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ARIZONA TRANSACTION PRIVILEGE TAX RULING TPR 97-5

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.

(On May 14, 2021, the statute references were updated to show their new numbers. See footnotes for details. In addition, the note on page 1 was added. No substantive changes were made.)

ISSUE:

Proof necessary to meet the requirements of the profit à prendre exemption under the commercial lease classification.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 42-5069(C)(15)¹ provides an exemption under the commercial lease classification for gross income received from granting or providing rights to real property that constitute a profit à prendre for the severance of minerals. The profit à prendre exemption does not include leasehold rights to the real property that are granted in addition to and not included within the right of the profit à prendre.

Arizona Administrative Code (A.A.C.) R15-10-118 places the burden of proof on the petitioner/taxpayer as to all issues of fact at formal hearings before the Department of Revenue. (Note: This rule expired in 2015. Burden of proof is now addressed in A.R.S. § 42-1255 added in 2004)

LEGAL REFERENCE:

A leasehold interest is the right of exclusive use and possession of the property by the lessee against all the world, including the lessor. See, e.g., *Wenner v. Dayton-Hudson Corp.*, 123 Ariz. 203, 206, 598 P.2d 1022 (App. 1979); *Tanner Companies v. Arizona State Land Department*, 142 Ariz. 183, 193, 688 P.2d 1075 (App. 1984).

¹ This ruling originally cited A.R.S. § 42-1310.09(C)(17) which has been renumbered as A.R.S. § 42-5069(C)(15).

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It is a well established rule of law, however, that statutes should be given their plain and ordinary meaning. *Meredith Corporation v. Arizona State Tax Commission*, 23 Ariz. App. 152, 531 P.2d 197 (1975).

Statutory constructions are to be avoided that render a clause, sentence or word superfluous, void, contradictory or insignificant. *Continental Bank v. Department of Revenue*, 131 Ariz. 6, 638 P.2d 228 (App. 1981).

DISCUSSION:

Arizona imposes a transaction privilege tax which differs from the sales tax imposed by most states. The Arizona transaction privilege tax is a tax imposed on the privilege of conducting business in the State of Arizona. This tax is levied on the lessor, not the lessee. The lessor may pass the burden of the tax on to the lessee; however, the lessor is ultimately liable to Arizona for the tax.

The state transaction privilege tax is levied on the commercial lease classification pursuant to A.R.S. § 42-5069². A.R.S. § 42-5069(C)(15)³ provides an exemption under the commercial lease classification for gross income received from granting or providing rights to real property that constitute a profit à prendre for the severance of minerals. The profit à prendre exemption does not include leasehold rights to the real property that are granted in addition to and not included within the right of the profit à prendre.

"Profit à prendre," for purposes of A.R.S. § 42-5069(C)(15)⁴, means "a right to use the land of another to mine minerals, and carries with it the right of entry and the right to remove and take the minerals from the land and also includes the right to use the surface of the land as is necessary and convenient for exercise of the profit."

The tax base, according to A.R.S. § 42-5069(C)(15)⁵, for a taxable leasehold right, if gross income derived from the grant of such right is not separately stated from the gross income derived from the grant of the profit à prendre, shall not exceed the fair market value of the leasehold rights computed after excluding the value of all rights under the profit à prendre.

For the purpose of administration of the transaction privilege tax and to prevent the evasion of tax, A.R.S. § 42-5023⁶ imposes a presumption that the gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established by a taxpayer.

² This ruling originally cited A.R.S. § 42-1310.09 which has been renumbered as A.R.S. § 42-5069.

³ See footnote number 1.

⁴ See footnote number 1.

⁵ See footnote number 1.

⁶ This ruling originally cited A.R.S. § 42-1329 which has been renumbered as A.R.S. § 42-5023.

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"Include" means to contain or encompass as part of a whole. *Random House Webster's Dictionary*, Ballantine Books, New York, 1993, p. 334. "Within" means in or into the interior of; in the compass or limits of; not beyond; in the field sphere of scope of. *Id.* at 758. "Addition" means something added; as well as; besides. *Id.* at 8.

According to A.R.S. § 42-5069(C)(15)⁷, the profit à prendre exemption does not include leasehold rights to the real property that are granted in addition to and not included within the right of the profit à prendre. Thus, proceeds resulting from the granting of a leasehold interest in addition to the profit à prendre are taxable whereas the proceeds resulting from the granting of leasehold interests included within the profit are not. There is no indication in the statute of the method to determine whether a leasehold interest is included within or in addition to the profit à prendre.

The Arizona Legislature has defined a profit à prendre to include use of the surface of the land as is necessary and convenient for exercise of the profit. The grant of a right to use does not transfer to the grantee a right of exclusive possession of real property. Thus, a profit à prendre does not include within its scope a leasehold interest in the real property.

