

STATE OF ARIZONA

Department of Revenue
Office of the Director
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Governor

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CERTIFIED MAIL [redacted]

**The Director's Review of the Decision
of the Hearing Officer Regarding:**

[redacted]

FEIN [redacted]

O R D E R

Case No. 200900134-C

On August 16, 2010 the Hearing Officer issued his decision regarding the protest of [redacted] (Taxpayer). Both the Section and Taxpayer appealed the decision to the Director of the Department of Revenue. As the appeals were timely, the Director issued a notice of intent to review the decision.

In accordance with the notice given the parties, the Director has reviewed the Hearing Officer's decision and now issues this Order.

Statement of Case

The Corporate Audit Division ("Division") issued a Notice of Proposed Refund Denial ("NPRD") to Taxpayer for tax years ending 2003, 2004 and 2005. Taxpayer protested the denial, and the Hearing Officer granted in part and denied in part Taxpayer's protest. The primary question was whether Taxpayer, an entity exempt from the Arizona income tax, but which has unrelated business income, may take the enterprise zone credit under A.R.S. § 43-1161. The Hearing Officer concluded that Taxpayer was eligible to take the enterprise zone credit. The Hearing Officer also held that Taxpayer could only claim a pro rata share of 17 first year credits for 2003, and that second and third year credits in 2004 and 2005 were limited accordingly.

The Section argues on appeal that Taxpayer is not entitled to take the credit either because it is an exempt entity taxable under Title 42, Chapter 12 while the credit is provided in Chapter 11 or because Taxpayer does not meet the qualifications of A.R.S. § 43-1161. The Section also argues that the Hearing Officer did not address two other issues the Section had raised: Whether Taxpayer's claims of second year credits in 2003 and third year credits in 2003 and 2004 were limited by its previous filings for 2002 and whether Taxpayer's documents for 2003 showed enough enterprise zone resident employees for the calculation of the claimed credits.

Taxpayer argues on appeal that its increase in first year employees for tax year 2003 was 33 and not the 17 allowed by the Hearing Officer.

Findings of Fact

The Director adopts and incorporates into this order from the findings of fact set forth in the decision of the Hearing Officer and makes additional findings as follows:

1. Taxpayer is a [redacted] based non-profit corporation that provides [redacted].
2. Pursuant to Arizona Revised Statutes (A.R.S.) § 43-1201, Taxpayer is exempt from Arizona income tax.
3. Taxpayer is subject to corporate income tax on its unrelated business taxable income pursuant to A.R.S. § 43-1231.
4. Taxpayer receives unrelated business income from activities that include [redacted].
5. Taxpayer owns 100% of [redacted] ([Sub 1 redacted]).
6. [Sub 1 redacted] is a limited liability company that is a disregarded entity for income tax purposes.

7. [Sub 1 redacted] owns 51% of [redacted] ([Sub 2 redacted]).
8. The other 49% of [Sub 2 redacted] is owned by [redacted] ([Outside Company redacted]).
9. [Sub 2 redacted] is a limited liability company that is treated as a partnership for income tax purposes.
10. [Sub 1 redacted] and [Outside Company redacted] entered into an operating agreement regarding [Sub 2 redacted].
11. The purpose of [Sub 2 redacted] is to [redacted]. Operating Agreement, ¶ 1.4.
12. The management of the business and affairs of [Sub 2 redacted] was vested in an operations manager who is to direct, manage and control the business of the [Sub 2 redacted] to the best of its ability. Operating Agreement, ¶ 3.2.
13. The initial manager of [Sub 2 redacted] was [Sub 1 redacted]. Operating Agreement, ¶ 3.2.
14. [Sub 1 redacted] and [Sub 2 redacted] entered into a management services agreement dated July 1, 1997 for the purpose of managing the business for [Sub 2 redacted]. Management Services Agreement, Recitals § F.
15. [Sub 1 redacted] and [Sub 2 redacted] were acting as independent contractors in the performance of the work, duties and obligations described in the management services agreement. Management Services Agreement, ¶ 10.
16. No relationship of partnership, joint venture, landlord/tenant or employment was created by the management services agreement. Management Services Agreement, ¶ 10.

