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Director

PRIVATE TAXPAYER RULING LR 22-003

January 28, 2022

Thank you for your letter dated January 26, 2020, requesting a private taxpayer ruling (“PTR”) on behalf of your client, *** (“Taxpayer”). Specifically, you requested a determination as to the applicability of the Arizona transaction privilege tax (“TPT”) to a *** [greater than 30 years] long-term ground lease (“Lease”).¹

Pursuant to Arizona Revised Statutes (“A.R.S.”) § 42-2101, the Arizona Department of Revenue (“Department”) may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

ISSUE:

1. Is the gross income derived from the Lease of real property subject to TPT under the commercial lease classification?
2. Is the gross income derived from the Lease of real property subject to city privilege tax as a speculative builder?
3. If the Lease is found to be taxable, must an accrual based taxpayer remit TPT when the Lease is paid in full or may portions of the upfront payment be recognized over the life of the Lease?

TAXPAYER’S POSITION(S):

The Lease constitutes a sale of real property, rather than a lease, and is excluded from state, county and city privilege taxes imposed under A.R.S. § 42-5069 and Model City Tax Code (“MCTC”) § -445 as a sale of real property. Neither the Department nor the City *** have issued clear guidance as to when a long-term lease may be considered a sale rather than a lease under the commercial lease classification. While *** [greater than 30 years] lease terms may be common, a one-time upfront lump sum payment on a *** [greater than 30 years] lease is uncommon. Factors supporting the Lease as a sale are:

¹ For purposes of this PTR, the use of the term TPT consists of state, county and city privilege taxes.

1. The Lease term is functionally equivalent to a sale under MCTC § -416(a)(3);
2. The base rent for the *** [greater than 30 years] term is due upfront in one lump sum; and
3. The Lease is an “absolute net lease,” such that the lessee bears all expense and financial risk related to the property.

If the Lease is found to be subject to TPT under A.R.S. § 42-5069 and MCTC § -445, under the accrual basis of reporting, Taxpayer should report the TPT on the upfront lump-sum payment over annual reporting periods through the *** [greater than 30 years] term of the Lease.

RULING:

The Department rules as follows:

1. The gross income derived from the Lease, unless otherwise exempted or deducted by statute, is taxable by the state and county, as a commercial lease of real property.
2. Sixty-five percent of the gross income derived from the Lease, unless otherwise excluded, exempted, or deducted by statute, is taxable by the city as a speculative builder.
3. Under the state and county commercial lease classification, accrual reporting taxpayers report the gross income when the right to the rent payment is fixed, *i.e.*, when the payment is due. Thus, the Lease terms provide that the payment is due in full within thirty days of signing the Lease or when construction starts, whichever is sooner. City privilege tax is due on speculative building in the tax period in which the transfer of title or equitable ownership occurs—this tax is due on the “Commencement Date” as provided in the Lease.

SUMMARY OF FACTS:

The following facts are a summary based on your ruling request dated January 26, 2021, as supplemented by correspondence dated February 10, 2021, March 22, 2021, and September 30, 2021:

Taxpayer, a *** corporation, operates a *** in the City ***, *** County, Arizona. Taxpayer also owns a parcel of real property that the *** County Assessor’s Office classifies as vacant commercial property for purposes of locally assessed property tax. Taxpayer is negotiating with an Arizona based *** (“Lessee”) for a *** [greater than 30 years] ground lease on the property. Taxpayer purchased the parcel in *** and at that time the parcel contained a parking lot with *** buildings, apparently

used as ***, which had water and electricity and were certified for occupancy. Taxpayer is not able to produce documentation as to when the following improvements were made after purchasing the property, but historical satellite imagery demonstrates the following improvements:

- Sometime between *** was built on the property;
- Sometime between *** existing structures were removed;
- Sometime between *** Taxpayer felled two-thirds of the *** trees, and removed or mulched the tree stumps.²

After signing the Lease, Lessee plans to build *** (hereinafter collectively referred to as the "Improvements"). The terms of the Lease are as follows:

1. An initial term of *** [greater than 30 years] years;
2. Four options for renewal at ten-year terms;
3. The lease payment is a lump sum payment for the initial term based on an independent appraiser's determination of fair market value ("FMV"), and is due thirty days after the Lease's effective date or when construction has commenced, whichever is earlier;
4. Lease payments on renewal shall be based on the FMV at the time of renewal and Lessee may choose to pay rent as a lump sum or on a monthly basis.
5. The Lease is an "absolute net lease" as commonly understood and requires Lessee to pay all costs, charges, expenses, taxes, insurance premiums, maintenance, repair, and replacement to the property and all obligations of any kind and nature related to the property. The Lease refers to these obligations collectively as "Additional Rent."
6. Lessee is the owner of the Improvements during the terms of the Lease and, upon termination of the Lease, will become Taxpayer's sole property;
7. Lessee may sublease portions of the Property during the initial and any subsequent renewal terms of the Lease.

