THE CITY SPECULATIVE BUILDER TAX

ARIZONA'S HIDDEN LAND TRANSFER TAX

A Detailed Explanation of the Speculative Builder Tax, When it Applies, What it Applies to, Deductions and Exemptions, and the Recent 2019 Amendments to the Tax.

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Developers who are either new to the Arizona market or unaware of Arizona's local tax structure are often surprised by unexpected assessments under a complex city tax. Arizona cities impose what is called the "speculative builder tax," which taxes the sale of improved real property. For commercial property, the tax is triggered if improved real property is sold during construction or within 24 months after substantial completion. For residential property (single family homes or condos) and improved commercial or residential lots, the tax is triggered whenever the property is sold, without regard to the 24 month period. This tax is in essence a hidden land transfer tax.

Unlike a number of other states, Arizona does not impose a land transfer tax on the conveyance of an interest in land and/or improved real property. However, Arizona cities and towns levy a speculative builder tax on sales of improved real property, thus mimicking the effect of a land transfer tax. Coupled with the complexity of the State of Arizona's regime for taxing contracting activities, the city speculative builder tax often presents challenges for owners and developers that are new to Arizona and Arizona business owners that are unfamiliar with its operation. It can trap the unwary, resulting in higher tax, penalty, and interest liabilities. This article is intended to demystify the city speculative builder tax; it provides detailed explanations of the mechanics and structure of the tax, its exemptions and deductions, and its judicial interpretation as defined by case law.

Before discussing the city speculative builder tax in more detail, it is crucial to reiterate that the speculative builder tax applies only at the city level. No speculative builder tax is imposed by the State of Arizona. In 2007, the Arizona Legislature amended the Arizona Revised Statutes to specifically exclude sales of improved real property by owners that do not actually perform construction activities from taxation under the state regime.[2]

This amendment comports with a 1991 Arizona Court of Appeals decision that rejected the Arizona Department of Revenue's attempt to read a speculative builder tax into the state regime for taxing contractors.[3] Consequently, the State of Arizona does not impose a speculative builder tax on the sale of improved real property as the cities do.

SUMMARY OF THE 2019 SPECULATIVE BUILDER AMENDMENT TO THE MODEL CITY TAX CODE, EFFECTIVE APRIL 1, 2019

The following is a summary of the 2019 speculative builder changes.[4] All amendments are effective April 1, 2019. These changes are also covered in the body of these materials.

- Changed the definition of "Improved Real Property" to clarify that only the first sale after the Certificate of Occupancy or similar document is issued is subject to tax, and any subsequent improvements, remodeling or expansion of the original building is not considered taxable as reconstruction or the creation of a new structure.

- Changed the definition of "Partially Improved Residential Real Property" by removing the word "residential" in several places and making grammatical edits, opening up the exemption for sales between two developers for both residential and commercial builders, including those who only do non-structural improvements to vacant land or add water, power, and streets.

- Eliminated Local Option M which allowed a deduction from the selling price for the cost of land. Local Option N remains in place, allowing for a deduction based on the "fair market value" of land, with 20% of total selling price as the default safe harbor.

- Removed the requirement that developers attach a written statement to their tax return for any sale to another developer.

- Added an exemption for in-place leases allowing a reduction in total selling price for the present value of obligated future lease receipts. This recognizes the sale of a property with existing leases is really the sale of a building combined with the sale of the business or residential or commercial lease.

- Placed in code a deduction that has been applied for decades in accordance with a practice decision and written direction provided by the cities, allowing a seller to reduce the selling price by the amount of taxes paid by their contractor to the state and county.

- Added language clarifying that a tax credit is allowed for any Spec builder tax paid by a prior owner if a subsequent sale is subjected to the tax.

- Added "Qualified Trust" to the list of persons who can make a bona fide sale of a home and thus be exempt from the tax, provided at least one resident in the home is a beneficiary of the trust.

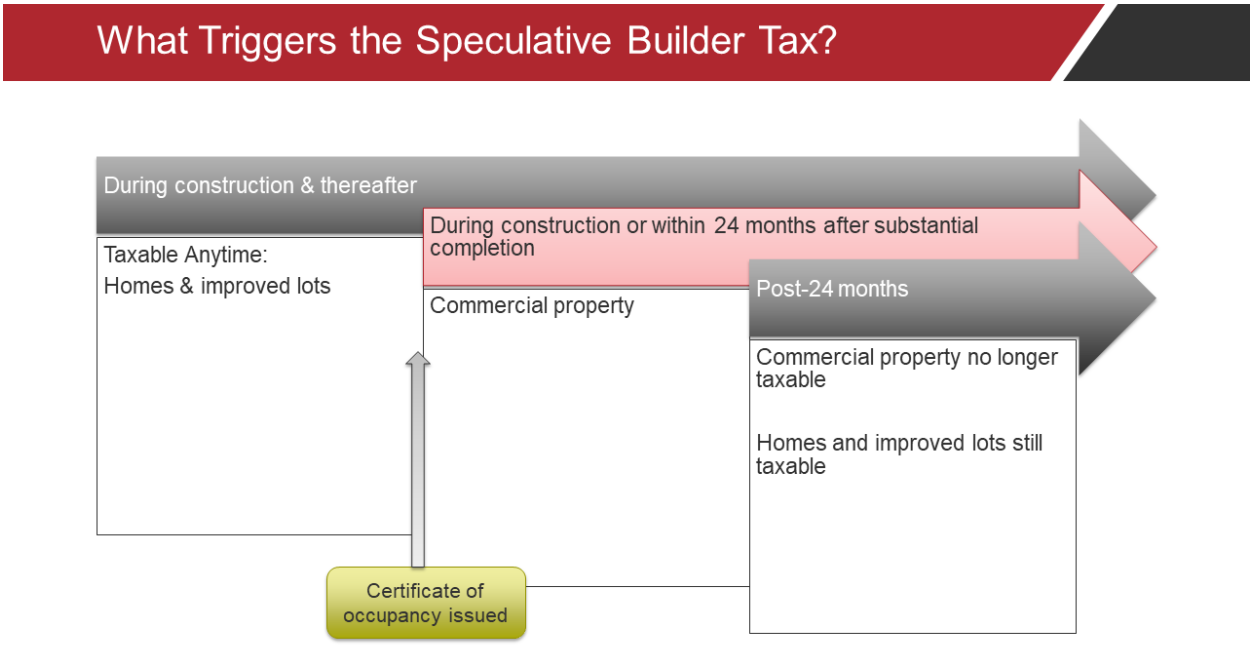
THE STRUCTURE AND MECHANICS OF THE CITY SPECULATIVE BUILDER TAX

In contrast to many states, whose city sales taxes simply piggy-back the state taxes, Arizona cities and towns have the authority to impose their own taxes. Due to the administrative

and compliance complications created by widely varying city tax regimes, however, the Arizona Legislature amended Arizona statutes in the 1980s to require Arizona cities and towns to adopt a uniform or model tax code as a precondition to imposing sales taxes. The resulting structure is the Model City Tax Code ("MCTC"),[5] which creates uniformity through the use of model tax statutes and regulations, but allows some flexibility through the use of standardized local and model options that cities may adopt when they want to deviate from the model provisions. The speculative builder tax is imposed under the Model City Tax Code.

The speculative builder tax generally applies to the sale of "improved real property" which is sold (1) prior to completion of the improvements or (2) before the expiration of 24 months after the improvements are substantially complete. However, if custom, model, or inventory homes or improved residential or commercial lots without a structure are involved, then the tax is imposed regardless of any time limitation.[6] Chart 1 depicts the basic application of the speculative builder tax.

Chart 1. Sales Subject to Speculative Builder Tax



1. The Object of Taxation and the Tax Base

Imposition of Tax

Section __-416(a) of the Model City Tax Code imposes a city privilege license tax on "speculative builders," as follows:

> The tax shall be equal to ____ percent (___%) of the gross income from the business activity upon every person engaging or continuing in business as a speculative builder within the City.[7]

Taxable Gross Income

"The gross income of a speculative builder" that is subject to tax "shall include the total selling price from the sale of improved real property at the time of closing of escrow or transfer of title."[8]

> ➢ **Comment: Factored Tax Deduction**.
>
> While "gross income" for speculative builder tax purposes is the total selling price, the Model City Tax Code excludes the amount of combined taxes associated with the sale from gross income. *See* MCTC § __-250. As a result, a speculative builder receives a factored tax deduction from the total selling price for the amount of its city tax liability that inheres(?) in the sale. It also receives a deduction for the amount of state and county transaction privilege taxes paid by its contractors. City taxes paid by the contractors are also credited against the speculative builder's liability. By allowing these deductions and credits, all sales taxes associated with the construction and sale of the improved real property are removed from the tax base.