17. No other provision of the management services agreement expressly provided that [Sub 1 redacted] and [Sub 2 redacted] were other than independent contractors under the management services agreement.
18. Both [Sub 1 redacted] and [Sub 2 redacted] use the mailing address of [location 1 redacted] in [redacted], Arizona.
19. The premises at [location 1 redacted] is comprised of approximately 120,000 square feet.
20. [Sub 2 redacted] is the sublessee of the business property located at [location 1 redacted]
21. [Sub 2 redacted] operated its business in facilities located at [location 1 redacted].
22. [Sub 1 redacted] provided all personnel required by [Sub 2 redacted].
23. The employees provided by [Sub 1 redacted] were in positions created by [Sub 2 redacted] and performed their job duties at [Sub 2 redacted]'s facilities.
24. Under the management agreement [Sub 1 redacted] was entitled to receive a management services fee of 100% of its direct costs of management and operation. Management Services Agreement, ¶ 4
25. [Sub 1 redacted] was not entitled to any other fees in connection with its services rendered to the [Sub 2 redacted] other than those specifically identified in the management services agreement. Management Services Agreement, ¶ 4.c.
26. Taxpayer timely filed income tax returns for tax years 2003, 2004 and 2005 and claimed enterprise zone credits for [Sub 1 redacted] in the amounts of \$157,501 for 2003, \$74,500 for 2004 and \$90,500 for 2005.

27. The Section denied the Taxpayer's income tax credit claims and issued a notice of proposed refund denial dated July 12, 2007.
28. No changes were made to Taxpayer's taxable income and liability in the refund denial.
29. The Section denied the requested enterprise zone credits totaling \$322,501 in their entirety because Taxpayer was not entitled to take the credit.
30. Taxpayer protested the tax credit denial of its refund claim for a total amount of \$287,526 plus interest, reducing its 2003 claim to \$122,526 and maintaining its 2004 claim of \$74,500, and its 2005 claim of \$90,500.

Conclusions of Law

1. Arizona corporations are subject to Arizona income tax imposed under A.R.S. § 43-1111 unless exempt by statute.
2. A.R.S. § 43-1201 lists organizations that are exempt from the Arizona Income tax.
3. Taxpayer is exempt from Arizona income tax under the provisions of A.R.S. § 43-1201.
4. Taxpayers exempt from the Arizona income tax are nevertheless subject to the Arizona income tax upon their "unrelated business taxable income" as defined in section 512 of the Internal Revenue Code. A.R.S. § 43-1231.
5. Exempt organizations with unrelated business taxable income are required to file income tax returns and pay income tax on their unrelated business income at the rates prescribed in A.R.S. § 43-1111. A.R.S. § 43-1241.

6. A.R.S. § 43-1161(A) provides a credit against Arizona income taxes for net increases in qualified employment positions of residents of Arizona by a business located in an enterprise zone (enterprise zone credit).
7. The enterprise zone credit is an incentive for businesses to increase qualified employment positions in certain locations within the state. A.R.S. § 41-1525(A).
8. An employee in a qualified employment position must be employed by the taxpayer business creating the position. See A.R.S. § 43-1161(C)(3)(f).
9. The job duties of the employee must be performed primarily at the zone location of the business. A.R.S. §§ 41-1525(B)(2)(k)(ii) and 43-1161(C)(3)(b).
10. A zone location is a single parcel or contiguous parcels of owned or leased land, the structures and personal property contained on the land or any part of the structures occupied by a taxpayer. A.R.S. § 43-1161(M)(4).
11. [Sub 2 redacted] was the sublessee of the business property located at [location 1 redacted] in [redacted] Arizona.
12. The law strictly construes statutes providing a tax exemption or credit because they violate the policy that all taxpayers should share the common burden of taxation. See *Tucson Transit Auth., Inc. v. Nelson*, 107 Ariz. 246, 252, 485 P.2d 816, 822 (1971).
13. Co-owners of a business, including partners in a partnership, may each claim only their pro rata share of the credit based on their ownership interest. A.R.S. § 43-1161(H).
14. [Sub 1 redacted] operated the business of [Sub 2 redacted] under the parties' management services agreement.

15. [Sub 2 redacted] is a limited liability company.
16. A member or manager of a limited liability company may transact business with the limited liability company and, subject to other applicable law, has the same rights and obligations with respect to those transactions as a person who is not a member or manager. A.R.S. § 29-608.
17. [Sub 1 redacted] employed the personnel utilized to operate the business of [Sub 2 redacted].
18. [Sub 2 redacted] was not the employer of the personnel and therefore [Sub 2 redacted] did not meet all of the qualifications of A.R.S. § 43-1161 to take the enterprise zone credit.
19. The personnel utilized to operate the business of [Sub 2 redacted] performed their job duties at the zone location of [Sub 2 redacted].
20. The personnel utilized to operate the business of [Sub 2 redacted] did not performed their job duties at the zone location of [Sub 1 redacted].
21. [Sub 2 redacted] was the business creating the employment positions.
22. [Sub 1 redacted] did not create any eligible employment positions.
23. [Sub 1 redacted] did not meet all of the qualifications of A.R.S. § 43-1161 to take the enterprise zone credit.
24. [Sub 1 redacted] and [Sub 2 redacted] were independent contractors.
25. [Sub 1 redacted] and [Sub 2 redacted] were not involved in a joint venture.
26. [Sub 1 redacted] and [Sub 2 redacted] were not partners.
27. [Sub 1 redacted] and [Sub 2 redacted] were not co-owners of the business of [Sub 2 redacted].

