Douglas A. Ducey
Governor

David Briant
Director

PRIVATER TAXPAYER RULING LR16-010

August 26, 2016

Thank you for your letter dated April 14, 2016 requesting a private taxpayer ruling ("PTR") on behalf of your client, ***, a single-member Delaware limited liability company ("***"). Specifically, you requested a ruling for a determination of whether, for the purposes of the Model City Tax Code ("MCTC"), *** is considered a "governmental entity" and exempt from the city privilege tax in the conduct of its leasing activity.

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. A.R.S. § 42-6001(A) authorizes the Department to collect and administer any transaction privilege and affiliated excise taxes imposed by any city or town in Arizona. Under A.R.S.§ 42-6002(A) state statutes govern the administration of the municipal privilege taxes levied by a city or town. Pursuant to A.R.S.§ 42-6005(B) the Department's guidance is binding on cities and towns when the state statutes and the MCTC are the same. This letter accordingly provides a joint response to your request which has tax implications within an Arizona city and town.[1]

ISSUES:

For the purposes of determining whether *** is subject to the MCTC's privilege tax imposed on account of a person's leasing activity within a city the following issues must be addressed:

1) Whether *** is a governmental entity?
2) If *** is a governmental entity whether it is performing a governmental or proprietary function?
3) If it is performing a proprietary function whether it is exempt as a "governmental entity" as provided in MCTC § 270(a)(2) and Phoenix City Code § 14-270(a)(2) from the city privilege tax?

RULING:

*** is a governmental entity because its creation and structure were authorized under the State of *** Investment Board's ("***") administrative rule IB 2.04, which was considered

[1] For the purposes of this ruling, neither the state or county transaction privilege tax is under consideration.

"necessary and appropriate" by the *** Attorney General to carry out ***'s functions of professional investment management of various trusts and operating funds established under the laws of the State of ***. In addition, ***'s investments are considered as investments in ***'s name as required by *** law and as such, it is subject to the standards imposed on *** and may only conduct its investments in accordance with governing statutes. Finally, *** is investing public money; it is not engaged in a business enterprise.

***'s primary function and by extension, ***'s primary function, is to provide professional investment management of the various *** trusts, and operating and capital funds established by law. More specifically, *** is charged with investing a portion of ***'s public monies in real estate. Real estate investments are specifically authorized as permitted investments by statute. Because *** is performing a specific activity for which *** and itself were organized, it is considered to be performing a governmental function. See *Salt River Project Agr. Imp. and Power Dist. v. City of Phoenix*, 631 P.2d 553, 129 Ariz. 398 (Ariz.App., 1981)

Because *** is a governmental entity performing a governmental as opposed to a proprietary function, it is exempt from the tax imposed by MCTC § 445 on its leasing activities in Arizona and MCTC§ 270(a)(2) and Phoenix City Code § 14-270(a)(2) need not be considered.

SUMMARY OF FACTS:

The following is a summary of the relevant facts based on your letter dated April 14, 2016 and subsequent correspondence with the Department dated June 13, 2016 including the operating agreements of each of the entities involved, a ruling by IRS regarding *** real estate subsidiary holdings, and an opinion letter from the State of *** Attorney General regarding the authority of *** to promulgate administrative rules to create title holding entities:

*** is an agency of the State of *** and is responsible for managing the assets of the *** Retirement System, The State Investment Fund and other State trust finds.[2] *** was created by *** Statutes ("***. Stat.") § 25.14. Its purpose is to provide professional investment management of the various trusts and operating funds established under the laws of the State of ***. Under ***. Stat. § 25.15, *** has broad authority to invest and

[2] ***'s website, *** indicates that its assets under management include the *** State Retirement System ("***RS") comprising 93% of its funds, the State Investment Fund which is a pool of cash balances of the ***RS, various state and local governmental units, comprising 6%, and five state trust funds which comprises 1 % of its assets.

reinvest pension funds; to collect income and rents; to acquire, manage, and sell real estate; and to employ outside counsel and contractors.

***. Stat. § 25.182 also gives *** broad authority to make any investment that does not violate the standards identified in ***. Stat § 25.15(2), which imposes a prudent investor standard of care. *** also has authority to create title holding entities as investment vehicles by virtue of *** the Administrative Rules it promulgated. Specifically, Administrative Rule IB 2.04 provides:

> The investment board may create and own limited liability companies through which it holds title to investments made with funds under its control as investments made in the name of the board. Primary operational responsibilities at such companies shall be vested in one or more independent managers, though investment board employees, members, agents or other representatives may serve as officers or directors upon advance approval by the investment board.