Definition of Speculative Builder

"Speculative builder" is defined by the Model City Tax Code as follows:

> "Speculative Builder" means either:
>
> (1) An owner-builder who sells or contracts to sell at any time, improved real property (as provided in Section –416) 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) above:
>
> (a) Prior to completion; or
>
> (b) Before the expiration of twenty-four (24) months after the improvements of the real property sold are substantially complete.[9]

> ➢ **Comment: Timeshares.**
>
> Because timeshares do not satisfy the definition of "home," the speculative builder tax only applies to sales of timeshares that occur within 24 months of substantial completion. *See* MTHO #71, discussed below.

Definition of Owner-Builder

An "owner-builder" is defined to mean "an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs or has reconstructed any improvement to real property."[10]

When a Project is "Substantially Complete"

For speculative builders other than residential homebuilders, the 24 month period is measured from the date that the improvements were "substantially complete." That term is defined as follows:

> "Substantially Complete" means that the construction contracting or reconstruction contracting:
>
> (1) Has passed final inspection or its equivalent;
>
> (2) Certificate of occupancy or its equivalent has been issued; or
>
> (3) Is ready for immediate occupancy or use.[11]

Sales Trigger the Imposition of Tax

Speculative builder tax is triggered by the sale of the improved real property. The term "sale" has been broadly defined by the Model City Tax Code as follows:

> "Sale of Improved Real Property" 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 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). In the case of multiple unit projects, "sale" refers to the sale of the entire project or to the sale of any individual parcel or unit.[12]

Administrative decisions issued by the Municipal Tax Hearing Office[13] have come out differently on the question of whether the transfer of property to a legal entity such as an LLC or corporation constitutes a taxable "sale" for city speculative builder tax purposes when the ultimate ownership in the property remains the same. In 2012, the Municipal Tax Hearing Office issued its decision in MTHO # 636/638/639 (Mun. Tax. Hr. Office April 11, 2012), in which it concluded that the transfer of buildings and land from two LLCs to a new legal entity in exchange for an ownership interest in the new entity was a non-taxable contribution and not a sale for speculative builder tax purposes. In 2013, the Municipal Tax Hearing Office issued its decision in MTHO #729 (Mun. Tax. Hr. Office Feb. 6, 2013), and came to the opposite conclusion. In that case, individuals owned real property that they were developing into a condominium project. The owners transferred the real property into a corporation they wholly owned, and the Municipal Tax Hearing Office concluded that this transfer met the definition of a sale and was subject to speculative builder tax.

Definition of Improved Real Property

Sales subject to tax are limited to sales of "improved real property," which is defined by the Model City Tax Code as follows:

> "Improved Real Property" means any real property:
>
> (A) Upon which a new structure has been substantially completed;
>
> (B) Where improvements have been made to land containing no structure (such as paving or landscaping);
>
> (C) Which has been "reconstructed" as provided by Section – 416.2; or
>
> (D) Where water, power, and streets have been constructed to the property line.[14]

For the purposes of this definition, once a structure has been deemed substantially complete, subsequent improvements to the structure shall not be considered for the purposes of determining the date of a taxable sale transaction.[15]

> ➢ **Comment: Off-Sites.**
>
> All three of the above-mentioned off-site improvements (water, power, and streets) must be constructed to the property line in order for the speculative builder tax to apply to the sale. *See* MTHO #157, discussed below.

In an unpublished decisions, *City of Chandler v. Whitewing II, LLC*, 1 CA-TX 12-0008 (Ariz. Ct. App. Oct. 22, 2013), the Arizona Court of Appeals ruled that the sale of real property on which existing improvements were removed to make way for future residential development is subject to city speculative builder tax. The taxpayer acquired land that had previously been used as a hog farm for development into a residential subdivision. The taxpayer cleared and graded the land, removed tangible personal property, removed a septic tank, and removed a 4,800 square foot concrete slab with associated footings and stem wall from the property. The taxpayer then subdivided the land and sold the vacant lots. The issue in the case was whether the taxpayer had sold "improved real property" as defined in MCTC § __-416(a)(2). The taxpayer argued that by removing tangible personal property and other improvements it had not improved the real property, because unlike paving and landscaping (the examples contained in the statute) it had not done anything to add to the land; it had only removed existing improvements. The court rejected the taxpayer's argument and ruled that "the question is whether **substantial alterations have added value to the property** so as to constitute an 'improvement' for tax purposes." Under this standard, the court found that the taxpayer's efforts to get the property ready to subdivide by removing existing improvements were sufficient to render the real property improved and subject to the speculative builder tax.

2. Overview of Key Exclusions, Deductions and Exemptions from the Tax Base

The following exclusions and deductions from the tax base are allowed in computing the speculative builder tax.

Standard 35% Deduction

Taxpayers are entitled to a flat statutory deduction amount of 35% on "all amounts subject to the tax."[16] This deduction is calculated on the net selling price of the property after other applicable deductions.

Land Deduction

Most Arizona cities, including the major cities in the metropolitan Phoenix area, do not allow a deduction for either the cost or the fair market value of the underlying land. However, a good number of the smaller, outlying cities and towns allow a deduction for the *fair market value* of the land. The fair market value must be documented to the satisfaction of the city (e.g., an appraisal) but in lieu of such documentation, 20% of the total selling price may be used as the land deduction amount. These cities have effectuated this deduction by adopting Local Option N to the Model City Tax Code.[17] Prior to April 1, 2019, a limited number of cities allowed a deduction for the *actual cost* of the land, effectuated by adopting Local Option M.[18] Local Option M was eliminated effective April 1, 2019.

The Official Copy of the Model City Tax Code maintained by the Arizona Department of Revenue or the tax code of the city in question should always be consulted as to which cities currently offer a land deduction. Chart 2 outlines the Arizona cities that allow a land deduction as of the date of this publication.

Chart 2. Cities and Towns Which Allow a Deduction for Land

Deduction for Fair Market Value of Land (Local Option N)

Bullhead City	Pinetop-Lakeside
Camp Verde	Prescott
Douglas	Prescott Valley
Kingman	Quartzsite
Lake Havasu City	Safford
Mammoth	Sedona
Parker	Show Low
Pima	Taylor
	Wilcox

Deduction for Cost of Land (Local Option M) (Eliminated effective April 1, 2019)

Duncan	Tucson
Nogales	Winslow
Patagonia	

- **Comment: No Land Deduction.**

Cities in the Phoenix metropolitan area do not have a land deduction.

Exclusion for Partially Improved Real Property Sold to Another Speculative Builder

A speculative builder is not taxed when it sells "partially improved real property" to another speculative builder if, *and only if*, the following conditions are met:

1. The speculative builder which purchases the real property must hold a valid speculative builder privilege license for the city in which the real property is located;
2. At the time of the transaction, the purchaser must furnish "a properly completed written declaration" to the seller which states "that the purchaser assumes liability for and will pay all privilege taxes which would otherwise be owed to the City at the time of the sale;" and
3. The seller must also: (i) maintain proper records of such sales in the same manner required for sales for resale; (ii) retain a copy of the purchaser's written declaration; and (iii) hold a valid speculative builder license from the city. [19]

"Partially improved real property" is defined as "any improved real property" which is "being developed for sale where the improvement to such property is not substantially complete at the time of the sale."[20]

Prior to April 1, 2019, MCTC § __-416(b)(4) applied only to sales of partially improved residential real property. Under the 2019 amendments, it now applies to sales of all partially improved real property, whether commercial or residential. Additionally, sellers were formerly required to provide a copy of the purchaser's written declaration to the city when the seller filed its transaction privilege tax return; under the 2019 amendments, the seller is required to only retain a copy.

> ➢ **Comment: Developers Selling Partially-Improved Lots to Builders.**
>
> If the builder provides all necessary certificates, this exemption would apply to a developer that subdivides land, installs the main water, sewer, drainage and utilities systems and streets and then sells ready-to-build lots to a builder. Under the 2019 amendment, it would also apply, as an example, to a partially completed garden office condo project the buyer intended to complete and sell.

