

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: September 27, 2012

Decision: MTHO # 636/638/639

Taxpayers:

Tax Collector: City of Mesa

Hearing Date: April 11, 2012

DISCUSSION

Introduction

On February 23, 2011, letters of protest were filed by ***Development #1, Development #2, and Development #3*** (Collectively referred to as “Taxpayers”) of tax assessments made by the City of Mesa (“City”). A hearing was commenced before the Municipal Tax Hearing Officer (“Hearing Officer”) on April 11, 2012. Appearing for the City was the ***Tax Audit Supervisor***, and a ***Senior Tax Auditor*** and the ***Assistant City Attorney***. Appearing for Taxpayers was their ***CPA***. At the conclusion of the April 11, 2012 hearing, the parties were granted an opportunity to file post-hearing documentation. On August 23, 2012, the Hearing Officer indicated the record was closed and a written decision would be issued on or before October 11, 2012.

DECISION

On January 27, 2011, the City issued an assessment of ***Development #1*** for additional taxes in the amount of \$585,610.62, interest up through December 2010 in the amount of \$90,921.78, and penalties totaling \$60,259.60. The assessment was for the period of October 2006 through March 2010. On January 27, 2011, the City issued an assessment of ***Development #2*** for additional taxes in the amount of \$15,143.71, interest up through December 2010 in the amount of \$3,767.39, and penalties totaling \$2,533.85. The assessment was for the period of March 2005 and April 2008. On January 27, 2011, the City issued an assessment of ***Development #3*** for additional taxes in the amount of \$333,878.68, interest up through December 2010 in the amount of \$51,062.33, and penalties totaling \$34,994.66. The assessment was for the period of January 2007 through March 2010.

Subsequent to the hearing, Taxpayers provided additional documentation to support claimed credits for taxes paid to construction contractors. After review of the additional documentation, the City issued revised assessments for Taxpayers on May 9, 2012. The revised assessment for ***Development #1*** was for additional taxes in the amount of

\$335,655.71, interest up through April 2012 in the amount of \$69,267.20, and penalties totaling \$35,264.11. The revised assessment for **Development #3** was for additional taxes in the amount of \$172,878.39, interest up through April 2012 in the amount of \$34,804.14, and penalties totaling \$18,894.63. There was no revision for **Development #2**.

The City assessment for **Development #1** was related to the activity of commercial rental of real property and speculative builder sales of “improved real property” known as **Super Development #1**, Lot 1 and Lots 4 through 11 on October 4, 2007 and **Super Development #1**, Lot 2 on March 4, 2010. The City noted that **Development #1** did not protest the assessment related to the activity of commercial rental of real property or the sale of Lot 2 on March 4, 2010.

The City assessment for **Development #2** was related to the activity of commercial rental of real property and two speculative builder sales of “improved real property” known as **Super Development #2**, Lot 4 on March 31, 2005 and **Super Development #2**, Lot 1 on April 14, 2008. The City noted **Development #2** did not protest the assessment related to the activity of commercial rental of real property.

The City assessment for **Development #3** was related to the activity of commercial rental of real property and speculative builder sales of “improved real property” known as **Super Development #3**, Lots 2 through 6 on October 4, 2007 and **Super Development #3**, Lot 1 on March 4, 2010. The City noted **Development #3** did not protest the assessment related to the activity of commercial rental of real property or the sale of Lot 1 on March 4, 2010.

Development #3 and **Development #1** argued the October 2007 sale of land was not subject to taxation as the transaction was merely a contribution to another entity in which **the Development** retained ownership interest. Taxpayers claimed that **Development #3** and **Development #1** contributed its building and land for an interest in the new entity and would not be subject to taxation.

The City noted that the properties in question were transferred via general warranty deeds from **Development #3** and **Development #1** to **DP8E** and **DP8W** on October 4, 2007. The City indicated a sale occurred pursuant to City Code Section 5-10-100 (“Section 100”) as “sale” is defined as any transfer of title or possession in any manner or means for a consideration. Section 100 defines a “person” to be considered as a distinct and separate person from any general or limited partnership or joint venture or other association with which such person is affiliated. The City argued that since improved real property was transferred from **Development #3** and **Development #1** to **DP8E** and **DP8W** for consideration, the transfers were taxable pursuant to City Code Section 5-10-416 (“Section 416”) as speculative builder sales. Taxpayers received consideration pursuant to City Code Section 5-10-200 (“Section 200”) which provides that forgiveness of indebtedness is considered as gross income. According to the City, Taxpayers debt associated with the improved real property was released as a result of the transfers. In response to Taxpayers post hearing brief, the City argued that Taxpayers failed to provide

