



## A Dash of SALT

### *Arizona Legislature Expands Sales Tax Exemption for Leases of Real Property Between Affiliated Parties*

*Last month's state and local tax (SALT) column examined the 16 different types of business activities that are subject to Arizona transaction privilege (sales) tax. This month's column focuses on recent legislative changes to the sales tax that applies to persons or companies engaged in the business of leasing real property – the "Commercial Lease Classification."*

Four of Arizona's 15 counties (Gila, Maricopa, Pima, and Pinal) impose sales tax at the rate of 0.5% on proceeds from renting real property. In addition, most Arizona municipalities impose sales tax on proceeds from renting real property at rates that vary from 1.0% in Sierra Vista to 4.0% in Fredonia and San Luis.

As its name implies, Arizona's "Commercial Lease" tax does not apply to transactions involving residential property. On the other hand, the real property rental tax imposed by most Arizona municipalities applies to proceeds from residential rental properties as well as to proceeds from commercial rental properties—but some municipalities do not impose tax on residential rental properties if the lessor only has one or two residential rental properties.

Although the Commercial Lease Classification accounts for less than 0.01% of state sales tax collections because the state tax rate for this classification is zero, many CPAs are all too familiar with this tax because one or more of their clients have received an assessment from the Arizona Department of Revenue (for a county and/or city that the Department collects taxes for) or from a city tax audit department for sales tax on one entity's rental proceeds from a related party, like a single member LLC owned by a doctor that receives rent from the doctor's professional corporation.

For federal income tax purposes,

transactions like these between related pass-through entities generally are not subject to tax because the LLC's rental income flows through the LLC to be reported by the LLC's owner—the doctor in this example—on his or her individual income tax return and the rental income is offset by the professional corporation's rent expense.

However, for sales tax purposes, unless an exemption applies, even rental transactions between related parties are subject to tax. For many years, the State of Arizona and some municipalities have allowed exemptions for: "[l]easing real property by a corporation to an affiliated corporation." But, if the lessor and the lessee were not both corporations, either S Corporations or C Corporations, the exemption did not apply. So, in today's world where it is so common to hold rental properties in LLCs, LLPs, partnerships, trusts, and other types of entities, more often than not, the exemption for "[l]easing real property by a corporation to an affiliated corporation" did not apply to transactions between related parties, which came as a surprise to many property owners and their CPAs.

Fortunately, the Arizona Legislature recently expanded existing exemptions from Arizona's state and local sales taxes for leases of real property between affiliated corporations to apply to leases of real property between affiliated "compa-



nies, businesses, persons or reciprocal insurers."

For purposes of these newly expanded exemptions: (1) "affiliated" means the lessor holds a controlling interest in the lessee, the lessee holds a controlling interest in the lessor, an affiliated entity holds a controlling interest in both the lessor and the lessee, or an unrelated party holds a controlling interest in both the lessor and lessee, and (2) "controlling interest" means direct or indirect ownership of at least eighty percent of the voting shares of a corporation or of the interests in a company, business, or person other than a corporation.

These exemptions were expanded via H.B. 2324 (Laws 2013, Chapter 27), which was effective Sept. 13, 2013 for county tax purposes. But, Arizona municipalities implemented the changes beginning July 1, 2013. **AZ CPA**

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