Pursuant to this broad authority, *** formed *** I, LLC, a Delaware limited liability company ("***"), on November 21, 2014. *** is the sole member of ***. ***'s purpose, is to acquire, hold, and sell investments, and to engage in any lawful activity.[3] *** intends for *** to serve as an acquisition vehicle for its real estate investments.[4] *** formed *** on October 16, 2015. *** is the sole member of ***.[5] ***'s purpose is to acquire, own, lease and eventually sell the ***.

*** and *** are special-purpose entities owned directly or indirectly by ***. The officers of *** and *** are also ***'s investment staff. For example, the individual holding the position of managing director – private markets at *** is the President of both *** and ***; the individual holding the position of portfolio manager – real estate at *** is the vice President of both *** and *** and the individual holding the position of managing analyst – real estate at *** is the assistant vice president of both *** and ***.[6] *** may direct these officers to undertake such additional duties and responsibilities as *** determines. *** and *** were

[3] See the *** operating Agreement.
[4] As ***'s sole member, *** is allocated all of ***'s profits and losses and receives all distributions from ***. Upon ***'s dissolution, and after satisfaction of its legal obligations, all of ***'s remaining assets will be distributed to ***. *** bears all risk of loss from ***, limited to the amount of its capital contributions.
[5] As the sole member of ***, *** will be allocated all profits and losses generated by ***, and will receive all distributions from ***. Upon dissolution of ***, and after the satisfaction of its legal obligations, all of ***'s remaining assets will be distributed to ***.
[6] See exhibit A of the operating agreements of both *** and ***.

formed for administrative ease in managing ***'s investment portfolio and to limit its liability with respect to the various investments.

The management of both *** and *** is vested in a Manager. The same manager, *** Manager, LLC a Delaware limited liability company ("*** Manager"), is the manager of both. *** Manager is solely owned by *** Street Partners, LP, a Delaware limited partnership ("***"). As provided in *** Manager's operating agreement,[7] its primary purpose and business is to act as the manager for *** and *** (and any other entities owned directly or indirectly by ***). *** and *** Manager are third parties.

Pursuant to the operating agreements of both ***[8] and ***[9] the specific duties and responsibilities of the manager are set forth in an advisory agreement ("Advisory Agreement").

The Advisory Agreement was entered into between *** and *** in 2014. *** is a third party investment manager that specializes in real estate. *** allocated a certain amount of money to *** for *** to manage pursuant to the terms of the Advisory Agreement. *** organized *** to manage the first tranche.[10] ***'s responsibilities are to invest the money allocated to it by *** in a manner that is consistent with ***'s investment plan, acquisition procedures and investment guidelines. *** originates, underwrites and ultimately acquires investments for *** and its wholly owned entities, including ***. *** is ultimately responsible for services delineated in the Advisory Agreement. *** Manager is also bound by the Advisory Agreement.[11]

DISCUSSION & LEGAL ANALYSIS:

General

The League of Arizona Cities and Towns created the MCTC in order to impose and administer city privilege taxes. City privilege taxes are imposed "upon persons on account of their business activities". See MCTC § 400(a)(1). All Arizona cities generally follow the MCTC in their imposition of their privilege taxes based upon their local ordinances. However, certain options exist, allowing each city to alter or qualify the imposition of its privilege taxes.[12]

[7] Section 2.3 of the *** Operating Agreement.
[8] Section 5.1 of the *** Operating Agreement.
[9] Section 5.1 of the *** Operating Agreement.
[10] By way of background, the first tranche flows through *** I, LLC; if there is a second tranche, it flows through *** II, LLC etc.)
[11] See Section 2.3 of the *** Manager Operating Agreement.
[12] As earlier indicated, this ruling only addresses applicable city privilege taxes.

MCTC § 445 imposes a tax on the gross income upon every *person* engaging or continuing in the business of leasing or renting real property located within the City for consideration to the tenant in actual possession.

MCTC § 100 defines a business as follows:

> Business: All activities or acts, personal or corporate, engaged in and caused to be engaged in with the object of gain, benefit, or advantage, either direct or indirect, but not casual activities or sales.

The tax base for the real property leasing classification is the gross proceeds of sales or gross income derived from the business, subject only to certain expressly allowed deductions.

***'s purpose is to acquire, own, lease and eventually sell the ***. ***'s real estate investment generates gross income from the leasing or renting of real property for a consideration and may potentially subject it to the city privilege tax.

