

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: August 11, 2008

Decision: MTHO # 404

Taxpayer:

Tax Collector: City of Tempe

Hearing Date: June 26, 2008

DISCUSSION

Introduction

On December 14, 2007, ***Taxpayer*** filed a protest of a tax assessment made by the City of Tempe (“City”). After review, the City concluded on December 26, 2007, that the protest was timely and in the proper form. On December 31, 2007, the Municipal Tax Hearing Officer (“Hearing Officer”) ordered the City to file a response to the protest on or before February 14, 2008. On February 14, 2008, the City filed a response. On February 21, 2008, the Hearing Officer ordered Taxpayer to file any reply on or before March 13, 2008. On February 29, 2008, the City requested Taxpayer’s reply deadline be extended to April 14, 2008, in order to allow the parties time to discuss a possible settlement. On March 5, 2008, the Hearing Officer extended Taxpayer’s reply deadline until April 14, 2008. On April 14, 2008, Taxpayer filed its reply. On May 14, 2008, a Notice of Tax Hearing (“Notice”) scheduled this matter for hearing commencing on June 23, 2008. On May 15, 2008, a Notice rescheduled the hearing for June 26, 2008. Both parties appeared and presented evidence at the June 26, 2008 hearing. On June 27, 2008, the Hearing Officer indicated the record was now closed and a written decision would be issued on or before August 11, 2008.

City Position

The City indicated Taxpayer obtained a transaction privilege license with the City on April 17, 1995. According to the City, Taxpayer described its business as “general contractor, remodeling.” The City conducted an audit of Taxpayer for the period October 2003 through September 2007. As a result of the audit, the City assessed Taxpayer for additional taxes in the amount of \$270,172.25, interest up through October 2007 in the amount of \$13,919.07, and penalties totaling \$25,560.75.

The City noted that Taxpayer entered into an agreement in February 2006, with ***ABC Company*** for the construction of infrastructure improvements for a shopping center known as the ***Marketplace***. According to the City, the ***Marketplace*** was the only

significant activity by Taxpayer in the City during the audit period. The City asserted Taxpayer acted as a construction contractor on the Marketplace project and as a result all of its receipts from **ABC Company** were included in the taxable gross receipts. The City indicated City Code Section 16-100 (“Section 100”) defines a construction as follows:

“Construction contractor means a person who undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or does himself or through others, construct, alter, repair, add to subtract from, improve, move, wreck, or demolish any building, highway, road, railroad, excavation, or other structure, project, development, or improvement to real property, or to do any part thereof. “Construction contractor” includes subcontractors, specialty contractors, prime contractors, and any person receiving consideration for the general supervision and/or coordination of such a construction project except for remediation contracting. This definition shall govern without regard to whether or not the construction contractor is acting in fulfillment of a contract.”

In response to Taxpayer, the City argued that *Arizona Department of Revenue v. Ormond Builders, Inc.* supports the City’s conclusion that Taxpayer was a contractor on the **Marketplace** project. The City asserted that the contract between Taxpayer and **ABC Company** requires Taxpayer to perform the same duties that the Court cited in the *Ormond* case in concluding that *Ormond* was a contractor. The City noted that in the *Ormond* case, the Court relied on the fact that *Ormond* was not a party or a signatory to any of the contracts and that the trade contractors could look only to the owners, if they were not paid. As a result, the Court concluded that *Ormond* was merely a conduit for payments from the owner to the subcontractors and those payments were not includable in gross income. The City asserted that unlike *Ormond*, Taxpayer’s contract with **ABC Company** clearly indicates Taxpayer is responsible for completion of the project and that the total contract is the amount of **ABC Company**’s total costs, plus a fixed fee. The City noted that all of the contracts with trade contractors are only between Taxpayer and the trade contractors. The City argued that in the event of non-payment, the trade contractors can look only to Taxpayer and not to **ABC Company**. Accordingly, the City concluded all of the payments received by Taxpayer pursuant to the contract with **ABC Company** are includable in Taxpayer’s gross income.