Exemption for Homeowner's Bona Fide Non-Business Sale of a Family Residence

An individual or qualified trust is not liable for the speculative builder tax on the sale of a family residence provided each of the following requirements is satisfied:

1. The "immediate family of the seller" has actually used the home as its principal residence or as a vacation home for the 6 months immediately preceding the offer to sell the property;
2. The seller has sold no more than two such vacation or family residences within the 36 months immediately preceding the offer to sell the property; and
3. The property has not been rented, leased, or licensed by the seller for any part of the 24 months immediately preceding the offer to sell the property.[21]

When a homeowner contracts for improvements to a family residence, the construction is presumed to be performed for the "owner's bona fide non-business purpose."[22] The contractor is thus liable for city privilege tax on construction contracting "on all such improvements."[23] Along the same lines, the purchase of tangible personal property by homeowners for inclusion in

the alteration, construction, or repair of the homeowner's residence is subject to city retail sales tax as a sale to the ultimate consumer.[24]

Prior to April 1, 2019, the exclusion for a homeowner's bona fide non-business sale was limited to sales by an individual, and no other representative of the owner, association, or entity qualified for exclusion. However, an administrator, personal representative or executor of an estate, or the guardian of a minor or incompetent person qualifies as a homeowner if the decedent, minor, or incompetent person would otherwise have qualified as a homeowner with respect to the property that has been sold.[25] However, effective April 1, 2019, the exemption also applies to sales by a qualified trust, which is defined as "any legal trust where a beneficiary of the trust is an individual that has been the resident of the property and that individual meets the criteria listed in" MCTC § __-416.1(a).[26]

Exemption for Income-Producing Capital Equipment

An exemption applies to that portion of the selling price which is attributable to the purchase of machinery and equipment which qualifies for the exemption from city retail sales or use tax for "income-producing capital equipment," pursuant to MCTC § __-465(g) (retail sales tax) and § __-660(g) (use tax).[27]

"Income-producing capital equipment" includes the following items:

1. Machinery or equipment used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations.
2. Mining machinery, or equipment, used directly in the process of extracting ore or minerals from the earth for commercial purposes.
3. Tangible personal property, sold to persons engaged in business classified under the telecommunications classification, including a person representing or working on behalf of such a person in a manner described in MCTC § __-415(b)(12) and A.R.S. § 42-5075(O), consisting of central office switching equipment; switchboards; private branch exchange equipment; microwave radio equipment, and carrier equipment.
4. Machinery, equipment, or transmission lines used directly in producing or transmitting electrical power, but not including distribution thereof.
5. Pipes or valves four inches (4") in diameter or larger and related equipment, used to transport oil, natural gas, artificial gas, water, or coal slurry.
6. Aircraft, navigational and communication instruments, and other accessories and related equipment sold to:
    A. A person holding (or exempted by federal law from obtaining) certain air carrier permits and licenses.
    B. Any foreign government.
    C. Persons who are not residents of Arizona and who will not use such property in Arizona other than in removing such property from Arizona, including corporations incorporated outside of Arizona and where the principal corporate office is located outside Arizona.
7. Machinery, tools, equipment and related supplies used or consumed directly in repairing, remodeling or maintaining aircraft, aircraft engines or aircraft component parts by or on behalf of a certificated or licensed carrier of persons or property.

8. Railroad rolling stock, rails, ties and signal control equipment used directly to transport persons or property.
9. Machinery or equipment used directly to drill for oil or gas or used directly in the process of extracting oil or gas for commercial purposes.
10. Certain buses or other urban mass transit vehicles.
11. Metering, monitoring, receiving, and transmitting equipment acquired by persons engaged in the business of providing utility services or telecommunications services.
12. Groundwater measuring devices required under A.R.S. § 45-604.
13. Machinery or equipment used in research and development (as defined in the MCTC).
14. New machinery and equipment consisting of agricultural aircraft, tractors, tractor-drawn implements, self-powered implements, and drip irrigation lines for use in commercial agriculture, horticulture, viticulture, or floriculture, if the municipality has adopted Local Option A.
15. Certain liquid, solid or gaseous chemicals used in manufacturing, processing, fabricating, mining, refining, metallurgical operations, research and development or job printing.
16. Clean rooms that are used for manufacturing, processing, fabrication or research and development of semiconductor products.
17. Machinery and equipment that are purchased by or on behalf of the owners of a soundstage complex and primarily used for motion picture, multimedia or interactive video production in the complex, if initial construction began between June 30, 1996 and January 1, 2002.
18. Tangible personal property that is used to receive, store, convert, produce, generate, decode, encode, control or transmit telecommunications information used by certain federally regulated operators.
19. Machinery and equipment that is used directly in the feeding of poultry, the environmental control of housing for poultry, the movement of eggs within a production and packaging facility or the sorting or cooling of eggs.
20. Pollution control machinery or equipment, including related structural components.
21. Certain machinery or equipment that enables a television station to originate and broadcast or to receive and broadcast digital television signals purchased to facilitate compliance with the Telecommunications Act of 1996.
22. Ancillary machinery and equipment used for the treatment of waste products created by the business activities which are allowed to purchase "income-producing capital equipment."
23. Repair and replacement parts, other than expendable items (see below), where the property is acquired to become an integral part of another item. [28]

Income-producing capital equipment does <u>not</u> include:

1. Expendable materials.
2. Janitorial equipment and hand tools.
3. Office equipment, furniture and supplies.
4. Tangible personal property used in selling or distributing activities.

5. Motor vehicles required to be licensed by the State of Arizona, except buses or other urban mass transit vehicles (specifically exempted above), without regard to the use of such motor vehicles.
6. Shops, buildings, docks, depots, and all other materials of whatever kind or character not specifically exempt.
7. Motors and pumps used in drip irrigation systems. [29]

Deduction for Labor to Installation of Income–Producing Capital Equipment

In addition to an exemption for the income-producing capital equipment, there is a deduction for the gross proceeds of sales or gross income derived from the installation, assembly, repair or maintenance of income-producing capital equipment as defined in § __-110 of the Model City Tax Code (see above), as long as that equipment does not become permanently attached to a building or other structure. The installation labor deduction excludes "gross income from that portion of contracting activity" consisting of "the development of or modification to real property in order to facilitate the installation, assembly, repair, maintenance or removal of the income-producing capital equipment." Additionally, "permanent attachment" is defined by the Model City Tax Code to mean at least one of the following:

1. To be incorporated into real property.
2. To become so affixed to real property that it becomes a part of the real property.
3. To be so attached to real property that removal would cause substantial damage to the real property from which it is removed.[30]

In 2013, the Arizona Legislature passed H.B. 2535, which eliminated the "permanent attachment" test and prohibited cities from imposing a sales tax on the "gross proceeds of sales or gross income derived from a contract for the installation, assembly, repair or maintenance of machinery, equipment or other tangible personal property described in A.R.S. § 42-5061, subsection B [the machinery and equipment deduction] and that has independent functional utility." The term "independent functional utility" is defined to mean that "the machinery, equipment or other tangible personal property can independently perform its function without attachment to real property, other than attachment for any of the following purposes:

1. Assembling the machinery, equipment or other tangible personal property;
2. Connecting items of machinery, equipment or other tangible personal property to each other.
3. Connecting the machinery, equipment or other tangible personal property, whether as an individual item or as a system of items, to water, power, gas, communication or other services;
4. Stabilizing or protecting the machinery, equipment or other tangible personal property during operation by bolting, burying or performing other similar non-permanent connections to either real property or real property improvements.

H.B. 2535 applies retroactively to June 30, 1997 (but cumulative refund claims based on the retroactive application of the new law are capped a $10,000).

Exemption for Tangible Personal Property Sold to Qualifying Hospitals, Qualifying Community Health Centers or Qualifying Health Care Organizations

There is an exemption for tangible personal property sold to a qualifying hospital, qualifying community health center or qualifying health care organization, pursuant to MCTC § __-465(p) (retail sales tax) and § __-660(p) (use tax).[31] This exemption is incorporated into the prime contracting and speculative builder classifications. Under the prime contracting classification, a contractor is able to take a deduction for the cost of the building materials incorporated into a project for one of these qualifying entities. Under the speculative builder tax, the portion of the selling price which is attributable to the purchase of machinery and equipment that is exempt from retail sales or use tax pursuant to MCTC § __-465(p) or § __-660(p) is exempt.[32]

A "qualifying hospital" is defined as:

1. A licensed hospital which is organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.
2. A licensed nursing care institution or a licensed residential care institution or a residential care facility operated in conjunction with a licensed nursing care institution or a licensed kidney dialysis center, which provides medical services, nursing services or health related services and is not used or held for profit.
3. A hospital, nursing care institution or residential care institution which is operated by the federal government, the State of Arizona or a political subdivision of Arizona.
4. A facility that is under construction and that on completion will be a facility under subdivision (1), (2) or (3) of this paragraph.[33]

A "qualifying community health center" is defined as: "an entity that is recognized as nonprofit under 501(c)(3) of the United States Internal Revenue Code, that is a community-based, primary care clinic that has a community-based board of directors and that is either (a) the sole provider of primary care in the community; [or] (b) a nonhospital affiliated clinic that is located in a federally designated medically underserved area in this state."[34]

A "qualifying health care organization" is defined as: "an entity that is recognized as nonprofit under § 501(c)(3) of the United States Internal Revenue Code and that uses, saves or invests at least eighty percent (80%) of all monies that it receives from all sources each year only for health and medical related educational and charitable services, as documented by annual financial audits prepared by an independent certified public accountant, performed according to generally accepted accounting standards and filed annually with the Arizona Department of Revenue. Monies that are used, saved or invested to lease, purchase or construct a facility for health and medical related education and charitable services are included in the eighty percent (80%) requirement."[35]

Thus, if a "qualifying hospital," "qualifying community health center," or "qualifying health care organization" building were sold within 24 months of substantial completion, there would be an exemption for the cost of the building materials and other tangible personal property included in the sale.