Whether *** is a Governmental Entity

As a general proposition, governmental activities are exempt from taxation. *Flowing Wells Irr. Dist. v. City of Tucson*, 863 P.2d 915, 916, 176 Ariz. 623, 624 (Ariz.Tax,1993);*City of Phoenix v. City of Goodyear,* 174 Ariz. 529, 851 P.2d 154 (Tax 1993); *Salt River Project Agricultural Improvement and Power Dist. v. City of Phoenix,* 129 Ariz. 398, 631 P.2d 553 (App.1981). In addition, a state is not subject to the general police power of local governments when it performs governmental functions. *Bd. of Regents v. City of Tempe*, 88 Ariz. 299, 309, 356 P.2d 399, 406 (1960). Proprietary activities of a government, however are taxable. *Flowing Wells Irr. Dist. v. City of Tucson*, 863 P.2d 915, 916, 176 Ariz. 623, 624 (Ariz.Tax,1993).

In addition to the general prohibition from taxing governmental entities performing governmental functions, MCTC § 270 provides an exclusion for gross income earned by certain *persons* deemed not to be engaged in business. One such 'person' is a governmental entity described in MCTC § 270(a)(2) as "the federal government, the State of Arizona, any other state or any political subdivision,[13] department, or agency of any of

[13] "Political subdivisions" of Arizona include not only counties, cities, towns, and school districts, but under the constitution include irrigation, power, electrical, agricultural improvement, drainage, and flood control districts. Const. art. 13, § 7 (A.R.S.). See *Hernandez v. Frohmiller*, 68 Ariz. 242 (Ariz. 1949).

the foregoing..." Additionally, MCTC § 270(b) provides that "transactions which, if conducted by any other person, would produce gross income subject to the tax under this chapter shall not be subject to the imposition of such tax if *conducted entirely* by a governmental entity …" (emphasis added). Thus, any 'person' seeking to benefit from this exemption must be able to show that not only are they a governmental entity but that they also *entirely conduct* the potentially taxable activity.

The first question that must be considered is whether ***, as an entity authorized and created by ***, is itself a governmental agency or entity. If it is a governmental entity, then the second question is whether *** is performing a governmental or proprietary function. If it is performing a governmental function, the inquiry ends there since governmental entities performing governmental functions are not taxable. If it is performing a proprietary function, then MCTC § 270 must be further examined.

A state agency is created only after the legislature delegates "the responsibility of performing a governmental function" to a particular entity. *Board of Regents of Universities and State College v. City of Tempe*, 88 Ariz. 299 at 309, 356 P.2d 399 at 406. In addition, governmental entities have no inherent power and possess only those powers and duties delegated to them by their enabling statutes. *Schwartz v. Superior Court*, 186 Ariz. 617, 619, 925 P.2d 1068, 1070 (App.1996).

*** itself is a governmental entity or agency. It was created by the *** Legislature by ***. Stat. § 15.76. ***'s powers and duties are set out in ***. Stat. Ch. 25, Trust Funds and Their Management. Its purpose is "to provide professional investment management of [the state's] trusts, operating funds and capital funds established by law" as identified in ***. Stat. § 25.14. In addition to the general investment power granted to ***, the *** Legislature established more specific powers and duties regarding the investment and management of each separate fund under ***'s control. See ***. Stat. § 25.14. For example, *** is expressly authorized to make equity investments with certain funds and to invest in real estate with certain other funds[14] etc. In relation to permitted real estate investments ***. Stat. § 620.22(5) provides that "permitted investments include real property together with the fixtures, furniture…pertaining to the real property …located in the United States… and that produces, or after suitable improvement can reasonably be expected to produce substantial income."

As a state agency, *** has the express authority to promulgate administrative rules that are deemed "necessary and appropriate to carry out its functions." ***. Stat. § 25.156. *** promulgated Administrative Rule IB 2.04 (see above) which permits it to create and own

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[14] See ***. Stat. §§ 25.17(3)(a) and 620.22.

LLCs through which it holds investments made with funds under its control. *** itself is expressly authorized to have its employees serve as members of LLCs. See ***. Stat. § 25.18(2)(c).

In an opinion issued by the Attorney General of *** on October 4, 2000, it was determined that *** was authorized to promulgate rule IB 2.04 and that "holding title through an LLC is "necessary and appropriate" to perform ***'s duty to invest the funds under its control prudently…" In addition, within the context of minimizing risk in a way that does not diminish return, it is "necessary and appropriate" for *** to have the ability to create such LLCs to hold title to investments that are otherwise authorized investments for ***."[15] The Attorney General also determined that ***'s promulgation of the rule did not contravene any statute and in fact an interpretation of ***'s governing statutes[16] that ***'s purchase of an equity investment through a wholly-owned LLC is an "investment purchase" in ***'s name actually advanced the purposes of the statutes.[17]

It is clear then that ***, as a state agency for the state of ***, is permitted to create LLCs, including *** and ***, through which it can hold investments and that those investments will be considered as investments in its ("***") name. The next logical question then is whether *** and, in particular, ***, are also considered agencies of the state of *** despite their separate existence from ***. To answer this question one must look at how ***'s entities are structured and how they may invest. This analysis is consistent with MCTC § 100 which suggests that a taxable 'person' must be considered separately from its affiliates, or parent.

