



Janice K. Brewer
Governor

Gale Garriott
Director

TAXPAYER INFORMATION RULING LR11-001

February 8, 2011

The Department issues this taxpayer information ruling in response to your letter of July 30, 2010, requesting a ruling on behalf of an undisclosed taxpayer. Specifically, you request the Department rule on the applicability of Arizona's corporate income tax on an out-of-state insurance company and its disregarded entity.

Statement of Facts

The following background information is based on written materials provided by the taxpayer.

Company A is a single member limited liability company disregarded for federal income tax purposes. Company B is the sole member of Company A.

Company B is an insurance company which is subject to and pays premium taxes imposed by another state.

Company B's primary connection to Arizona is through its ownership of Company A which has been located in Arizona since 2006. Company A was formed to provide various support services including information technology support marketing and claims processing, to Company B, its subsidiaries and third party business partners.

Neither Company A or Company B is currently an Arizona authorized insurer. However, Taxpayer represents Company B's insurance products are of a type which, were such offered to Arizona residents, would be subject to Arizona premium tax pursuant to Arizona Revised Statutes § 20-224.¹

Company C and Company D, which are subsidiaries of Company B, are authorized Arizona insurers that pay premium tax to the Arizona Department of Insurance. The Insurance products sold by Company C and Company D are the same as sold by Company B.

Questions Presented by Taxpayer:

- 1) Is Company A subject to Arizona corporate income tax?

¹ This representation means Company B is not a title insurance company. Title insurance companies are not subject to Arizona's insurance premium tax and are instead subject to Arizona's corporate income tax.

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- 2) Is Company B subject to the Arizona corporate income tax by virtue of its ownership interest in Company A, a disregarded entity performing support functions in Arizona?

Applicable Law:

Arizona Revised Statute (A.R.S.) § 43-1111 provides there shall be:

levied, collected and paid for each taxable year upon the entire Arizona taxable income of every corporation, unless exempt under section 43-1126 or 43-1201 or as otherwise provided in this title or by law, taxes in an amount of 6.968 per cent of net income or fifty dollars, whichever is greater.

Organizations exempt from Arizona corporate income tax under A.R.S. § 43-1201(14) include insurance companies paying to the state upon premium income derived from sources within this state.

A.R.S. § 20-224(A) instructs “each authorized domestic insurer, each other insurer and each formerly authorized insurer...[to] file with the director a report in the form prescribed by the director showing total direct premium income.”

A.R.S. § 20-224(B) imposes upon each insurer a tax of 2.0 percent of such net premiums.

A.R.S. § 20-224(D) provides Arizona’s insurance premium tax shall not apply to title insurance.

A.R.S. § 20-1566(A) states in lieu of the premium tax provisions of section 20-224, title insurers shall be subject to taxation on income as other private corporations.

A.R.S. § 20-226 provides:

- A. With respect to authorized insurers the premium tax provided by section 20-224 shall be payment in full and in lieu of all other demands for any and all state, county, district, municipal and school taxes, licenses and excises of whatever kind or character, excepting only:
 - 1. The fees prescribed by this title.
 - 2. Taxes on real and tangible personal property located within this state.
 - 3. The transaction privilege tax and the use tax imposed as provided in title 42, chapter 5, articles 1 and 4.
 - 4. The transaction privilege taxes and use taxes imposed by any county, city or town.
- B. Except as provided in subsection A of this section, the state preempts the field of imposing excise, privilege, franchise, income, license and similar taxes upon insurers and their general agents and agents as such and on the intangible property of insurers or such agents. Except as provided in

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subsection A of this section, no county, municipality, district, school district or other political subdivision or agency in this state shall levy upon insurers, or upon their general agents and agents as such, any tax additional to such as are levied in this title. Nothing in this section allows a county, city or town to impose a transaction privilege tax or use tax on insurance policies, premiums, brokers or agents.