Exemption for Construction of Egg Production Facility

Gross income from a contract to build "an environmentally controlled facility for the raising of poultry for the production of eggs and the sorting or cooling and packaging of eggs" is exempt from tax.[36]

Exemption for Labor to Install Clean Rooms

Revenue derived from the installation, assembly, repair, or maintenance of semiconductor products clean rooms is exempt where the clean room equipment qualifies for exemption from retail sales tax under MCTC § __-465(g), relating to income producing capital equipment. This exemption or "installation labor" is not subject to a permanent attachment exclusion.[37] Additionally, the sales price of the clean room machinery and equipment is exempt.[38] Thus, the furnishing and installation of semiconductor clean room equipment is not taxable and the subsequent sale of a clean room would not be taxable under the speculative builder classification.

Exemption for Agricultural Pollution Control Equipment

An exemption applies to revenue derived from a contract entered into "with a person who is engaged in the commercial production of livestock, livestock products or agricultural, horticultural, viticultural or floricultural crops or products" in Arizona for the construction, alteration, repair, improvement, movement, wrecking or demolition, or addition to or subtraction from any building highway, road, excavation, manufactured building, or other structure, project, development, or improvement "used directly and primarily to prevent, monitor, control or reduce air, water or land pollution."[39]

Exemption for Development and Impact Fees

Development or impact fees included in a construction or development contract to offset governmental costs of providing public infrastructure, public safety, and other public services to a development are exempt.[40] The development fees must be authorized by A.R.S. §§ 9-463.05, 11-1102, or A.R.S. Title 48, regardless of the jurisdiction to which the fees are paid.[41]

Solar Energy Device Deduction

For taxable periods beginning from and after July 1, 2008 and ending before January 1, 2017, the gross proceeds of sales of gross income derived from a contract to provide and install a solar energy device were deductible. Contractors were required to register with the Department of Revenue as solar energy contractors and to make their books and records relating to sales of solar energy devices available to the Department of Revenue and the cities for examination.[42]

Architectural and Engineering Services Exclusion

For taxable periods beginning July 1, 2008, the portion of gross proceeds of sales or gross income attributable to the actual direct costs of providing architectural or engineering services that are incorporated into a contract are not subject to the speculative builder tax. "Direct costs" means the portion of the actual costs that are directly expended in providing architectural or engineering services.[43]

In-Place Lease Exemption

Effective April 1, 2019, the in-place lease deduction was codified.[44] Prior to this date, the value of such leases was deductible because it was considered an intangible asset rather than improved real property.

In-Place Lease Deduction as of April 1, 2019

The in-place lease deduction is now codified in the Model City Tax Code. The value of the deduction depends on whether the leases are residential or commercial. For residential leases, the deduction is equal to the total value of all expected lease receipts through the end of the current lease term multiplied by 1.5. Expected lease receipts includes non-refundable deposits but not refundable deposits, even if the refundable deposit may be forfeited. For commercial leases, the value of the deduction is equal to the present value of the expected lease receipts through the end of the current lease period or first option of either party to terminate the lease, whichever is less. The discount rate used to calculate the present value shall be the 100% mid-term applicable federal rated published by the IRS for the month preceding the close of escrow plus three percentage points.

Historical Comments on the In-Place Lease Deduction

Prior to April 1, 2019, the in-place lease exclusion was not codified in the MCTC and cities sometimes argued that it did not apply or disputes the value as proposed by the taxpayer.

Taxpayers also had some flexibility in establishing the value of the in-place lease. For multi-year commercial leases, on audit, taxpayers have successfully established the value of in-place leases by: (1) discounting the rent payable over the term of the lease to present value and (2) providing data on comparable sales without the in-place leases. *See* MTHO #176, discussed below. For apartment complexes, taxpayers have successfully established value by determining the rent payable over a twelve-month period on those in-place leases. *See* City of Phoenix CAP No. 1394 (March 2, 1999) (value of assigned leases not subject to speculative builder tax and determining that a twelve-month rent payable was reasonable based on the average lease term).

MTHO Decisions on In-Place Leases

The following MTHO decisions apply the historical in-place lease deduction, as developed through case law.

In MTHO #1,[45] the Municipal Tax Hearing Office held that § 400 of the MCTC sets forth the presumption that the entire amount of gross income from the sale of improved real property is subject to the speculative builder tax until the contrary is established by the taxpayer.

In this case, the taxpayer constructed an apartment complex and sold the complex substantially leased-up. The taxpayer argued that the entire amount of gross income from the sale should not be subject to the speculative builder tax because the taxpayer sold an ongoing business, instead of merely a building and land. The taxpayer argued that part of the gross income from the sale price included the value of the in-place leases, which are intangibles not subject to the speculative builder tax. Nevertheless, the Hearing Office held that the tax applied to the entire amount of the gross income from the sale, including the sale of the leases. However, it did so because the taxpayer failed to rebut the above-stated presumption by providing any evidence that the leases had any value. Note that in a later decision, MTHO #176,

the taxpayer was able to successfully establish the value of the in-place leases and the value was excluded from the tax base. Additionally, effective April 1, 2019, the value of in-place leases is now expressly excluded from the gross receipts subject to tax.[46]

In MTHO #176,[47] the Municipal Tax Hearing Office held that the value of a long term lease should not be included in the total selling price of improved real property, i.e. the tax base, because long term leases constitute intangible property.

The taxpayer secured a long term lease on the improved real property before it sold the same property to a third-party purchaser. The taxpayer established that as a result of securing the long term lease, the purchaser paid a premium to the taxpayer. Consequently, the Hearing Office held that the intangible value of the rental stream from a lease is not includable in the sales price of improved real property.

Deduction for State and County Prime Contracting Tax

Prior to April 1, 2019, the deduction for state and county prime contracting tax paid by the prime contractor was not in the MCTC, but it was allowed by cities. However, after April 1, 2019, it is codified at MCTC § __-416(c)(2). There is also a factored tax deduction for the speculative builder tax owed on sale. Finally, no deduction for city contracting taxes, but there is a tax credit instead.

3. Tax Credits

After the speculative builder tax liability has been determined, a speculative builder is allowed the following tax credits against its tax liability for certain taxes paid to the city during other phases of the project.[48] These credits cannot be claimed by the speculative builder unless and until the vendor or contractor has reported to the city the gross income related to the improved real property.[49] The credits function to effectively limit the imposition of speculative builder tax to the overhead and profit of the developer and the value of the land (unless the city has adopted one of the land deductions discussed above). The total amount of the credits cannot exceed the speculative builder tax liability.[50]

Tax Credit for Purchase of Building Materials

A tax credit is allowed for the "amount of city privilege or use tax, or the equivalent excise tax," which is paid directly to a taxing jurisdiction or as a separately itemized charge paid directly to the vendor with respect to building materials which have been incorporated into the project which is the subject of the speculative builder tax.[51]

Tax Credit for Taxes Paid by Prime Contractor

A tax credit is allowed in an amount equal to the privilege taxes which a construction contractor has paid to the city or separately charged to the speculative builder with respect to the gross income which the contractor has derived from the construction of any improvements to the real property which is the subject of the speculative builder tax – in other words, the speculative builder can claim a credit for the city taxes paid or invoiced by the prime contractor on the project.[52] This prevents a double taxing of the actual cost of the construction, as construction contractors are liable for city privilege tax on their gross income.[53] The credit applies to any contracting upon the land or improvements, without regard to whether the contracting is performed for the speculative builder or a prior owner of the property.

Tax Credit for Speculative Builder Tax on Certain Prior Sales

Effective April 1, 2019, a tax credit is allowed in the amount of the taxes paid to the city by any speculative builder on the gross income derived from the sale of improved real property pursuant to MCTC §§ __-416(a)(2)(B) [reconstruction contracting] or __-416(a)(2)(D) [sale where water, power, and streets have been constructed to the property line] against the gross income of a speculative builder from the sale of improved real property pursuant to MCTC § __-416(a)(2)(A) [sale after substantial completion].[54] In other words, this provision allows a speculative builder who purchases improved real property from another speculative builder to claim a tax credit for the speculative builder tax paid by the previous builder.

4. Reconstruction Contracting: Converting Apartments to Condos

The speculative builder tax also applies to "reconstruction contracting" – essentially, the conversion of apartments into condos – under the following provisions.