any evidence that the sale of real property by Taxpayers was a contribution of capital. The City asserted that Taxpayers had provided no documentation to demonstrate that Taxpayers held any ownership in *DP8E* or *DP8W* or any responsibility for the debt associated with the properties at issue. According to the City, the subject properties were transferred by warranty deeds from the Taxpayers to *DP8E* and *DP8W*. Further, there was consideration because Taxpayers were relieved of debt as shown by the Full Reconveyances recorded with the Maricopa County Recorder's Office demonstrating full satisfaction of the debt. The City noted that City Code Section 5-10-200 ("Section 200") provides that forgiveness of indebtedness is considered to be gross income. In addition, the City argued that the sale of the improved real property cannot qualify as casual as the definition in Section 100 of "casual activity or sale" specifically excludes the sale of real property. The City had imposed penalties on Taxpayers pursuant to City Code Section 5-10-540 ("Section 540") for failure to file tax returns and failure to timely pay taxes. The City asserted that Taxpayers were unresponsive to requests for records and documentation during the audit process and as a result does not warrant the abatement of penalties.

"Sale" is defined in City Code Section 5-10-100 ("Section 100") to mean any transfer of title or possession, or both, exchange, barter, conditional or otherwise, in any manner or by any means whatsoever, including consignment transactions and auctions of property for a consideration. The City argued there was a sale pursuant to Section 100 as evidenced by the warranty deeds and the fact that Taxpayers were relieved of debt responsibility of \$80,392,160.00 as a result of the transfer of properties.

Taxpayers indicated that *Monumental Diversified, LLC* ("*MD*") was organized in 2005 to acquire, lease, own, develop and sell real property. *MD* was owned by *Development Retail Partners, LLC* ("*DR*") and *Monumental Diversified1* ("*MD1*"). According to Taxpayers, "*DR*" and "*MD1*" formed in 2007 a two tier subsidiary structure of *DP8E* and *DP8W* as property holders. *DP8E* and *DP8W* were wholly owned by their managing entities *DP8E-MGR* and *DP8W-MGR*. Taxpayers provided a copy of *Development Retail's* 2007 IRS Form 1065 partnership return which provided two Statements of Disclosure ("Disclosure"). Those Disclosures stated that *Development #3* and *Development #1* were single member LLC's owned by "*DR*" and they were transferring/contributing assets and liabilities on October 5, 2007 to "*MD*" for a membership interest in the entity.

Based on the additional information/documentation provide by Taxpayers subsequent to the hearing, we are convinced the transfers from *Development #3* and *Development #1* to *DP8E* and *DP8W* were non-taxable contributions. While the Disclosures refer to contributions to "*MD*", *DP8E* and *DP8W* were wholly owned subsidiaries of "*MD*". In turn, *Development #3* and *Development #1* were owned by *Development-SG Holdings* which was owned by "*DR*". As a result, "*DR*" contributed *Development #3* and *Development #1* to "*MD*"/*DP8E*/*DP8W*. Consistent with the City's June 19, 2012 post-hearing submission, we conclude the transfers in question were non-taxable contributions. We shall order the City to remove all taxes, interest, and penalties assessed on the October 4, 2007 transfers. The remaining assessments against Taxpayers are up

held.

Lastly, we have the matter of penalties on the remaining assessments. The City assessed Taxpayer for penalties pursuant to City Code Section 5-10-540 (“Section 540”) for failure to file, and failure to timely pay. The penalties for failure to timely file and failure to timely pay may be waived for “reasonable cause”. Reasonable cause is defined in Section 540 that a taxpayer exercised ordinary business care and prudence, i.e., had a reasonable basis for believing that the tax did not apply to the business activity. The City argued that Taxpayers were unresponsive to requests for records and documentation during the audit process and does not warrant the abatement of penalties. Taxpayers argued that it had demonstrated a reasonable basis for believing that no taxes applied to its contribution to capital. As a result, Taxpayers requested all penalties be waived. We have already indicated the penalties would be waived on the October 4, 2007 transfers as we found them to be not taxable. We have not been provided with any reasonable cause to waive any remaining penalties. Based on all the above, we conclude that Taxpayers protest should be partly, denied and partly granted, consistent with the Discussion, Findings, and Conclusions, herein.