MCTC § 100 defines a 'person' as follows:

> *Person:* An individual, firm, partnership, joint venture, association, corporation, estate, trust, receiver, syndicate, broker, the federal government, this State, or any political subdivision or agency of the State. *For purposes of this Chapter, a person shall be considered a distinct and separate person from any general or limited partnership or joint venture or other association with which such person is affiliated.* A subsidiary corporation shall be considered a separate person from its parent corporation for purposes of taxation of transactions with its parent corporation.

Thus essentially, the question is whether *** as a sub-unit or corporate instrumentality of a state agency is itself considered an agency of the state. A similar question was

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[15] *** Attorney General's opinion letter dated October 4, 2000, Re: ***'s authority to promulgate administrative rule IB 2.04, pg. 5.
[16] With certain exceptions, ***. Stat. § 25.17(7) generally provides that *** shall make loans and investment purchases from any funds under its control in the name of the board.
[17] *** Attorney General's opinion letter, pg. 7.

considered in *Board of Regents of Universities and State College v. City of Tempe*, 356 P.2d 399, 403, 88 Ariz. 299, 305 (Ariz. 1960) where the Arizona Board of Regents ("Board") contended that it was an agency of the State and the City argued that the Board was a corporate instrumentality of the State, but was not itself the State, and so not exempted from operation of the broad police powers delegated by the State to the City. It is important to note that in that case, it was the activities supervised by the Building and Grounds Department of the Arizona State University that were under consideration, not the activities of the Board itself. In considering the issue the Arizona Supreme Court noted that the "resolution ...depends, in the main, on the legal status and powers of the *university* and of the city." *Board of Regents of Universities and State College v. City of Tempe*, 356 P.2d 399, 401, 88 Ariz. 299, 303 (Ariz. 1960). The Board generally had power to "purchase, receive, hold, make and take leases for the benefit of the state and for the institutions under its jurisdiction and to enact ordinances for the government of the institutions under its jurisdiction." Id.

In particular the Supreme Court noted:

> We think it perfectly clear, however, that the Board of Regents may, for all purposes, be classified as a public agency of the State rather than a private corporation. In *State of Arizona v. Miser*, supra, Chief Justice McAlister said: 'The fact that the university is incorporated does not make it any the less an arm, branch or agency of the state for educational purposes, and affects in no particular the power of the legislature over it.' Justice Lockwood, concurring, agreed that: 'the University of Arizona, whatever its legal form, is but an agency of the State of Arizona, created for the purpose of carrying out one of the most important governmental functions of the state, to wit: the education of its citizens ….' *Citations omitted*.

See Board of Regents of Universities and State College v. City of Tempe, 356 P.2d 399, 403, 88 Ariz. 299, 305-06 (Ariz. 1960). The Arizona Supreme Court ultimately held that the Board was a state agency and that the city could not apply its building codes to the university even though the university was located within the city. The Supreme Court did not make any distinction between the Board and the university being a subunit or instrumentality under the control of the Board, and the status of the Board as an agent of the state was ultimately applied to the university without question.

That analysis should also apply here and ***, whatever its legal form, should be considered as much an agency of the state of *** as ***.

First, *** was formed pursuant to *** Administrative rule IB 2.04 promulgated by ***. This

rule was determined by the *** Attorney General to be 'necessary and appropriate' to carry out ***'s functions of providing professional investment management of the state's trusts, operating funds and capital funds. *** invests monies allocated to it by *** which in turn is allocated to *** by the bundle of statutes governing its operation.

With certain exceptions, ***. Stat. § 25.17(7) generally provides that *** shall "make loans and investment purchases from any funds under its control in the name of the board." As noted earlier, the *** Attorney General authorized rule IB 2.04 as being necessary and appropriate to conduct ***'s activities and indicated that creating LLC's to hold investments would be considered investments in its name. Because ***'s investments are considered as being in the name of *** it is subject to the same standards of responsibility when dealing with investments and can only invest in those investments authorized by ***'s governing statutes.