Definition of "Reconstruction"

The Model City Tax Code defines "reconstruction" as "the subdividing of real property and, in addition, all construction contracting activities performed upon said real property" so long as each of the following conditions are satisfied:

1. A structure existed on said real property prior to the reconstruction activities;
2. The prior value (as defined by the Model City Tax Code) of said structure exceeds 15% of the prior value of the integrated property (land, improvement and structure);
3. The total cost of all construction contracting activities performed on said real property and the 24 month period prior to the sale of any part of the real property exceeds 15% of the prior value of the real property; and
4. The structure which existed on the real property prior to the reconstruction activity still exists in some form upon the property, and is included, in whole or in part, in the property sold.[55]

> ➢ **Comment: Apartment Conversions.**
>
> An example of reconstruction contracting would be the conversion of apartments into condominiums, with the sale of the individual condominium units. It should be noted, however, that in order to meet the definition of reconstruction contracting (and thus to be subject to the speculative builder tax), the costs of construction and renovation must exceed 15% of the prior value of the complex. If those costs do not exceed the 15% threshold, the speculative builder tax does not apply to the sale of the condo units.

> ➢ **Comment: Fix & Flippers.**
>
> An owner-builder who fixes and flips single family homes is not a reconstruction contractor because it does not subdivide land. Furthermore, though not clearly established through case law, fix and flippers do not likely meet the definition of speculative builder because the fix & flipper did not build the original house.

Reconstruction Contracting "Prior Value" Deduction

In cases involving "reconstruction contracting," the speculative builder may exclude from its gross income the allowable "prior value" in determining the speculative builder's gross income in addition to other applicable exclusions, deductions and exemptions.[56] "Prior value" is defined to mean "the value of the total integrated property, with improvements, as existing immediately prior to any reconstruction activity." A property's full cash value for secondary tax purposes in the year immediately preceding the reconstruction activities is the property's "prior value" provided the full cash value "is intended to represent the property's full cash value."[57]

Additionally, a taxpayer may use the "alternative prior value" in lieu of the full cash value of the property for secondary property tax purposes. The "alternative prior value" is the "actual cost of the reconstructed property prior to reconstruction," but taxpayers electing alternative prior value must present "evidence of such cost" to the city's tax collector.[58] Whether the evidence of actual cost is satisfactory "is determined by the tax collector, in his sole discretion."[59] Evidence of the actual cost "shall consist, at a minimum, of proof of the actual, arms-length acquisition price, accompanied by a full appraisal of all property involved." The appraisal "shall have been performed by a real estate broker or MAI appraiser specifically for the purpose of assisting in the acquisition." The appraisal must also "have been performed on behalf of the seller or a lending institution which has lent at least sixty-five percent (65%) of the acquisition price." The alternative value may only be used if the property was acquired by the reconstruction taxpayer not more than 36 months prior to the sale of the first condo unit.[60]

5. The "Owner-Builder" Classification: Taxation of Commercial Speculative Builders that "Time-Out" of the 24-Month Trigger Period

In addition to the speculative builder provisions, the Model City Tax Code contains an additional provision that taxes "owner-builders that are not speculative builders" under certain circumstances. This provision applies to a developer that intended but failed to sell improved real property as a speculative builder during the 24-month trigger period and, as such, treated its subcontractors as exempt under MCTC § __-415(c) and provided exemption certificates to those contractors.

MCTC § __-417 addresses this situation by requiring the would-be speculative builder to pay tax at the expiration of the 24-month period on (1) the value of all work of the trade contractors for which exemption certificates were provided, and (2) the sales price of all tangible personal property purchased by the owner-builder and incorporated into the improved real property.

An owner-builder in this situation, however, is generally provided with the same exemptions, deductions, and tax credits as a speculative builder.[61]

> ➢ **Comment: Owner-Builder Classification Is Generally Inapplicable to Residential Builders.**
>
> The Model City Tax Code contains § __-417, so that would-be speculative builders and the subcontractors that work for them will not "time-out" of the tax liability by selling the improved real property after 24-months from substantial completion. Because the speculative builder tax applies to the sale of most residential property regardless of when that property is sold, § __-417 generally does not apply to residential property, such as custom, inventory or model homes.

SUCCESSOR LIABILITY: BUYERS AND LENDERS LIABLE FOR TAX

Unlike many other privilege license taxes imposed under the Model City Tax Code, the speculative builder tax includes a provision for successor liability. If a seller does not pay the speculative builder tax, then the buyer of the improved real property is responsible for paying the tax.[62] Section -595(c) of the Model City Tax Code provides that:

> Any person who purchases, or who acquires by foreclosure, by sale under trust deed or warranty deed in lieu of foreclosure, or by any other method, improved real property or a portion of improved real property for which the Privilege Tax imposed by this Chapter has not been paid shall be responsible for payment of such tax as a speculative builder or owner builder, as provided in Sections ___-416 and ___-417.

In the case of lender foreclosures, the speculative builder tax is not due at the time of foreclosure, but rather is due when the lender sells the property without any time limitations.[63]

1. Successor Liability Decisions Issued by the Municipal Tax Hearing Office

The Municipal Tax Hearing Office has issued a number of decisions regarding the application of the successor liability provision in the Model City Tax Code.

A Successor Is Liable for the Tax of Its Predecessor and Tax Becomes Due upon Transfer of the Property

Municipal Tax Hearing Office, Decision No. 178, City of Surprise (September 16, 2004)

In MTHO #178, the Municipal Tax Hearing Office held that under MCTC § __-595, the buyer should be liable for the tax assessment against the seller. Under the facts of the case, the seller transferred an apartment complex to the taxpayer as a contribution in exchange for a membership interest in the taxpayer. The city treated the transfer as a sale subject to speculative builder tax and notified the seller of the tax assessment. The seller did not protest or pay the tax assessment. Subsequently, the city notified the buyer that it would be liable for the seller's unpaid tax as a successor under MCTC § __-595.

In its decision, the Hearing Office concluded that the buyer was the successor in interest and thus liable for the tax liability of the seller once the property was transferred to the buyer. Furthermore, the buyer could not challenge the underlying tax liability of the seller, because the seller had not protested the assessment, and it had already become final. Finally, the Hearing Office found that tax became due upon sale from the seller to the buyer, not upon the buyer's subsequent sale.

If the Seller Has No Liability, the Successor Has No Liability

Municipal Tax Hearing Office, Decision No. 286 & 294, City of Scottsdale (August 30, 2006)

In MTHO # 286 & 294, the city assessed tax under a theory of successor liability. A company owned land on which a shopping center was to be built. The company obtained a

native plant permit and hired a third party to remove the native plants and put them in boxes for subsequent replanting. After completing this work, the company sold the land to the taxpayer. The city asserted that the sale was taxable under the speculative builder classification. Since it was unable to impose tax on the seller, the city asserted that the taxpayer (the buyer) owed the tax as a successor to the seller.

The speculative builder tax is only imposed on the sale of "improved real property," including land "where improvements have been made to land containing no structure (such as paving or landscaping)."[64] The city asserted that removing native plants constituted landscaping, making the land improved real property. The Hearing Office disagreed and found that the native plant removal did not amount to landscaping. As a result, the seller was not liable for speculative builder tax.

Since a successor is only liable for the tax owed by the party whose interests it succeeds, and the seller did not owe speculative builder tax in its own right, there was no outstanding liability that could be passed to the taxpayer. Thus, the Hearing Office found that speculative builder tax did not apply to the buyer.

A Foreclosing Lender that Takes Title to Property at a Trustee Sale Is Subject to Speculative Builder Tax as a Successor on the Purchase Price it Paid at the Trustee Sale

Municipal Tax Hearing Office Decision No. 125, City of Scottsdale (August 26, 2003)

In MTHO #125, the taxpayer loaned money to an individual to build a primary residence. The borrower ended up defaulting on its loan, and the taxpayer acquired the property at the trustee's sale. The city then assessed speculative builder tax on the taxpayer, asserting that it was the borrower's successor.

The Hearing Office found that the transfer of title that occurred at the trustee sale constituted a sale for purposes of the speculative builder tax. As a result, the borrower became liable for speculative builder tax. Since the borrower failed to pay the tax due, the taxpayer properly succeeded to the borrower's interests pursuant to § __-595, and became liable for the payment of the tax. In addition, the taxpayer was subject to tax based on the purchase price of the property at the trustee sale. The Model City Tax Code, section 595 was amended in 2012 to change the result of this ruling. The 2012 amendment provides that the creditor will be taxed as a speculative builder when it ultimately sells the foreclosed property. See MCTC section 595 (c)(1).