Discussion

The following questions are presented for Review to the Director.

1. May Taxpayer, a corporate entity exempt from the Arizona income tax which has unrelated business income take the enterprise zone credit under A.R.S. § 43-1161?
2. Does an arrangement whereby a majority member of an LLC, under an agreement with the LLC, provides employees to work in positions created in the business of the LLC qualify for the enterprise zone credit under A.R.S. § 43-1161?
3. If Taxpayer can take the enterprise zone credit, is Taxpayer entitled to all of the credit or only its pro rata share of the credit based on its ownership interest in the LLC?
4. Did Taxpayer's documents for 2003 show enough enterprise zone resident employees for the calculation of the claimed credits.
5. What is the correct number of new employees eligible for first year credits for 2003?
6. What is the correct number of second and third year credits in 2004 and 2005?
7. Are Taxpayer's claims of second year credits in 2003 and third year credits in 2003 and 2004 limited by its previous filings for 2002?

If the Section is correct on either question 1 or question 2, Taxpayer is precluded from taking any enterprise zone credit and it will not be necessary to address the other questions that were presented. For the reasons that follow, the Hearing Officer's decision that Taxpayer is entitled to an enterprise zone credit is reversed. Because

Taxpayer is not entitled to the enterprise zone credit for tax years 2003, 2004 and 2005, it is not necessary to address the other questions raised in the parties respective appeals to the Director.

Taxpayer claimed the enterprise zone tax credit based on its 100% ownership of [Sub 1 redacted], a limited liability company that is disregarded for income tax purposes. [Sub 1 redacted] has a 51% ownership interest in [Sub 2 redacted], a limited liability company that is treated as a partnership for income tax purposes. [Sub 1 redacted] provides employees to [Sub 2 redacted] under a management services agreement with [Sub 2 redacted]. Taxpayer claimed the enterprise zone credit for the employees of [Sub 1 redacted] that were provided to [Sub 2 redacted] under the management services agreement.

The decision below correctly recognized that it was the business of [Sub 2 redacted], and not [Sub 1 redacted], that created the employment positions Taxpayer claimed for the enterprise zone credit. The decision also correctly recognized that the employment positions were filled by employees of [Sub 1 redacted] and not employees of [Sub 2 redacted]. The decision erred however in holding that Taxpayer was entitled to claim a pro rata share of the credit at issue because [Sub 1 redacted] and [Sub 2 redacted] were co-owners of the business and were involved in a joint venture.

[Sub 1 redacted] and [Sub 2 redacted] were not co-owners of the business of [Sub 2 redacted]. [Sub 2 redacted] owned the business. [Sub 1 redacted] was simply one of the members of [Sub 2 redacted]. Independent of the ownership interest, [Sub 1 redacted] and [Sub 2 redacted] entered into a management services agreement for [Sub 1 redacted] to operate the business for [Sub 2 redacted]. [Sub 1 redacted] did not fill the employment positions as a contribution by a member of the limited liability company, but under a management services agreement for which [Sub 1 redacted]

received a fee. A member of a limited liability company is free to transact business with the LLC as any other person. The employees were thus provided under an agreement unrelated to [Sub 1 redacted]' partial ownership of [Sub 2 redacted]. The Management Services Agreement makes clear that [Sub 1 redacted] and [Sub 2 redacted] were not partners or in a joint venture, but were independent contractors.

The question therefore is whether either [Sub 1 redacted] or [Sub 2 redacted] independently qualifies for the enterprise zone credit. To qualify for the credit, a taxpayer must show that:

- It is the owner of a business located in an enterprise zone
- the business had net increases in qualified employment positions
- the employees in those positions were employed by the business, and
- the job duties of the employees were performed primarily at the zone location of the business, *i.e.*, the portion of the facility occupied by the business.

Based on the record, neither [Sub 1 redacted] nor [Sub 2 redacted] meet all of the above criteria to qualify for the credit. The positions claimed for the credit were created in the business of [Sub 2 redacted] and the job duties were performed at the zone location of [Sub 2 redacted]. However, [Sub 2 redacted] was not the employer. [Sub 2 redacted] therefore does not qualify for the enterprise zone credit.