Third, ***'s structure is governed by administrative rule IB 2.04. IB 2.04 specifically provides that the "primary operational responsibilities ... shall be vested in one or more independent managers, though investment board employees, members, agents or other representatives may serve as officers or directors upon advance approval by the investment board." Thus, both *** and *** engaged the same independent third party manager, *** Manager, controlled by ***, to manage their real estate investments. In addition, as noted earlier certain *** employees hold key officer positions in *** and ***.

And finally, *** is investing public money. Under A.R.S. § 35-302 the phrase "public money" … includes bonds and evidence of indebtedness, and money belonging to, received or held by, state, county, district, city or town officers in their official capacity. In addition, although it was decided on a prior definition of public money,[18] the case of *McClead v. Pima County*, 849 P.2d 1378, 1382-83, 174 Ariz. 348, 352-53 (Ariz. App. Div. 1,1992) held that the state pension fund manager is a state agency and the funds it controls constitute public money, and therefore gave private citizens standing to sue the fund manager for improper use of public monies. See also *Fund Manager v. Superior Ct.*, 152 Ariz. 255, 259–60, 731 P.2d 620, 624–25 (App.1986) (citing *Fund Manager v. Arizona Dep't of Admin*., 151 Ariz. 93, 725 P.2d 1127 (App.1986)). Because *** and in turn *** is investing for the most part pension funds, trust funds and certain operating funds of the State of ***, it is no doubt investing public monies and is not engaged in a business enterprise.

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[18] The prior definition of the term was contained in A.R.S. § 35–212.B which broadly defined "public monies" as "all monies coming into the lawful possession, custody or control of state agencies, boards, commissions or departments or a state officer, employee or agent in his official capacity, irrespective of the source from which, or the manner in which, the monies are received."

Thus *** is a governmental entity because its creation and structure were authorized under ***'s administrative rules which were considered "necessary and appropriate" by the *** Attorney General to carry out ***'s functions. Additionally, ***'s investments are considered as investments in ***'s name and as such, it is subject to the standards imposed on *** and may only conduct its investments in accordance with governing statutes. Finally, *** is investing public money; it is not engaged in a business enterprise.

Whether *** is performing a Governmental or Proprietary Function

As noted earlier, even if it is determined that *** is a governmental entity, it must be determined whether it is performing a proprietary or governmental function. Generally speaking, a governmental entity performing proprietary functions may be subject to tax on its activities unless a specific exemption exists, whereas a governmental entity performing governmental functions is not taxable. *Flowing Wells Irr. Dist. v. City of Tucson*, 863 P.2d 915, 916, 176 Ariz. 623, 624 (Ariz.Tax,1993);*City of Phoenix v. City of Goodyear,* 174 Ariz. 529, 851 P.2d 154 (Tax 1993); *Salt River Project Agricultural Improvement and Power Dist. v. City of Phoenix,* 129 Ariz. 398, 631 P.2d 553 (App.1981). A governmental function is generally recognized as one undertaken because of a duty imposed on the entity for the welfare or protection of its citizens or a function that is fundamentally inherent in or encompassed within the basic nature of government. *Copper Country Mobile Home v. City of Globe,* 131 Ariz. 329, 333, 641 P.2d 243, 247 (App.1982); *Book-Cellar, Inc. v. City of Phoenix,* 150 Ariz. 42, 44, 721 P.2d 1169, 1171 (App.1986).

In the case of *Salt River Project Agr. Imp. and Power Dist. v. City of Phoenix*, 631 P.2d 553, 556, 129 Ariz. 398, 401 (Ariz.App., 1981), the Arizona Court of Appeals held that the Salt River Project was engaged in a governmental function because it was engaged in the *primary* public purpose for which it was authorized and formed: the reclamation and irrigation of arid lands, the drainage of waterlogged lands, and the production of electricity for these purposes. Thus, a governmental function may exist where the function performed is inherently related to the basic nature of government or where a governmental entity is performing the governmental function for which it was established.

Thus, the question here is whether *** is performing a duty imposed on it for the welfare or protection of the citizens of ***, performing a function fundamental or inherent in the basic nature of government or performing the primary public purpose for which it was formed? As noted earlier, ***'s primary function and by extension, ***'s primary function, is to provide professional investment management of ***'s trusts, operating and capital funds established by law. More specifically, *** is charged with investing a portion of ***'s public monies in real estate. This is specifically authorized as a permitted investment by statute. This, in addition

to the fact that the investment will bring general benefit to the *** public makes the function *** performs a governmental function.

Because *** is a state governmental entity performing a governmental function it is exempt from city privilege taxes. That being the case the exemption under MCTC § 270 need not be considered.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. Therefore, the conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondence. 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.