2. Lender Foreclosures

The Model City Tax Code provisions, specifically § __-595(c), dealing with the applicability of the speculative builder tax in a foreclosure was amended in 2010 to provide that as a general rule a lender that forecloses on a property will not be liable for the tax upon foreclosure but rather when the lender sells the property "at any time" (and not just within a 24 month period from completion of construction as is the case with speculative builder tax as applied to commercial properties or improved lots). The tax will be based on the sales price of that transaction.[65] Previously, Municipal Tax Hearing Office decisions dealing with a lender's liability for the speculative builder tax on foreclosure held the lender liable for the tax immediately upon foreclosure and based on the purchase price the lender paid at the trustee sale. *See* MTHO #125 and #178, discussed above. Other key features of the Model City Tax Code dealing with lender foreclosures follow:

1. The partially improved real property exemption of § -416(b)(4) will apply to the subsequent sale by the lender if the property meets the definition of "partially improved real property" of § -416(a)(4) (any improved real property where the improvement to such property is not substantially complete at the time of sale).[66]
2. If the lender uses the foreclosed property for any business purposes, rather than holding the property for sale and using it as the debtor used it, the lender will be liable for the tax when the first business use occurs with the tax based on the fair market value of the property at that time (the credit bid will be deemed to be the fair market value).[67]
3. Once the lender pays the tax, neither it nor any future owner shall be liable for any unpaid tax due from the debtor upon the foreclosure.[68]
4. If the debtor pays any amount of the tax, that payment shall be a credit against the lender's successor liability.[69]
5. The lender, upon foreclosure, must obtain a city sales tax license if it does not already have one.[70]

These provisions were made retroactive to May 1, 2010.

OPPORTUNITIES TO STRUCTURE SALES AROUND THE TAX ARE LIMITED

Because the Model City Tax Code defines both "speculative builder" and "sale" in such broad terms, there are limited opportunities to structure a transaction to avoid speculative builder tax liability entirely. The following section discusses the applicability of the speculative builder tax to various methods of structuring a transaction.

Contract to Sell the Non-Residential Improved Real Property But Title is Not Transferred Until After the 24-Month Period

The definition of "speculative builder" is likely broad enough to subject this transaction to the tax. The Model City Tax Code defines "speculative builder" as an owner-builder that either sells or *'contracts to sell'* improved real property within twenty-four months of substantial completion.

Long Term Lease Rather Than Sale

This transaction will not vitiate the speculative builder tax if the lease is for a term of 30 years or more (with options for renewal being included as a part of the term). MCTC § __-416(a)(3) defines the "sale of improved real property" to include leases of thirty years or more, including any options to renew.

> ➢ **Comment: Commercial Property – Lease, Don't Sell.**
>
> For commercial property, an owner/developer could avoid speculative builder tax if it does not sell the property but leases, uses, or holds the property for 24 months or more after substantial completion. However, the lease with all renewal options considered must be less than 30 years.

Short Term Lease With Option to Buy

The speculative builder tax is likely not avoided by structuring the transaction as a short term lease (to get past the 24-month trigger period) with a purchase option that could only be exercised after the expiration of the 24-month period. The definition of "sale of improved real property" is probably broad enough to capture this transaction. That term 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." Additionally, the definition of "speculative builder" includes builders who "contract to sell" improved real property. That language could possibly cover a lease with a purchase option. The cities could take that position because the structure could be viewed as a tax avoidance scheme. However, as noted above, a short term lease of commercial property with no purchase option, followed by a sale outside the 24-month period, should not result in speculative builder tax liability.

Transfer Property to Wholly-Owned Entity and Sell Membership Interests

A speculative builder may try to put the property in a limited liability company (or corporation) and sell the membership interests in the LLC or stock in the corporation. Arizona cities would most likely take the position that this scenario is covered by the "definition of sale of improved real property" which includes "any form of transaction … *which in substance is a transfer of title of, or equitable ownership in, improved real property…*" Cities are aggressive when it comes to the speculative builder tax and would surely take this position where the sole or the substantial asset of the LLC or corporation was the improved real property.

Allocation of Purchase Price

By definition, the speculative builder tax applies only to the sale of "improved real property" as defined by the Model City Tax Code. Consequently, there is an opportunity to reduce the tax base for items such as tangible personal property or intangibles conveyed along with the improved real property. These items fall outside the scope of the speculative builder classification. Typically, this opportunity accompanies the sale of furnished homes or time-shares, apartment complexes, or commercial spaces.

For example, commercial properties may be sold along with exempt income-producing capital equipment. Similarly, tangible personal property, such as a washer/dryer or free-standing (non-built-in) refrigerator, which is transferred as part of a sale of a time-share or furnished home, is non-taxable.

To the extent a sale involves any or all of these non-taxable components, it is prudent planning to allocate the purchase price among land, improvements, tangible personal property, and intangibles based on some reasonable verifiable basis. Because the speculative builder tax is presumed to apply to the entire amount of gross income from the sale, the seller bears the burden of establishing both that the non-taxable elements have value and that the allocated value is reasonable.[71]

For tangible personal property, including income-producing capital equipment, original cost (based on purchase invoices) should constitute sufficient evidence of value for allocation and deduction purposes. If the property is sold at the outer limit of the 24-month trigger period, replacement cost less depreciation may be appropriate.

SUMMARY OF ADMINISTRATIVE AND JUDICIAL INTERPRETATIONS OF THE SPECULATIVE BUILDER TAX

The following cases illustrate how the Municipal Tax Hearing Office[72] and the Arizona courts have interpreted the speculative builder tax. In general, these administrative and judicial decisions have reasonably interpreted the speculative builder tax provisions to avoid a constrained construction. The following cases describe the contours of the speculative builder tax and display the various nuances and subtleties in the application of the tax to various factual scenarios.

Tax Does Not Apply to Sales of Vacant Land Even Though the Seller is Obligated to Construct Improvements After the Transfer of Title

In *Estancia Development Associates, L.L.C. v. City of Scottsdale*,[73] the Arizona Court of Appeals held that the speculative builder provision of the Model City Tax Code does not apply to the sale of real property which is unimproved at the time of sale, even though the sales contract requires the seller to make subsequent improvements to the property.[74] Estancia owned unimproved land in Scottsdale which had been subdivided into individual lots. Estancia sold the lots and agreed in the purchase contract to make off-site improvements, including to construct sewers and paved roads and to install telephone, water, cable television, electric, and natural gas service to each lot. At the close of escrow, no structures had been erected on the lots and none of the off-site improvements had been constructed. Estancia completed the off-site improvements after the close of escrow.[75]

Based on those facts, the lower court upheld Scottsdale's assessment of tax on the grounds that while Estancia had not sold improved real property, it had "nevertheless contracted to sell improved real property."[76] The Court of Appeals disagreed, holding that the definition of "improved real property" did not extend to "vacant land on which improvements were promised to be made but as of the time of the sale have not been made."[77] The court expressly relied on the use of the past perfect tense in defining "improved real property" as land "upon which a structure has been *constructed*," where improvements such as landscaping or paving "*have been made* to land" without a structure, or "where water, power and streets *have been constructed* to the property line."[78]

> ➢ **Comment: Cities Attempt to Change Model City Tax Code to Overrule *Estancia* Failed.**
>
> Arizona cities responded to the *Estancia* decision by proposing to amend the Model City Tax Code's definition for "improved real property" to include real property "where the seller has committed" by any means "to make or have made any of the" improvements already listed in the definition "regardless of the stage of completion at the close of escrow or transfer of title." To date, the proposed amendment has not been adopted.

> ➢ **Comment: Cities Try to Get Around *Estancia*.**
>
> While under *Estancia* the sale of unimproved lots where streets and utilities are put in after the lot sale does not trigger the speculative builder tax, the cities take the position that even though streets or utilities (water and electricity) may not be in at the time of sale, if there are any other improvements that were made to the lot at the time of sale, such as grading, landscaping or re-vegetation, the tax applies.

The Entire Price of an Apartment Complex is Subject to Speculative Builder Tax Even Though Portions of the Project were Completed More than 24 Months Prior to the Sale

In *Mt. Germann and Ellis LLC v. City of Chandler*,[79] an unpublished memorandum decision issued by the Arizona Court of Appeals, the taxpayer constructed a 36-building apartment complex. The taxpayer sold the entire development on May 24, 2007 for $58,000,000. At the date of the sale, 15 buildings were sold within 24 months of substantial completion and 21 buildings were sold more than 24 months after substantial completion. The taxpayer took the position that speculative builder tax should be paid on the 15 buildings that were completed within the 24 months prior to the date of sale, and that only the tax under the owner-builder classification was owed on the 21 buildings substantially complete more than 24 months from the date of the sale (this resulted in a substantially lower overall tax bill than treating all buildings as subject to speculative builder tax). The taxpayer asserted that this allocation method had been adopted by other cities and was the accepted approach. However, the Court of Appeals rejected the allocation method and held that speculative builder tax was owed on all 36 of the buildings. The Court reasoned that a speculative builder is an owner-builder who sells or contracts to sells improved real property "before the expiration of twenty-four months after the improvements of the real property sold are substantially complete, and the "improvements" must refer to the entire development being sold, not individual buildings. Because the project at issue in the case as a whole was substantially completed within 24 months of the sale, the Court concluded that the entire project was subject to speculative builder tax.