FINDINGS OF FACT

1. On February 23, 2011, Taxpayers filed a protest of tax assessments made by the City.
2. On January 27, 2011, the City issued an audit assessment of ***Development #1*** for additional taxes in the amount of \$585,610.62, interest up through December 2010 in the amount of \$90,921.78, and penalties totaling \$60,259.60.
3. The assessment was for the period of October 2006 through March 2010.
4. On January 27, 2011, the City issued an assessment of ***Development #2*** for additional taxes in the amount of \$15,143.71, interest up through December 2010 in the amount of \$3,767.39, and penalties totaling \$2,533.85.
5. The assessment was for the period of March 2005 and April 2008.
6. On January 27, 2011, the City issued an assessment of ***Development #3*** for additional taxes in the amount of \$333,878.68, interest up through December 2010 in the amount of \$51,062.33, and penalties totaling \$34,994.66.
7. The assessment was for the period of January 2007 through March 2010.

8. At the conclusion of the hearing, Taxpayers provided additional documentation to support claimed credits for taxes paid to construction contractors.
9. After review of the additional documentation, the City issued revised assessments for Taxpayers on May 9, 2012.
10. The revised assessment for ***Development #1*** was for additional taxes in the amount of \$335,655.71, interest up through April 2012 in the amount of \$69,267.20, and penalties totaling \$35,264.11.
11. The revised assessment for ***Development #3*** was for additional taxes in the amount of \$172,878.39, interest up through April 2012 in the amount of \$34,804.14, and penalties totaling \$18,894.63.
12. There was no revision for ***Development #2***.
13. The City assessment for Taxpayers was related to the activity of commercial rental of real property and speculative builder sales of improved real property.
14. The properties in question for ***Development #3*** and ***Development #1*** were transferred via general warranty deeds from ***Development #3*** and ***Development #1*** to ***DP8E*** and ***DP8W*** on October 4, 2007.
15. ***“MD”*** was owned by ***“DR”*** and ***“MDI”***.
16. ***“DR”*** and ***“MDI”*** formed and capitalized two subsidiary structures as property holders (***DP8E*** and ***DP8W***).
17. ***DP8E*** and ***DP8W*** were wholly owned by ***DP8E-MGR*** and ***DP8W-MGR*** with ***“DR”*** being the sole member of both entities.
18. ***Development #3*** and ***Development #1*** were single member LLC’s owned by ***“DR”***.
19. On October 4, 2007, ***“DR”*** contributed the properties it held in ***Development #3*** and ***Development #1*** to ***“MD”/DP8E/DP8W*** for a membership interest in the entity.

CONCLUSIONS OF LAW

1. Pursuant to ARS Section 42-6056, the Municipal Tax Hearing Officer is to hear

all reviews of petitions for hearing or redetermination under the Model City Tax Code.

2. Section 5-10-445 (“Section 445”) imposes a tax on the gross income from the business activity of commercial rental.
3. *Development #3* and *Development #1* were taxable pursuant to Section 445 during their respective assessment periods.
4. Section 5-10-415 (“Section 415”) imposes a tax on the business activity of construction.
5. *Development #2* was taxable pursuant to Section 415 during the assessment period.
6. Section 416 imposes a tax on the business activity of speculative building.
7. *Development #2* had taxable speculative builder income pursuant to Section 416 from the sale of *Development #2*, Lot 4 on March 31, 2005.
8. *Development #1* had taxable speculative builder income pursuant to Section 416 for the sale of *Development #1*, Lot 2 on March 4, 2010.
9. *Development #3* had taxable speculative builder income pursuant to Section 416 from the sale of *Development #3*, Lot 1 on March 4, 2010.
10. The transfers of *Development #3* and *Development #1* on October 4, 2007 to *DP8E* and *DP8W* were non-taxable contributions.
11. The City was authorized pursuant to Section 540 to assess penalties.
12. With the exception of the October 4, 2007 transfers, Taxpayers have not demonstrated reasonable cause to have the penalties waived for failing to timely file or timely pay taxes.
13. Taxpayers February 23, 2011 protests should be partly granted and partly denied, consistent with the Discussion, Findings, and Conclusions, herein.
14. Both parties have timely rights of appeal to the Arizona Tax Court pursuant to Model City Tax Code Section --575

ORDER

It is therefore ordered that the February 23, 2011 protests by *Development #1*, *Development #2*, and *Development #3* of a tax assessment made by the City of Mesa should be partly granted and partly denied consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Mesa shall remove the assessments to *Development #1* and *Development #2* for the October 4, 2007 transfers to *MD-DP8E*, and *MD-DP8W*.

It is further ordered that this Decision is effective immediately.

Municipal Tax Hearing Officer