A.R.S. § 29-857 provides:

A limited liability company established under this chapter or a foreign limited liability company transacting business in this state pursuant to this chapter shall pay the taxes that are imposed by the laws of this state or any political subdivision of this state on domestic and foreign limited partnerships on an identical basis, except that, for purposes of title 43, a domestic or foreign limited liability company and its members shall be taxed as if the limited liability company is either a partnership or a corporation or is disregarded as an entity as determined pursuant to the internal revenue code as defined in section 43-105.

Relevant Arizona Case Law:

All exemptions from taxation should be strictly construed. See generally *City of Phoenix v. Bowles*, 65 Ariz. 315, 180 P.2d 222 (1947).

There is a wide difference between a "lieu tax" and an exemption from taxation. The "lieu tax" is a substituted tax. *State Tax Commission v. Shattuck*, 44 Ariz. 379, 391, 38 P.2d 631, 636 (1934).

In *Prudential Insurance*, the Arizona Supreme Court held the Arizona legislature intended to limit the taxation of insurance companies to the taxes set forth in A.R.S. §§ 20-224 and 20-226. *City of Tempe v. Prudential Insurance Co. of America*, 109 Ariz. 429, 510 P.2d 745 (1973).

Taxpayer Position:

- 1) Company A is not subject to Arizona corporate income tax due to Arizona's conformity to the federal tax classification of Company A as a disregarded entity. Accordingly, Company A is disregarded for Arizona income tax purposes and its income and activities are attributed to Company B, its sole owner.
- 2) Company B is not subject to Arizona corporate income tax because it is an insurance company which is subject to the Arizona premium tax in lieu of income tax pursuant to A.R.S. § 20-226. The Arizona Department of Revenue and the Arizona Attorney General's Office have consistently held that in lieu provisions apply to

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insurance companies whether or not they actually pay Arizona premium tax. Accordingly, Arizona corporate income tax may not be imposed upon Company B, despite the fact it pays premium tax to another state and not Arizona.

Conclusion:

- 1) Is Company A subject to Arizona corporate income tax?

Company A is a disregarded entity for federal income tax purposes. As a result, its federal income and activities are attributed to Company B, its sole owner. Arizona's tax treatment of LLC's mirrors the federal treatment under A.R.S. § 29-857. Therefore, Company A is a disregarded entity for both federal and Arizona income tax purposes and its income and activities are attributed to Company B, its sole owner. As a result, Company A is not subject to Arizona's corporate income tax.

- 2) Is Company B subject to the Arizona corporate income tax by virtue of its ownership interest in Company A, a disregarded entity performing support functions in Arizona?

Company B is an out-of-state insurance company subject to insurance premium tax in another state. If Company B were an authorized Arizona insurer it would be subject to Arizona's insurance premium tax. Generally, ownership of a single member LLC doing business in Arizona by an out-of-state corporation would subject the out-of-state corporation to Arizona's corporate income tax. However, in this case the out-of-state corporation is an insurance company, and for Arizona purposes insurance companies are subject to insurance premium tax, not corporate income tax.

The Arizona insurance premium tax is a substitute tax and not an exemption from taxation. This important distinction along with the clear language of A.R.S. § 20-226 led the court in *Prudential Insurance* to conclude the Arizona legislature intended to limit the taxation of insurance companies to the taxes set forth in A.R.S. §§ 20-224 and 20-226. Therefore insurance companies (excluding title insurance companies) are only subject to Arizona's insurance premium tax and those taxes specifically listed in A.R.S. § 20-226(A)(1-4). The taxes enumerated in A.R.S. § 20-226(A)(1-4) are limited to insurance fees, property taxes, and state, county and city transaction privilege taxes. As a result, Company B is not subject to Arizona's corporate income tax.

This response is a taxpayer information ruling (TIR) and the determination herein is based solely on the facts provided in your request. 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 taxpayer information ruling shall be null and void. Further, the determination is subject to future change depending on changes in

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statutes, administrative rules, case law, or notification of a different Department position.

If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.

Lrulings/11-001-D