The City disputed Taxpayer’s argument that payments to trade contractors should be excluded because each trade contractor completed an Arizona Form 5005 (“Form 5005”) indicating responsibility for payment of privilege tax. The City noted that Form 5005 indicates “the purpose of this form is to provide a subcontractor with the validation required for tax exemption of a particular project, for a period of time, or until revoked.” The City asserted Taxpayer was the general contractor and payments flowed from the Taxpayer to the subcontractors. The City opined the Form 5005’s were meaningless since there were no payments flowing from the subcontractors to Taxpayer on which an exemption could be claimed. The City argued that Taxpayer could not relieve itself of its obligation under the law by a contractual agreement with its subcontractors.

The City disputed Taxpayer’s claim that the City was well aware all of the trade

contractors had paid sales taxes on the contracts. According to the City, all of the trade contractors have not paid transaction privilege taxes on their contracts. Since some of the trade contractors have paid transaction privilege taxes on the project, the City indicated a willingness to accept properly completed assignments and waivers from subcontractors pursuant to City Code Section 16-565 (“Section 565”). The City acknowledged that Taxpayer provided letters which authorized the release of information in connection with a development agreement between the City and *ABC Company*. However, the City asserted these letters do not satisfy the requirements for an assignment and waiver pursuant to Section 565.

The City did not allow any deductions for Taxpayer’s claim of \$702,920.51 of remediation contracting included in Taxpayer’s contract with *ABC Company*. The City noted that the contract may include some amounts that meet the definition of remediation contracting but that there was not sufficient documentation to determine the eligible amounts. The City indicated that City Code Section 16-360(a) (“Section 360”) provides that all deductions, exclusions or exemptions are conditional upon adequate proof and documentation. The City argued that Taxpayer failed to meet its burden of proof for the claimed exemption for remediation contracting. Accordingly, the City did not allow the claim.

The City disputed Taxpayer’s claim that it was entitled to a tax credit pursuant to City Code Section 16-417(3) (A) (“Section 417”) for taxes paid to another jurisdiction. The City asserted Section 417 applies to owner-builders and Taxpayer was not an owner-builder since, it had no ownership interest in the *Marketplace*.

The City disputed Taxpayer’s claim for a deduction for professional services. According to the City, City Code Section 16-415 (“Section 415”) imposes a tax on the gross income from the business activity of construction contracting within the City. The City asserted that Section 415 provides no exemption or deduction for professional services to a contractor.

In response to Taxpayer’s allegation that the City miscalculated the use tax, the City reviewed its calculations and concluded them to be correct. The City also noted that Taxpayer alleged the City included \$16,422.00 of computer purchases on which Taxpayer had paid privilege tax. The City disputed Taxpayer’s claim that it had provided invoices documenting the payment of the taxes. The City indicated a willingness to adjust the assessment if such documentation was provided.

The City noted that City Code Section 16-540(a) (“Section 540”) provides that interest may not be waived by the City or abated by the Hearing Officer unless the underlying tax is abated. The City opined that the imposition of penalties was appropriate pursuant to Section 540(f) as Taxpayer failed to report any income related to the *Marketplace* project. The City indicated that Taxpayer appeared to be arguing that it had been advised by a competent tax practitioner that no taxes were owed. The City argued that Section 540(f) permits waivers of penalties for reliance on tax practitioners that occur prior to the delinquency date of the return. In this case, the City asserted the advice came after the

audit was conducted. As a result, the City recommended no waiver of penalties.

Taxpayer Position

Taxpayer argued that it served as a construction consultant on the *Marketplace* and was paid \$781,800.00. Taxpayer asserted that since it was a consultant rather than a contractor it should not be taxed on the amounts that briefly passed through its bank accounts on the *Marketplace*, a total of \$24,184,608.83. According to Taxpayer, the only amount, if any, that it should be taxed on would be the \$781,800.00 amount it earned on the *Marketplace* (minus fees for remediation). Taxpayer noted that City Code Section 16-200 (“Section 200”) provides that gross income includes the value accruing from the providing of the services or in this case the \$781,800.00 amount.

