Residential Rental Property Classification

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Effective June 1, 2004

Issue

What is the legal classification of a property, or any portion of a property, used for both short term and extended stay occupancies?

Discussion

The Department was asked to review the provisions affecting the qualifications for Legal Class Four status of hotels, motels, apartments, and other similar facilities. The properties reviewed had not designated specific rooms or units solely for rental residential purposes.

Real property in Arizona that is devoted to producing income for the owner is generally considered to be commercially used, is classified as Legal Class One and is assessed with a twenty-five percent assessment ratio. However, Legal Class Four states, “Real and personal property and improvements to the property that are used solely as leased or rented property for residential purposes, that are not included in class one, two, three, six, seven or eight and that are valued at full cash value” A.R.S. 42-12004. Properties in Legal Class Four have a ten percent assessment ratio.

Research

Recent Court of Appeals decisions have helped to clarify the classification of property devoted to residential rental use. The decisions establish that the leasing or renting of property for profit is a commercial use that is properly classified in Legal Class One. However, the legislature created an exception for property devoted solely for residential rental use by creating Legal Class Four, specifically A.R.S. 42-12004(A)(1).

In Krausz vs. Maricopa County (1 CA-TX00-0022), the owner of an office building was seeking a reclassification because the building was rented to the Arizona Department of Environmental Quality (ADEQ). The owner’s argument was that the rented office space was leased to a government entity, and therefore the leased property should be considered to be noncommercial. The court ruled that even though the tenant used the

property for a government use, the owner was leasing the property at a market rate with the intention of making a profit, which is a commercial use. The Court stated:

> "The legislature clearly desired a separate specific class for leased residential property. It accomplished its purpose by creating class four property that includes real and personal property and improvements 'used solely as leased or rented property for residential purposes, that are not included in class one [including commercial], two, three, six, seven or eight.' A.R.S. 42-12001(12).
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> "The adoption of A.R.S. section 42-12004(A)(1) illustrated the need to statutorily segregate leased residential property lest it be classified as commercial. Without the statute, class one would have arguably included leased residential property because the owner could have been viewed as putting the property to a commercial use. With the adoption of A.R.S. section 42-12004(A)(1), such property plainly falls within the narrower classification of leased residential property, and thereby is excluded from the broader commercial classification created by A.R.S. section 42-12001."

In U-Stor Bell vs. Maricopa County (1 CA-TX 00-0013), the owners contended that the on-site apartment built for the manager's residence of the mini-storage facility should be classified as Legal Class Four, giving the property a mixed-use assessment ratio. However, the court held that the apartment was not "used solely for residential purposes" but was used for business purposes since the manager was required to live on the premises, as a condition of employment to manage the mini-storage and to provide additional security. The total use of the property was determined to be commercial use and should be assessed as Legal Class One. The Court noted in this decision:

> "As we intimated in Krausz, it was ordinary landlords' use of their property for the production of rental income that prompted the legislature to adopt 42-12004(A)(1) and its predecessors to avoid commercial classification of such property. In this

> case the taxpayers' special commercial use of their manager apartments is qualitatively different from the more common use that the legislature sought to remove from commercial classification.
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> "Neither the taxpayer or their on-site managers use the manager apartments "solely" for residential purposes. Further, the taxpayers do not "lease" or "rent" the manager apartment to their on-site managers within the ordinary meaning of those terms. The taxpayers' manager apartments therefore do not come within the intended scope of the 'exception' to commercial classification provided by 42-12004(A)(1).

Although not a Court of Appeals decision, a case was filed in January, 2003 in the Arizona Tax Court which provides additional guidance. In Sierra Vista Sunwood Inn Ltd. Partnership vs. Cochise County (TX2001-000341) the owners wanted a mixed assessment ratio of Legal Class One and Legal Class Four applied to their hotel properties to reflect both commercial and residential rental use because the rooms were used for both short term and extended stay lodging.

The court observed that the properties subject to the appeal were classified solely as Class One commercial properties and consisted of buildings categorized as inns or suites that catered to patrons who needed lodging on both a short term and an extended stay basis, especially considering the properties' close proximity to the Fort Huachuca Military Base. However, the court noted that transient occupancy of a hotel is excluded from the provisions of the Arizona Residential Landlord and Tenant Act (A.R.S. 33-1301 through 33-1381), and the property owners had presented no evidence to support their claim that the hotels were complying with the provisions of that act. No data was given to show that neither the hotel operators nor their patrons were subject to statutory termination notice requirements, and each could freely rent or terminate the stay with minimal notice. The court also reasoned that there would be a definitive

building, structure, or specified rooms set aside for residential use, and noted no evidence was presented to inducate that this had been done.

> The Court issued an "Under Advisement Ruling" finding that the taxpayer's properties did not fall within Class Four pursuant to A.R.S. 42-12004, and thus were not entitled to "mixed use" classification pursuant to A.R.S. 42-15010.

Conclusion

Based on this research, the Department finds that the **owner's** use takes precedence over the **tenant's** use. Properties that are available for either short term or extended stay occupancy are considered to be used commercially and should be classified as Legal Class One. If there is sufficient evidence offered by the owner to document that all or part of the property is used solely for residential rental use, the Assessor may consider changing that portion of the property to Legal Class Four.

The following criteria must be met before a property can be considered to be "used solely for rental residential purposes":

- The property must be made available to the public subject to the laws governing the rental of dwelling units and the rights and obligations of the Arizona Residential Landlord and Tenant Act (A.R.S. 33-1301 to 33-1381).

  Note: This act specifically excludes "transient occupancy in a hotel, motel, or recreational lodging." It also excludes "occupancy by an employee of a landlord as a manager or custodian whose right to occupancy is conditional upon employment in and about the premises."

- The property must be available for rental residential use only, on a year round basis.
- The rental units must be specified as being available for use or actually used for rental residential purposes.

- The property owner has registered the property with the County Assessor as residential rental property as required under A.R.S. 33-1901 and 33-1902.

Effective Date: June 1, 2004

This guideline will be incorporated in the next update of the Assessment Procedures Manual, at which time, this guideline will be rescinded.