The plain and ordinary meaning of the word "within" can refer to both location (in the interior or limits of) or to the scope of an item or word. Defining the word "within" as used in A.R.S. § 42-5069(C)(15)⁸ to mean "in the scope of" would cause the provision dealing with leasehold interests to be void or contradictory because a profit à prendre never includes within its scope a leasehold interest. Thus, the Arizona Legislature must have intended to use the word "within" to address the location of the leasehold grant in the agreement granting both leasehold and profit à prendre interest.

In the event that a leasehold interest is granted in addition to the profit à prendre, and in the event that the grant of such right is not separately stated from the gross income derived from the grant of the profit à prendre, taxpayer must meet its burden of proving the fair market value of the leasehold rights computed after excluding the value of all rights under the profit à prendre.

RULING:

In order to demonstrate the portion of lease proceeds exempt under the profit à prendre exemption, a taxpayer must first provide a copy of its lease agreement in order to prove whether leasehold rights are granted in addition to the profit à prendre. As referred to in A.R.S. § 42-5069(C)(15)⁹, a leasehold interest is granted "in addition to" the profit if such grant is contained in a separate section or subsection from the grant of the profit à prendre interest. The existence of a separate section or subsection granting such leasehold rights would clearly satisfy the "in addition to" language of the statute and would not be "within"

⁷ See footnote number 1.

⁸ See footnote number 1.

⁹ See footnote number 1.

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the grant of the profit. In contrast, a clause lumping together both leasehold and profit interests would demonstrate inseparability.

EXAMPLES:

1. An agreement in the following form will be considered a grant of a leasehold interest in addition to the profit à prendre because the leasehold and profit rights conveyed below are in two separate subsections of the agreement. Therefore, the taxpayer must meet its burden of proving the fair market value of the leasehold rights computed after excluding the value of all rights under the profit à prendre.

Section 1 - Rights of Grantee

Section 1.1 - Grantor hereby conveys to Grantee the right to use the Property to mine minerals, along with the right of entry and the right to remove and take the minerals from the land. Such a right also includes the right to use the surface of the land as is necessary and convenient for exercise of the profit.

Section 1.2 - Grantor hereby conveys to Grantee a leasehold interest in the Property, including the right to erect buildings for the operation of the mining business and the right to erect storage and processing facilities. Prior to Grantor's retaking of possession at the end of this Agreement, any buildings erected by Grantee shall be removed and the Property shall be returned to its original state.

2. Agreements in the following forms will be considered a grant of a leasehold interest included within the profit à prendre because the leasehold interest and profit rights are not in two separate sections or subsections of the agreement. Therefore, the total amount received under the agreement qualifies for the profit à prendre exemption.

Agreement 1

Section 1 - Grantor hereby conveys to Grantee the right to use the Property to mine minerals, along with the right of entry and the right to remove and take the minerals from the land. Such a right also includes the right to use the surface of the land as is necessary and convenient for exercise of the profit. Grantee's right to use the Property shall include the right to erect buildings for the operation of the mining business and the right to erect storage and processing facilities. Prior to Grantor's retaking of possession at the end of this Agreement, any buildings erected by Grantee shall be removed and the Property shall be returned to its original state.

Agreement 2

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Section 1 - Grantor hereby conveys to Grantee a profit à prendre in the Property. The profit rights hereby conveyed include:

Section 1.1 - The right to use the surface of the land as is necessary and convenient for exercise of the profit.

Section 2.2 - The right to erect buildings for the operation of the mining business and the right to erect storage and processing facilities. Prior to Grantor's retaking of possession at the end of this Agreement, any buildings erected by Grantee shall be removed and the Property shall be returned to its original state.

In the event that the agreement in question grants leasehold rights in addition to the profit à prendre, the taxpayer will then have the burden of producing documentation to demonstrate the fair market value of the leasehold interest exclusive of the profit à prendre interest. Examples of documentation meeting such burden of proof are: (1) an appraisal by a licensed real estate appraiser of the State of Arizona; (2) a comparative market analysis based upon the leasehold value of comparative real property with no mining potential; or (3) a comparative market analysis based upon the total value of comparative real property with no mining potential and the extrapolation of rental amounts from such value.

For the procedures for requesting refunds of taxes paid on the gross proceeds from the granting of profit à prendre interests, see TPP 97-2¹⁰.

Mark W. Killian, Director

Signed: October 31, 1997

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 that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning 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 96-1 for more detailed information regarding documents issued by the Department of Revenue.

¹⁰ TPP 97-2 is an obsolete procedure that dealt with retroactive refunds that had to be filed by 12/31/1997.