Taxpayer argued that even if it was deemed to be a contractor, the trade contractors who worked on the *Marketplace* were construction contractors who were responsible for taxes on the amounts paid to them. Taxpayer indicated that Section 415(b) (1) provides that gross income derived from acting as a “subcontractor” is exempt from tax. Subcontractor is defined in Section 415 as a construction contractor who is performing work for a construction contractor who has provided the subcontractor with a written declaration it is liable for the tax for the project. It is also a requirement that the contractor must be provided with the general contractor’s privilege license number in order to be considered as a subcontractor. Taxpayer asserted the exact opposite occurred in this case as each trade contractor specifically acknowledged that it was a prime contractor that was responsible for taxes. Additionally, Taxpayer noted that each of the trade contractors agreed pursuant to their contract with Taxpayer that the trade contractors would pay City taxes. According to Taxpayer, each of the trade contractors wrote a letter to the City stating that the trade contractor(s) was responsible for sales tax and each trade contractor signed a Prime Contractor’s Certificate (“Certificate”) with the Arizona Department of Revenue (“DOR”). As a result, Taxpayer argued each of the trade contractors were not subcontractors but rather prime contractors.

Taxpayer asserted that its contract with *ABC Company* differed substantially from a general contractor agreement. Taxpayer opined that a general contractor charges a set fee for a project and then negotiates with subcontractors and pays them. Taxpayer indicated that its contract with *ABC Company* provides that Taxpayer would receive a set fee for its services. According to Taxpayer it was to collect the amounts owing from *ABC Company* for the trade contractors and pass those exact amounts on to the trade contractors. Taxpayer expressed a belief that the City was well aware all of the trade contractors paid the City sales taxes on their contracts. Taxpayer noted the contracts totaled \$19,306,370.00. Taxpayer argued that the City is now demanding to be paid for the taxes a second time.

Taxpayer asserted that work performed in remediation of hazardous material is exempt from taxation. Taxpayer claimed that approximately \$702,920.51 of remediation was

performed on the *Marketplace* for which no remediation credit was given.

In response to the City, Taxpayer asserted it was not responsible for the actual performance of the construction contract by the trade contractors. According to Taxpayer, its Scope of Work during the construction phase of the contract was as follows:

“Preparation of trade contractors approved for use by the Owner; preliminary lien information, review and correction; preparation, review, and processing of applications for payment; change order preparation, processing, and contract modification; construction costs updates (line item), and budget comparison; revise and refine project construction budgets and monetary draw schedule on a monthly basis incorporating approved changes, and identify variances between actual and budgeted costs; lien waiver processing and filing; provide project update summary reports and field logs on a monthly basis; assess progress of the project, delays (if any) and the percentages of completion of trade contractors’ work”

Based on the above, Taxpayer argued there was no requirement for it to perform or supervise any of the actual construction. Taxpayer indicated it was only required to administer the trade contracts. Taxpayer noted that each of the contracts with the trade contractors reflected that *ABC Company* had the financial responsibility and funds available to fully fund and complete their respective agreements. As a result, Taxpayer asserted the trade contractors had acknowledged that the ultimate legal responsibility for paying them was with *ABC Company*.

According to Taxpayer, each of the trade contractors signed a Form 5005 indicating that it would be liable for the taxes. Taxpayer asserted that a subcontractor signing a Form 5005 assumes the prime contracting transaction privilege tax liability. Taxpayer noted that ARS Section 42-5075(E) (“Section 5075”) provides as follows:

“if the person who provides the certificate is not liable for tax as a prime contractor, that person is nevertheless deemed to be the prime contractor in lieu of the contractor and is subject to the tax under this section under the gross receipts or gross proceeds received by the contractor.”

Since the trade contractors were personally responsible for the taxes on the *Marketplace*, Taxpayer argued that would dispose of the City’s request that the trade contractors submit an Assignment and Waiver form (“Assignment”) pursuant to Section 565 in order to credit Taxpayer for tax payments made by the trade contractors. Taxpayer asserted that Section 565 simply does not apply because it is only applicable when it determined that the taxes have been reported and paid to the City by the wrong taxpayer. In this case, Taxpayer asserts that the wrong taxpayer has not paid the taxes on the *Marketplace*.

