

ARIZONA DEPARTMENT OF REVENUE

ARIZONA TRANSACTION PRIVILEGE TAX RULING

TPR 93-9

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ISSUE:

Applicability of the affiliated corporation exemption under the commercial lease classification for nonprofit corporations and for subchapter S corporations.

APPLICABLE LAW:

A.R.S. § 42-1310.09.C.5 provides an exemption from transaction privilege tax under the commercial lease classification for the lease of real property by a corporation to an affiliated corporation.

DISCUSSION:

General Provisions

A.R.S. § 42-1310.09.C.5 provides an exemption from transaction privilege tax under the commercial lease classification for the leasing of real property by a corporation to an affiliated corporation. "Affiliated corporation" is defined as "a corporation which owns **or** controls at least 80 percent of the lessor, is at least 80 percent owned **or** controlled by the lessor or is at least 80 percent owned **or** controlled by a corporation which also owns **or** controls at least 80 percent of the lessor." (Emphasis added.)

The key phrase in this section is "owned **or** controlled". The wording indicates that the terms "owned" and "controlled" are not required to be used in conjunction but can be utilized separately and distinctly from one another.

A.R.S. § 42-1310.09.C.5 provides that ownership and control are determined by reference to

the voting shares of the corporation. The term voting shares is not defined in the transaction privilege statutes, but is defined in Arizona's general corporation statutes as "the units into which proprietary interests in a corporation are divided." (A.R.S. § 10-002.17.) A for-profit corporation will always have voting shares because it will always have stockholders with voting rights.

Shares of stock are evidence of an ownership interest in a for-profit corporation. Shareholders of a for-profit corporation have the right to vote for the board of directors of the corporation and, upon liquidation, the right to participate pro rata in the distribution of the assets of the corporation.

Affiliated Nonprofit Corporations

The question has arisen as to whether the exemption from transaction privilege tax provided to affiliated corporations under the commercial lease classification applies to nonprofit corporations which qualify for tax exempt status under § 501(c)(3) of the Internal Revenue Code.

A.R.S. § 42-1310.09.C.5 states that ownership and control are determined by reference to the voting shares of the corporation. However, A.R.S. § 10-1026 prohibits nonprofit corporations from issuing stock. In addition, due to the requirements of the Internal Revenue Code, members of a nonprofit corporation may not share pro rata in the assets of the corporation upon liquidation. Therefore, members of a nonprofit corporation do not have an ownership interest in the assets of a nonprofit corporation.

The term "voting shares" is generally considered to be synonymous with the term "voting stock" in relation to corporate ownership. Voting stock is defined in Black's Law Dictionary as that type of stock which gives the holder the right to vote for directors and other matters. However, the same dictionary defines "share" as a part or definite portion of a thing held by a number of people in common. Therefore, a nonprofit corporation which provides its members with the right to vote has "voting shares" which can be used to determine the control of the corporation.

The terms "voting stock" and "voting shares" do not always have an identical meaning. The term voting stock refers to stock issued by a for-profit corporation which carries an ownership interest in the corporation along with the right to vote. In contrast, a voting share confers the right to vote but does not necessarily include an ownership interest in the corporation. This distinction makes it clear that it is possible to test affiliation between related nonprofit corporations by looking at the voting shares to determine whether one nonprofit corporation controls another nonprofit corporation.

As a result of the fact that nonprofit corporations are prohibited from issuing stock by Arizona

law, in order to determine corporate affiliation in a situation involving nonprofit corporations, **control** of the corporation through voting shares is the determining factor. The articles of incorporation of a nonprofit corporation generally provide that either its members or its board of directors control the corporation through the exercise of voting rights. (A.R.S. § 10-1015.)

Just as a for-profit corporation may issue different classes of stock with different rights attaching to each, a nonprofit corporation may have one or more classes of members with different voting rights. Moreover, a nonprofit corporation may issue certificates evidencing membership rights and voting rights as authorized in the articles of incorporation. (A.R.S. § 10-1011.A.) These voting rights, whether or not they have been formalized through the issuance of certificates, serve the same purpose as voting stock of a for-profit corporation. The party holding the majority of voting rights controls the nonprofit corporation.

A nonprofit corporation is controlled by its board of directors. Therefore, control over the selection of the subsidiary's board of directors is the key factor in determining the extent of control which a controlling nonprofit corporation has over an affiliated subsidiary nonprofit corporation.

Subchapter S Corporations:

The question has arisen as to whether the exemption from transaction privilege tax provided to affiliated corporations under the commercial lease classification applies to corporations which elect tax treatment under subchapter S of the Internal Revenue Code.

The Internal Revenue Code defines affiliation by referring to the ownership of at least 80 percent of the total voting rights **and** value of a subsidiary corporation. In contrast, A.R.S. § 42-1310.09.C.5 defines affiliation by referring to ownership **or** control of a related corporation.

Due to these differences, an S corporation could be exempt from transaction privilege tax on a commercial lease where an S corporation owns or controls a related C corporation, while retaining its subchapter S status.

For example, an S corporation could be exempt from transaction privilege tax on a commercial lease with an affiliated C corporation which has issued two classes of stock, one voting and one non-voting, if an S corporation owns 80 per cent or more of the voting stock of the C corporation but less than 80 per cent of the nonvoting stock.

RULING:

A nonprofit corporation which qualifies for tax exempt status under IRC § 501(c)(3) is affiliated with another nonprofit corporation for purposes of the exemption from transaction privilege tax provided by A.R.S. § 42-1310.09.C.5 if the parent or central nonprofit corporation controls the

subsidiary tax exempt corporation by holding 80 percent of its voting shares or rights.

A nonprofit corporation controls an affiliated nonprofit corporation if the board of directors of the controlling corporation controls the voting rights for the election of 80 per cent of the board of directors of the subsidiary nonprofit corporation.

In the alternative, if a parent or central nonprofit corporation which qualifies for tax exempt status under IRC § 501(c)(3), controls one or more subsidiaries and qualifies to file a group information return with its subsidiaries, the nonprofit corporations are affiliated and qualify for the exemption if the organization meets the 80 percent test.

An S corporation which owns or controls more than 80 per cent of the voting power of a C corporation, is affiliated with the C corporation as required by A.R.S. § 42-1310.09.C.5 and qualifies for the exemption from transaction privilege tax under the commercial lease classification.

Paul Waddell, Director
Signed March 2, 1993