DISCUSSION AND LEGAL ANALYSIS:

Arizona's TPT differs from the sales tax imposed by most states.³ It is a tax on the privilege of conducting business in the State of Arizona. Differing from a true sales tax, the TPT is levied on income derived by the seller, who is legally allowed to pass the economic expense of the tax on to the purchaser. However, the seller is ultimately liable to Arizona for the tax. The Arizona TPT is imposed under sixteen separate business classifications. A.R.S. § 42-6103 provides that the state's

² Satellite imagery obtained from the *** County Assessor ***, ***.

³ Although there are some differences, references of Arizona's TPT refers to all Arizona taxing jurisdictions.

TPT provisions shall govern the imposition of county excise taxes. Accordingly, all sales subject to TPT are also subject to applicable county excise taxes.

Commercial Lease Classification

A.R.S. § 42-5069 imposes the TPT on “the business of leasing for a consideration the use or occupancy of real property.” A.R.S. § 42-5069(B) designates the commercial lease taxpayer as any “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.” A.R.S. § 42-5069(B) explicitly excludes leasing real property used for residential or agricultural purposes from this tax classification. A.R.S. § 42-5069(D) calculates the tax base for the commercial lease classification from “gross proceeds of sales or gross income derived from the business.”

The state commercial lease rate has been statutorily set at 0% since July 1, 1997.⁴ While the state no longer imposes TPT on income derived from commercial leases, as of the date of this private taxpayer ruling, the county excise taxes for Maricopa, Pinal, Pima, Gila, and Coconino counties are still applicable to commercial lease income. In addition, city taxes are also applicable to commercial leases (see below).

Arizona Administrative Code (“A.A.C.”) R15-5-1604 dealing with commercial leases provides that the gross income derived from commercial leases includes all amounts paid to or on behalf of a lessor. Those amounts are taxable for TPT purposes. Thus, property tax, insurance, and common area charges (among other charges) are all considered taxable if the underlying lease arrangement is also taxable.⁵

City Tax

The imposition of city privilege taxes is separate and distinct from the state’s TPT and accompanying county excise taxes. As with the state’s TPT, city privilege taxes are imposed on the vendor for the privilege of engaging in business in the city. The MCTC was created in order to impose and administer city privilege taxes. Similar to Arizona’s TPT, city privilege taxes are imposed “upon persons on account of their business activities.” See MCTC § -400(a)(1). All Arizona cities follow the MCTC in the

⁴ See A.R.S. § 42-5010(A)(4).

⁵ Arizona Transaction Privilege Tax Ruling TPR 95-17 provides additional discussion on the gross income that is subject to tax under the commercial lease classification.

imposition of their privilege tax based upon their local ordinances. However, certain options exist, allowing each city to alter or qualify the imposition of its privilege tax.⁶

Rental, Leasing, and Licensing for Use of Real Property.

MCTC § -445 imposes city privilege tax on the gross income of persons engaged in the rental, leasing, or licensing for use of real property. This gross income includes payments made by a lessee to or on behalf of the lessor; property taxes, repairs, or improvements are considered to be part of the taxable gross income, as are charges by the lessor to the lessee for such items as telecommunications, utilities, pet fees or maintenance.

Speculative Builders.

MCTC § -416 imposes a city privilege tax on the gross income of every person engaging or continuing in business as a speculative builder within the city. MCTC § -416(a)(1) provides that a speculative builder's taxable gross income includes the total selling price from the sale of "improved real property" at the time of closing of escrow or transfer of title.

MCTC § -416(a)(2) defines "improved real property" as real property:

- (A) upon which a new structure has been substantially completed; or
- (B) where improvements have been made to land containing no structure (such as paving or landscaping); or
- (C) which has been reconstructed as provided by Regulation; or
- (D) where water, power, and streets have been constructed to the property line.

In addition, MCTC § -416(a)(3) defines "sale of improved real property" very broadly and it includes any form of transaction, whether characterized as a lease or otherwise, which in substance is a transfer of title of, or equitable ownership in, improved real property.