Taxpayer indicated that the terms of the *ABC Company* contract provided that Taxpayer would administer contracts with trade contractors, not perform them. Taxpayer argued that it did not assume the duties of a general contractor responsible for construction of the *Marketplace*. As discussed in *Ormond*, since Taxpayer did not have the responsibility to complete the trade contractors’ work, Taxpayer could not be considered a contractor for that work. Taxpayer noted that Section 100 defines a “construction contractor” as a

person who undertakes the construction, alternation, repair and/or improve a building, structure or project. Taxpayer argued that each of the trade contractors fits the definition of construction contractor.

Taxpayer requested all interest and penalties be waived. Taxpayer indicated that since the City has received all tax payments to which the City was entitled, Taxpayer opined it was unjust for the City to claim interest. According to Taxpayer, it has consistently filed and paid City taxes in a timely manner. Additionally, Taxpayer asserted that a tax advisor has advised Taxpayer that the taxes demanded by the City were not proper. Accordingly, Taxpayer requested the penalties be waived.

ANALYSIS

The first issue to be resolved is whether or not Taxpayer was a construction contractor. As noted by the parties, Section 100 provides a broad definition for a construction contractor. It is defined as a person that undertakes or offers to undertake to or does himself or through others construct, alter, etc. a building or structure or project, etc. We conclude based on the testimony and review of the contract between *ABC Company* and Taxpayer that Taxpayer was clearly a construction contractor pursuant to Section 100. The contract refers to Taxpayer as a contractor; Taxpayer was required to fully execute and perform the entirety of the scope of the work set forth in the contract; Taxpayer developed a list of subcontractors for *ABC Company* to choose from; Taxpayer was to be solely responsible for the methods and means of accomplishing the work; Taxpayer was to be paid for the actual cost of the work plus a contractor's fee; and Taxpayer had full responsibility for performance of the work and direction of the work force. Consistent with the definition set forth in Section 100 and the *Ormond* case, we conclude Taxpayer was a construction contractor.

As noted by Taxpayer, the Court in *Ormond* did not include the amounts in gross income that Ormond received to pay other contractors on behalf of the project owners. We find the facts in this case are sufficiently different from *Ormond* to lead us to a different conclusion. In this case, Taxpayer contracted directly with each of the trade contractors. Taxpayer had the authority to order changes at any time to the work; Taxpayer was obligated to pay the trade contractors for the contract amount of their work; and, before final payment was made to the trade contractors, Taxpayer had to accept the work of the trade contractors. Based on all the above, we conclude that the amount of Taxpayer's gross income for the *Marketplace* project included the amounts paid to the trade contractors. As a result, we uphold the City's determination of gross income pursuant to Section 415.

Taxpayer protested the City's error rate which was used to calculate the use tax assessment. While the City originally had calculated an error rate of 17.67 percent, it was subsequently adjusted downward to 13.3 percent. As that error rate was less than the error rate proposed by Taxpayer, we shall approve the City's 13.3 percent error rate.

Taxpayer protested the City's failure to allow an exemption for \$702,920.51 of alleged remediation costs. We note the definition of construction contractor states that it excludes remediation contracting. Section 360 places the burden of proof upon the taxpayer claiming an exemption, deduction, or exclusion. As a result, the burden of proof was on Taxpayer to demonstrate it was entitled to an exemption for remediation costs. Section 100 provides a definition for remediation costs. Taxpayer provided testimony that it used a broader definition for remediation costs than the definition set forth in Section 100. As a result, we are unable to determine how much, if any, of the proposed \$702,920.51 meets the definition set forth in Section 100. Accordingly, we conclude that Taxpayer has failed to meet its burden of proving it should be allowed an exemption for \$702,920.51 of alleged remediation costs.

As part of the process, the City was able to ascertain that the trade contractors have paid \$187,082.63 in City taxes on the *Marketplace* during the audit period. The City has refused to allow Taxpayer a credit for this amount because of concerns that the trade contractor(s) will subsequently present a written declaration from Taxpayer that the trade contractor(s) are not liable for such tax. Pursuant to the City's assessment they will be collecting the \$187,082.63 twice. Without a written declaration from Taxpayer pursuant to Section 415(c), the trade contractors cannot be considered as subcontractors. Taxpayer has provided sworn testimony that no such declaration has been provided nor will they subsequently be provided. As a result, we do not share the City's concerns regarding a tax credit being granted to Taxpayer which would be followed by a trade contractor providing a written declaration from Taxpayer. For that to happen, Taxpayer would have had to commit perjury. Based on the above, we conclude Taxpayer should receive a tax credit in the amount of \$187,082.63 for taxes paid by the trade contractors. While Taxpayer has requested subpoenas to be issued to the trade contractors to determine the amount of taxes paid by the trade contractors, we shall not grant that request. The City has determined the total amount of taxes that were paid by the trade contractors for the *Marketplace* project for the audit period. Issuing of subpoenas will not change the amount of tax credit and as a result would not change our Decision.