[Sub 1 redacted] was the employer of the employees and provided those employees to [Sub 2 redacted] under a management services agreement. However, the job duties of the employees were not performed at [Sub 1 redacted]' zone location.

The zone location of a taxpayer is the property that is owned or leased by the taxpayer and occupied by the taxpayer. While both [Sub 1 redacted] and [Sub 2 redacted] use the same street address, the record indicates that [Sub 2 redacted] is the sublessee of

the property. That is the location where [Sub 2 redacted] performs its business functions. To the extent [Sub 1 redacted] may also occupy space at that address, the space occupied by [Sub 1 redacted] is the zone location of [Sub 1 redacted] and is not the zone location of [Sub 2 redacted] where the job duties were performed. .

Under the arrangement between [Sub 2 redacted] and [Sub 1 redacted], [Sub 1 redacted] is the employer, but [Sub 2 redacted] created the positions and used the employees in its business at its zone location. Neither [Sub 1 redacted] nor [Sub 2 redacted] independently qualifies for the enterprise zone credit.

This situation is similar to a question addressed by the department in Corporate Tax Ruling (CTR) 02-5. Question 21 asked whether a construction site was considered to be a zone location for the contractor. The answer was no because the zone location must be a taxpayer's permanent place of business within the enterprise zone. Property owned by the customer and intended for the customer's use is not a zone location of the contractor. Similarly here, the property leased by [Sub 2 redacted] and intended for [Sub 2 redacted]'s use is not the zone location of [Sub 1 redacted].

Additionally, A.R.S. § 43-1161(C)(3)(b) provides in part that if an eligible employee in a qualified employment position is transferred or assigned to work in the taxpayer's workplace at a different location that is also located in an enterprise zone and qualifies as a zone location, it may be considered to be continuous employment if it continues to meet all qualified employment position requirements. By using the phrase "taxpayer's workplace" it is clear the credit was intended to be taken for employees employed by the taxpayer taking the credit that worked in the taxpayer's workplace in the zone location.

Here the business is owned and operated by [Sub 2 redacted]. The employees are employed by [Sub 1 redacted]. Under a management services agreement the

employees hired and employed by [Sub 1 redacted] are used to operate the business of [Sub 2 redacted] at [Sub 2 redacted]'s zone location. [Sub 2 redacted] does not qualify for the credit because it is not the employer. [Sub 1 redacted] does not qualify for the credit because the employees did not perform their job duties primarily at [Sub 1 redacted] zone location but at the zone location of [Sub 2 redacted].

Taxpayer cited A.R.S. § 23-571 relating to professional employer organizations. First, Taxpayer has not argued that provisions relating to professional employer organizations apply. Second, any citation to A.R.S. § 23-571 is misplaced. That section was enacted in 2005 by Senate Bill 1472, Laws 2005, Ch 212. A.R.S. § 23-571 would have no bearing on Taxpayer's entitlement to the first year credit for 2003.

Taxpayer also argued that its management service is a viable business operation that has established, grown and maintained an employment base at various Arizona locations including at the pertinent [redacted] location. Thus [Sub 1 redacted] employees aren't per se, working in the [Sub 2 redacted] business, but are [Sub 1 redacted] employees working in [Sub 1 redacted] management services business. However, those employees are performing their job duties in the zone location of [Sub 2 redacted] and not [Sub 1 redacted].

ORDER

In summary, under the arrangement between [Sub 2 redacted] and [Sub 1 redacted], [Sub 2 redacted] created the employment positions in its business but the employees were employed by [Sub 1 redacted]. As a result, neither of the two entities independently meet all requirements to qualify for the credit under A.R.S. § 43-1161. The Hearing Officer's decision is reversed in so far as it held that Taxpayer was entitled to any enterprise zone credit for tax years 2003, 2004 or 2005. Having reversed the

Hearing Officer's decision regarding Taxpayer's entitlement to any enterprise zone credit, the remaining issues raised by the parties will not be addressed.

This decision is the final order of the Department of Revenue. Taxpayer may contest the final order of the Department in one of two manners. Within 60 days of the receipt of the final order, Taxpayer may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140 Phoenix, AZ 85007 or, if the amount in dispute is greater than five thousand dollars, Taxpayer may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003). For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this day of May 24, 2011.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing
mailed to:

[redacted]

Copies of the foregoing mailed to:

cc: [redacted]

GG:lh

cc: Corporate Income Tax Audit
Tax Policy Group