MCTC § -100 defines "speculative builder" and "substantially complete" as:

"Speculative Builder" means either:

⁶ The MCTC can be found online at <https://azdor.gov/model-city-tax-code/model-city-tax-code>.

1. an owner-builder who sells or contracts to sell, at any time, improved real property consisting of:
 - a. custom, model, or inventory homes, regardless of the stage of completion of such homes; or
 - b. improved residential or commercial lots without a structure; or
2. an owner-builder who sells or contracts to sell improved real property, other than improved real property specified in subsection 1:
 - a. prior to completion; or
 - b. before the expiration of twenty-four months after the improvements of the real property sold are substantially complete.

“Substantially Complete” means the construction contracting or reconstruction contracting:

- (1) has passed final inspection or its equivalent; or
- (2) certificate of occupancy or its equivalent has been issued; or
- (3) is ready for immediate occupancy or use.

MCTC § -416(a)(2) provides that “once a structure has been deemed ‘substantially complete’ subsequent improvements to the structure shall not be considered for the purpose of determining the date on which a sale transaction would be taxable under this Section.”

Additionally, MCTC § 416 includes provisions for exclusions, exemptions, deductions, and tax credits that may be available to a speculative builder provided that the city in which the speculative builder is conducting business has adopted that specific provision.

Long-Term Ground Lease as a Sale

For purposes of this discussion it is to be understood that any reference to a “lease” is to be defined as a lease for real property. The Financial Accounting Standards Board has determined that *from the lessee’s standpoint* a lease is either a capital lease or an operating lease under the following conditions:⁷ A capital lease is characterized as a lease that meets one of the following:⁸

1. The lease transfers ownership of the property to the lessee by the end of the lease term;
2. The lease provides a bargain purchase option;

⁷ *Statement of Financial Accounting Standards No. 13. Accounting for Leases*, Financial Accounting Standards Board, pg. 7 (1976).

⁸ *Id.* at 8

3. The lease term is equal to seventy-five percent or more of the estimated economic life of the leased property and the beginning of the lease term does not fall within the last twenty-five percent of the total estimated economic life of the leased property; or
4. The present value at the beginning of the lease term of the minimum lease payments (the original term and not including options for renewal nor executory costs such as insurance, maintenance, and taxes in connection with the leased property) equals or exceeds ninety percent of the excess of the fair valued of the leased property to the lessor at the inception of the lease.

An operating lease is any other lease not characterized as a capital lease.⁹ Thus, a capital lease is one in which the lessee has characterized the lease on their balance sheet as an asset, whereas the operating lease is treated as a true expense.

Treatment of Long Term Ground Lease – State and County

State statutes—which, by default, apply the counties for this purpose—do not impose a tax on the sale of improved real property, and do not contain a provision to treat a long-term ground lease as a sale. A.R.S. § 42-5069(A) simply reads that “the commercial lease classification is comprised of the business of leasing for a consideration the use or occupancy of real property.”

For state TPT and county excise tax purposes, there is no language indicating that a long-term capital lease is treated as a sale of real property because the sale of real property is not taxable. Nor is there any language concerning long-term lease where all rights in the property revert back to the lessor upon lease termination should be considered a conditional sale.

Although certain elements of the transaction appear similar to a sale (*e.g.*, base rent due up front, or Lessee assumes financial risk), the Lease provides that upon termination, all rights in the property revert back to the lessor. Accordingly, based on the state TPT statutes, is a commercial lease of real property for state and county tax purposes.

Treatment of Long Term Ground Lease - City

For city purposes, sixty-five percent of the gross income derived from engaging in business as a speculative builder is subject to city privilege tax. A “speculative builder” is defined as an owner-builder who contracts to sell, at anytime, improved real property, including improved commercial

⁹ *Id.* at 7.

lots without a structure. "Sale of improved real property" is defined to include "any form of transaction, whether characterized as a lease or otherwise, which in substance is a transfer of title of, or equitable ownership in, improved real property and includes any lease of the property for a term of thirty (30) years or more (with all options for renewal being included as a part of the term)."¹⁰

An owner-builder is an "owner or lessor of real property who, *by himself or by or through others*, constructs or has constructed . . . any improvements to real property."¹¹ Improved real property includes "improvements . . . made to land containing no structure (such as paving or landscaping)."¹²

The term "landscaping" is not specifically defined in the MCTC, however, MCTC Reg. -460.1(b) provides that while landscape maintenance is not construction contracting, demolition, earth moving, and wrecking activities are. This coincides with the definition of "landscaping" provided in A.R.S. § 42-5075(J) as "installing lawns, *grading or leveling ground*, installing gravel or boulders, planting trees and other plants, *felling trees, removing or mulching tree stumps*, removing other imbedded plants, building irrigation berms, installing railroad ties and *installing underground sprinkler or watering systems*." (Emphasis added).