Tax Applies to the Selling Price of the Real Property Rather than the Assessed Value of the Real Property and the Selling Price Must Exclude Personal Property Elements

In *Cibola Vista Spa and Resort, L.L.C. v. City of Peoria*,[80] the Arizona Tax Court held that the speculative builder tax due on the sale of timeshares must be based on the selling price of the real property rather than on its assessed value for property tax purposes, and that the total selling price of the property must exclude the selling price of any personal property elements.

In this case, the selling price of a timeshare unit included both real property and personal property elements. The city taxed the entire sales price. The taxpayer argued that the speculative builder tax should be imposed only on the real property elements based upon the property tax value of that real property. The Tax Court disagreed, indicating that the real property tax assessed value of the timeshare units would not necessarily be equivalent to the

selling price of the real property. The Court concluded that the speculative builder tax must be based on the total sales price minus the selling price of the personal property elements.

Tax Does Not Apply to a Transfer of Assets Resulting from Corporate Reorganization Because Such Transfers are Not Sales within the Meaning of the Municipal Tax Code

In *In Re Luby's Cafeterias, Inc.*,[81] the Municipal Tax Hearing Office held that the speculative builder tax did not apply to the transfer of assets pursuant to a corporate reorganization plan.

The taxpayer underwent a corporate reorganization which transferred all of the taxpayer's operating assets into a limited partnership. However, the limited partnership continued to be wholly owned by the taxpayer. In addition, after reorganization, the taxpayer's shareholders continued to have the same voting, dividend and liquidation rights and ownership interests as they had prior to reorganization. Also, the taxpayer continued to have control over the same assets and business activities as before and the reorganization was conducted properly on a tax free basis for state and federal income tax purposes. Consequently, the Hearing Office concluded that no taxable sale resulted from transferring assets during corporate reorganization because such transfers did not constitute sales under the municipal tax code and moreover, the transfer of assets did not involve consideration.

Tax Does Not Apply to a Contribution of Assets to a Partnership in Exchange for an Interest in the Partnership Where the Liabilities Assumed by Other Partners is Not Greater than the Basis of the Contributing Taxpayer Partner

In *R & B Executive Investments*,[82] the Municipal Tax Hearing Office held that the contribution of property associated with the formation of a partnership is not subject to privilege license taxes, such as the speculative builder tax. In addition, the Hearing Office held that refinancing of a property after it has been contributed to a partnership is also not subject to privilege license taxes because the contributing partner remains liable and such refinancing is not a sale in substance. Moreover, the Hearing Office held that the sale of an equity position in the partnership that has received the contributed property does not constitute a transaction subject to privilege license taxes because the partnership in general receives the proceeds of the equity position sale, not the general partner that contributed the property.

As in *In Re Luby's* (discussed above), the taxpayer transferred its interest in a property into a limited partnership. However, unlike that case, the *R & B Executive Investments* taxpayer did not wholly own the limited partnership; rather, the taxpayer was merely a general partner with other unrelated partners. Thus, the case was distinguishable from cases like *In Re Luby's* because the property was transferred between entities that did not have identical underlying ownership (in contrast, the transfer of property in *In Re Luby's* and similar cases involved the same individuals possessing the same relative ownership interest in the assets both before and after the transfer – the property was transferred between entities with identical underlying ownership). Nevertheless, the Hearing Office concluded that, in general, contributions to partnerships are treated as tax free exchanges, except when the liabilities assumed by the other partners are greater than the contributing partner's basis. Therefore, the Hearing Office concluded that the contribution of property associated with the formation of a partnership is not a sale in substance and the speculative builder tax does not apply.

Cuts and Fills (Spill Over from Road Construction) and Drainage Modifications to Lots Did Not Constitute "Improvements"

In MTHO #215[83] the Municipal Tax Hearing Office held that cuts and fills involved with road construction that spilled onto the lots and the removal and subsequent replacement of native plants on the disputed lots because of the road construction did not constitute improvements to the lots. The Hearing Office also held that construction of the street alone to the property lines of the lots would not result in "improved real property," and that the sales of lots (with no structures), which were part of a development with improved common areas that the lot purchaser has right to use and enjoy would not constitute "improved real property."

Tax Does Not Apply to the Sale of a Lot Without a Structure that is Part of a Development With Improved Common Areas

In MTHO #157,[84] the Municipal Tax Hearing Office held that the speculative builder tax did not apply to the sale of a residential lot without a structure even though the purchaser obtained the right to use and enjoy the development's improved common areas as part of its purchase. Moreover, the Hearing Office held that speculative builder tax did not apply to the sale of a lot without a structure or other improvements, where the developer constructed water to the property line but did not also run power to the property line or construct streets.

Here, the taxpayer planned to develop residential lots, a golf course, and a clubhouse. Before building any structures on the residential lots, the taxpayer made a number of improvements to common areas within the development, including the completion of some streets, the grading of other streets, the construction of a guardhouse for the community, and beginning to install sewer lines. The Hearing Office concluded that improved common areas are not "sold" along with the unimproved lots; rather, the purchaser acquired only a right to use common areas. In addition, while the taxpayer constructed water up to the respective property lines, neither power nor paved roadways to the lots was constructed. On this issue, the Hearing Office concluded that the speculative builder tax did not apply to the taxpayer's sale of lots without structures because the lots did not constitute "improved real property" as defined by MCTC § __-416(a)(2)(D), which requires the construction of water, power, *and* streets, and not just one of the three.

No Double Taxation Where the Taxpayer Also Pays Commercial Leasing Tax on the Property

In MTHO #188,[85] the Municipal Tax Hearing Office held that applying the speculative builder tax and the commercial leasing tax to a taxpayer for a single property does not constitute double taxation because each tax is assessed at different times and for different taxable activities with respect to the same improved real property.

In this case, the taxpayer applied for a city privilege license to engage in the business of commercially leasing the property. The taxpayer paid the city a monthly commercial leasing privilege license tax for almost a year and a half, until the taxpayer finally sold the improved real property. At the time of the sale, the taxpayer was assessed the speculative builder tax. The taxpayer contended that paying both the commercial leasing tax and the speculative builder tax amounted to impermissible double taxation. However, the Hearing Office concluded that double taxation had not occurred because the commercial leasing tax related to activities performed during the time before the property was sold, whereas the speculative builder tax related to the act of selling the property, which occurred and was assessed on the date of sale.

Tax Amount Can Be Determined by Computing the Market Value of the Improved Real Property Where the Amount Paid by the Purchaser to the Taxpayer is Not Specified

In MTHO #107,[86] the Municipal Tax Hearing Office held that it is appropriate to compute the speculative builder tax according to the market value of the improved real property when the property has been transferred by the taxpayer to the purchaser but no monetary consideration has been specified.

In this case, the taxpayer agreed to transfer title to the improved real property to the purchaser. In exchange, the purchaser agreed to pay the taxpayer once the purchaser sold portions of the property. The Hearing Office concluded that even though no monetary consideration was exchanged, consideration still existed because the taxpayer received the promise of future monetary payment upon the purchaser's sale of the property. Therefore, since there was no monetary amount specified at the time of the sale, the Hearing Office concluded that under MCTC § -210, the city appropriately computed the speculative builder tax by determining the market value of the property according to comparable properties.

Tax Applies to Transactions Where Only the Title is Transferred and No Money is Exchanged

In MTHO #164,[87] the Municipal Tax Hearing Office held that a transfer of title without exchange of monies constitutes a sale of improved real property subject to the speculative builder tax.

In this case, the taxpayer, a limited liability company, claimed to have distributed the improved real property at cost to its members and then the taxpayer's members redistributed the property at cost to another related entity. The Hearing Office found that during this distribution and redistribution of the property, there was no exchange of monies but there was a transfer of title. Moreover, the Hearing Office stated that sales subject to the speculative builder tax are defined to include a transfer of title or a change in equitable ownership. Therefore, the Hearing Office concluded that a sale had occurred because the taxpayer had transferred title to the related entity, thus triggering the speculative builder tax.

Tax Applies to the Sale of Timeshare Units Within 24 Months After Substantial Completion Only

In MTHO #71[88], the Municipal Tax Hearing Office held that timeshare units are not inventory homes and as such, the speculative builder tax cannot apply to all sales of a timeshare regardless of when sold. Rather, the speculative builder tax only applies to the sale of timeshares before the expiration of 24 months after the substantial completion of improvements to the timeshare property.

