional wells. Additionally, ... is given a 30 day written right of first refusal in the event ... is offering, or is offered, for sale the property which is subject to the easements which are granted.

It is a cardinal rule of statutory construction that words and phrases used in a statute are to be given their obvious and natural meaning. A contract establishing such extensive rights and responsibilities far exceeds the meaning of the phrase "furnishing water to consumers".

The transaction privilege tax is also imposed, under the commercial lease classification, on the business of leasing for a consideration the use or occupancy of real property. A lessor who leases for a consideration under one or more lease agreements the use or occupancy of real property that is used by the lessee for commercial purposes is deemed to be in business and subject to tax. The tax base is the gross proceeds of sales of gross income derived from the business. (A.R.S. § 42-1310.09)

"[A] lease embraces any agreement, whether express or implied, which gives rise to the relationship of landlord and tenant." *Pagano v. Redevelopment Authority, Etc.*, 249 Pa. Super. 303, 376 A.2d 999 (1977). Generally, the relationship of landlord and tenant is created where one person occupies the land of another in subordination to the other's title and with his consent. In addition, a lease must contain the following items: 1) a description of the property, 2) the duration of the term, and 3) the rental consideration.

Arizona Department of Revenue *Guideline For Determining A Lease Activity - G 91-9* provides parameters to use in determining when a transaction would be considered a lease for transaction privilege tax purposes.

Conclusion and Ruling:

The following ruling is given based on the facts presented in your request.

The department rules that the agreement between ... and ... constitutes a lease of real property. Consequently, the gross income derived by ... under the terms of this agreement is subject to transaction privilege tax under the commercial lease classification. There is no statutory deduction provided under the commercial lease classification for leases to a qualified environmental technology manufacturer, producer or processor.

The conclusion in this private taxpayer ruling does not extend beyond the facts as presented in the request for a private taxpayer ruling dated August 28, 1995, and related documents.

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 and is valid for a period of four years from the date of issuance except as set out herein. 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.