Accordingly, Taxpayer's installation of ***, removal of *** trees, and removing tree stumps constitutes landscaping (a contracting activity) and is an improvement to real property by an owner-builder. Because the Lease is a *** [greater than 30 years] capital lease of improved real property, it is a transfer of title, or transfer of equitable ownership, of improved real property by an owner-builder. Thus, Taxpayer is subject to the city privilege tax as a speculative builder on sixty-five percent of the base rent, unless otherwise deducted or exempted by statute.

Cash vs. Accrual Lease Payments

A taxpayer must elect a method of reporting based on either the accrual or cash method at the time it applies for a TPT license.¹³ Cash receipts method taxpayers report their income in the reporting period in which the lease payments are actually received, regardless of when the sale occurred. Thus, a lessor reporting under the cash method will only report the lease payments received in the reporting periods when the rent is actually collected.

¹⁰ See MCTC § -416(a)(3).

¹¹ See MCTC § -100.

¹² See MCTC § -416(a)(2)(B).

¹³ A.A.C. R15-5-2211(B).

Accrual method taxpayers report their income in the reporting period in which the sale occurs, regardless of when payment is received.¹⁴ A sale is defined to mean “any transfer of . . . possession, . . . lease or rental . . . for a consideration.”¹⁵ “Consideration” is defined as “[s]omething (such as an act, a forbearance, or a return promise) bargained for and received by a promisor from a promisee.”¹⁶ Thus, in a commercial lease, a “sale” for determining the timing for reporting occurs when the lessor transfers possession and the lessee makes a promise to pay rent. In other words, an accrual basis lessor will report rental income when it has a fixed right to receive the rent (*i.e.*, the lessor has performed its obligations under the lease) and the amount of rent to be received has been made certain.

Commonly, a commercial lease provides that rent payments are due at the beginning of a period (*e.g.*, monthly or annually). Thus, an accrual lessor’s right to receive that payment is fixed for the beginning of a period (generally monthly, although at times annually)—if all of the lessor’s performance obligations under the lease have been completed—and the lessor would report and remit tax on rent during that period, regardless of whether the Lessee was late with the payment. By contrast, a cash method lessor would wait to report until it has actually received the late rent payment.

Taxpayer reports using the accrual method. Accordingly, state and county TPT on the gross income derived from a commercial lease of real property is owed in the reporting period in which the sale is made, or when all events have occurred fixing Taxpayer’s right to the payment. Taxpayer’s lease provides that:

As of the Commencement Date, there shall be due and owing from Tenant to Landlord as base rent for the Premises (“Base Rent”) for the initial Term of *** [greater than 30 years] years, to be paid in advance, the lump-sum amount of [redacted]. Base rent shall be payable no later than the earlier of the date that is (i) [thirty] days after the Effective Date, or (ii) the commencement of construction of the Tenant Improvements r

The Lessee must pay the base rent no later than either “(i) [thirty] days after the Effective Date, or (ii) the commencement of construction of the Tenant Improvements as evidenced by Tenant’s commencement of any work on the Premises.”¹⁷ Thus, Taxpayer’s fixed right to the base rent is either: (1) thirty days after the Effective Date or (2) when construction has commenced, if

¹⁴ A.A.C. R15-5-2211(A)(1).

¹⁵ A.R.S. § 42-5001(18).

¹⁶ CONSIDERATION, Black’s Law Dictionary (11th ed. 2019).

¹⁷ *Id.* at 11.

construction starts within thirty days of the effective date. As a result, Taxpayer must report the full lump sum base rent for county TPT in the reporting period in which the construction starts or the end of thirty days from the effective date, whichever falls sooner.¹⁸

The city privilege tax on speculative building is imposed on the sixty-five percent of the gross income derived from a sale of improved real property. The city privilege tax is due on speculative building when the transfer of title, or equitable ownership occurs. Taxpayer will transfer equitable ownership in the improved real property to Lessee, as defined in the Lease, on the Commencement Date.

As a result, Taxpayer must report the full lump sum base rent for city privilege tax in the reporting period in which the Commencement date begins.

This response is a private taxpayer ruling and the determinations herein are 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 private 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.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling. In addition, this private taxpayer ruling only applies to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling.

¹⁸ Because the effective state rate is 0% reporting under the commercial lease classification refers to the counties in which commercial lease is taxable.