In this case, the taxpayer was in the business of selling timeshares and the city taxed the taxpayer's sales of timeshares beyond 24 months after improvements to the timeshares were completed. The city argued that selling timeshares was equivalent to selling inventory homes, therefore, the speculative builder tax applied to the sales at any time. The taxpayer argued that the timeshares could not be classified as homes because a home is a place where one lives for an extended period of time, whereas the owner of a timeshare purchases a right to stay in the timeshare for a limited period of time, without any right to store belongings there beyond that limited period. The Hearing Office agreed with the taxpayer in stating that the word "home" implies permanence and a place where one's belongings can be stored. Consequently, the Hearing Office concluded that the timeshares were not inventory homes (which could have the

speculative builder tax applied at any time), but were instead subject to the 24 month limitation applicable to sales of commercial properties.

Tax Does Not Apply to Title Transfers Between Related Parties For Nominal Consideration Because No Sale Subject to the Tax Occurs

In MTHO #21,[89] the Municipal Hearing Office held that nominal consideration given for improved real property is insufficient to trigger the speculative builder tax.

In this case, the taxpayer was a limited partnership that had a direct ownership in 99% of a related financing company. The taxpayer transferred the improved property with a value of $20,694,954 to the financing company for $10 dollars and other good and valuable consideration. The city argued that a sale had taken place because the financing company had given $10 dollars in consideration to the taxpayer. According to the city, consideration did not have to be equal, only present. The Hearing Office disagreed and concluded that nominal consideration in a sale did not trigger the speculative builder tax, especially because the property was essentially transferred between the same party which controlled the taxpayer and the financing company. Moreover, the Hearing Office noted that if nominal consideration were sufficient to trigger the speculative builder tax, then the tax code would have explicitly stated as much. In addition, in finding no sale subject to the tax, the Hearing Office found it important that the taxpayer was not avoiding taxes and had a legitimate purpose for transferring the property from the taxpayer to the financing company.

Speculative Builder Tax Applies Whether the Builder Makes a Profit on the Sale or Not, and May Be Assessed at Any Time Until the Statute of Limitations Has Expired

In MTHO #437[90] the Municipal Tax Hearing Office held that a speculative builder owed tax on the sale of improved real property even when the builder made no profit on the sale. The tax applies to the gross income from sales, not the profit, even if the property was sold at a loss to the builder. Furthermore, the taxpayer's argument that it was unfair to make the builder pay the tax two years after the sale failed because as long as the statute of limitations is still open, a city may assess the speculative builder tax. Since the taxpayer failed to file a return for the periods at issue, the statute of limitations had not run (statute stays open for four years after the date a return is filed – if a return was never filed, the statute had not even begun to run yet).

Casual Sale Exemption Does Not Apply to Real Property Sales; Penalties May Be Abated for Reasonable Cause if the Speculative Builder Was Unaware of the Tax

In MTHO #446,[91] the Municipal Tax Hearing Office found that the casual sale exemption (which exempts certain infrequent transactions from sales tax) does not apply to sales of real property and does not exempt sales from taxation under the speculative builder classification. However, penalties for late filing and late payment of the speculative builder tax may be abated for reasonable cause. The Hearing Officer concluded that reasonable cause existed where the builder was completely unaware of the speculative builder tax. Of course, the underlying tax and interest were still due regardless of whether or not the builder was aware of the tax.

[1] Thank you to Karen Lowell, an associate at Lewis Roca Rothgerber Christie LLP, with her assistance in preparing these materials.

[2] HB 2627, Laws 2007, ch. 188, *codified at* A.R.S. § 42-5075(N)(8).

[3] *SDC Mgmt., Inc. v. State ex rel. Arizona Dep't of Revenue*, 167 Ariz. 491, 808 P.2d 1243 (App. 1991).

[4] Municipal Tax Code Commission Executive Summary, March 2019.

[5] A complete copy of the Model City Tax Code is available online *at* http://www.modelcitytaxcode.org.

[6] MCTC §§ __-416 (imposing speculative builder tax), __-100 (defining the term "speculative builder").

[7] § __-416(a)

[8] § __-416(a)(1).

[9] § __-100 (definition of speculative builder).

[10] § __-100 (definition of owner-builder).

[11] § __-100 (definition of substantially complete).

[12] § __-416(a)(3).

[13] The Municipal Tax Hearing Office is the administrative body that formerly heard municipal sales tax appeals. Effective January 1, 2015, this function was transferred to the Office of Administrative Appeals as a part of Arizona's sales tax simplification initiative. *See* H.B. 2111 (2013) and H.B. 2389 (2014).

[14] §__-416(a)(2).

[15] *Id.*

[16] § __-416(c)(2)(B).

[17] § __-416(b)(2).

[18] § __-416(b)(2).

[19] § __-416(b)(4).

[20] § __-416(a)(4).

[21] § __-416.1(a).

[22] § __-416.1(b).

[23] *Id.*

[24] § __-416.1(c).

[25] § __-416.1(d).

[26] § __-416.1(e).

[27] § __-416(c)(1)(A).

[28] §§ __-110(a) – (c).

[29] § __-110(d).

[30] § __-416(c)(2)(C).

[31] § __-416(c)(1)(A).

[32] *Id.*

[33] §__-100 (definition of qualifying hospital).

[34] §__-100 (definition of qualifying community health center).

[35] §__-100 (definition of qualifying health care organization).

[36] § __-416(c)(1)(B).

[37] § __-416(c)(1)(C).

[38] § __-416(c)(1)(A)(i) and § __-110(a)(16) (defining income producing capital equipment to include clean room equipment).

[39] § __-416(c)(1)(D).

[40] § __-416(c)(1)(E).

[41] § __-416(c)(1)(E)(iii).

[42] § __-416(c)(2)(D).

[43] § __-416(b)(5).

[44] § __-416(c)(1)(F).

[45] Municipal Tax Hearing Office Decision No. 1, City of Phoenix (February 20, 2002).

[46] § __-416(c)(1)(F).

[47] Municipal Tax Hearing Office Decision No. 176, City of Peoria (June 31, 2004).

[48] §§ __-416(c)(3)(A) – (C).

[49] § __-416(c)(3)(D).

[50] § __-416(c)(3).

[51] § __-416(c)(3)(A).

[52] § __-416(c)(3)(B).

[53] § __-415(a).

[54] § __-416(c)(3)(C).

[55] § __-416.2(a).

[56] § __-416(b)(1).

[57] § __-416.2(b).

[58] § __-416.2(c).

[59] *Id.*

[60] *Id.*

[61] §§ __-417(b) – (c).

[62] § __-595(c).

[63] § __-595(c)(1).

[64] § __-416(a)(2)(B).

[65] *See* § __-595(c)(1).

[66] *Id.*

[67] § __-595(c)(2).

[68] § __-595(c)(3).

[69] § __-595(c)(4).

[70] § __-595(c)(5).

[71] *See* MCTC § __-400; *see also* MTHO #1.

[72] The Municipal Tax Hearing Office was the administrative agency that heard city sales tax appeals for audits initiated prior to December 31, 2014. For audit initiated on or after January 1, 2015, this function was transferred to the Office of Administrative Appeals.

[73] 196 Ariz. 87, 993 P.2d 1051 (Ct. App. 1999).

[74] *Id.* at 88, 993 P.2d at 1052.

[75] *Id.*

[76] *Id.* at 89, 993 P.2d at 1053.

[77] *Id.* at 90, 993, P.2d at 1054.

[78] *Id.* (quoting, with emphasis added, Scottsdale Revenue Code § 416(a)(2)).

[79] Arizona Court of Appeals, 1 CA-TX 12-0002 (Dec. 18, 2012).

[80] Arizona Tax Court, No. TX 2005-050292 (April 9, 2007).

[81] City of Glendale, Decision of Hearing Officer (November 27, 2001).

[82] City of Phoenix, City Auditor Ruling No. CAP 457 (October 30, 1984).

[83] Municipal Tax Hearing Office Decision No. 215, City of Scottsdale (November 18, 2005).

[84] Municipal Tax Hearing Office Decision No. 157, Town of Fountain Hills (August 24, 2004).

[85] Municipal Tax Hearing Office Decision No. 188, City of Tucson (October 4, 2004).

[86] Municipal Tax Hearing Office Decision No. 107, City of Phoenix (August 16, 2004).

[87] Municipal Tax Hearing Office Decision No. 164, City of Peoria (April 19, 2004).

[88] Municipal Tax Hearing Office Decision No. 71, City of Scottsdale (February 26, 2003).

[89] Municipal Tax Hearing Office Decision No. 21, City of Scottsdale (April 15, 2002).

[90] Municipal Tax Hearing Office Decision No. 437, City of Peoria (August 13, 2008).

[91] Municipal Tax Hearing Office Decision No. 446, Town of Marana (September 3, 2008).