Since Taxpayer failed to timely pay taxes, the City was authorized pursuant to Section 540 to assess interest and to assess penalties for late payment. Section 540 does not permit any waiver of interest unless the underlying taxes are also abated. As a result, no interest can be waived on the remaining taxes that are owed. The penalties shall be waived if there is a demonstration by the taxpayer of reasonable cause for failing to pay the taxes in a timely manner. With the exception of the \$781,800.00 fee collected by Taxpayer, we do find Taxpayer has presented reasonable cause for failing to timely pay taxes on the remaining taxable income. While we did not agree with Taxpayer's arguments on non-inclusion of the monies paid to the trade contractors, we find the Taxpayer's arguments could be made by a reasonable businessperson. Accordingly, we conclude all penalties should be waived with the exception of those penalties assessed on the \$781,800.00 amount.

Taxpayer has requested reimbursement of fees and costs related to this matter. We note

that City Code Section 578 (“Section 578”) provides that such a request should be presented to the City’s Taxpayer Resolution Officer. We also note that Section 578 provides the fees and costs may be reimbursed if the taxpayer is the prevailing party. For a taxpayer to be considered as the prevailing party there must be a finding that the City’s position was not substantially justified and the taxpayer must prevail on the most significant issue or set of issues. As the Presiding Officer, we conclude the most significant issue(s) was whether or not Taxpayer was a contractor and what the amount of Taxpayer’s gross income was. Taxpayer did not prevail on those issues. While the tax credit issue was a significant dollar amount, we do not conclude it was the most significant issue.

FINDINGS OF FACT

1. On February 14, 2007, Taxpayer filed a protest of a tax assessment made by the City.
2. After review, the City concluded on December 26, 2007, that the protest was timely and in the proper form.
3. On December 31, 2007, the Hearing Officer ordered the City to file a response to the protest on or before February 14, 2008.
4. On February 14, 2008, the City filed a response to the protest.
5. On February 21, 2008, the Hearing Officer ordered Taxpayer to file any reply on or before March 13, 2008.
6. On February 28, 2008, the City requested Taxpayer’s reply deadline be extended to April 14, 2008, in order to allow the parties time to discuss a possible settlement.
7. On March 5, 2008, the Hearing Officer extended Taxpayer’s reply deadline until April 14, 2008.
8. On April 14, 2008, Taxpayer filed a reply.
9. On May 14, 2008, a Notice scheduled this matter for hearing commencing June 23, 2008.
10. On May 14, 2008, a Notice rescheduled the hearing to commence on June 26, 2008.
11. Both parties appeared and presented evidence at the June 26, 2008 hearing.
12. On June 27, 2008, the Hearing Officer indicated the record was closed and a written decision would be issued on or before August 11, 2008.

13. Taxpayer obtained a transaction privilege license with the City on April 17, 1995.
14. Taxpayer described its business as “general contractor, remodeling.”
15. The City conducted an audit of Taxpayer for the period October 2003 through September 2007.
16. The City assessed Taxpayer for additional taxes in the amount of \$270,172.25, interest up through October 2007 in the amount of \$13,919.07, and penalties totaling \$25,560.75.
17. Taxpayer entered into an agreement in February 2006 with **ABC Company** for the construction of infrastructure improvements for a shopping center known as the **Marketplace**.
18. The **Marketplace** was the only significant activity by Taxpayer in the City during the audit period.
19. During the audit period, the trade contractors paid City taxes on the **Marketplace** project totaling \$187,082.63.
20. Taxpayer entered into a February 15, 2006 agreement with **ABC Company** to act as the contractor on the **Marketplace** project.
21. The agreement with **ABC Company** provided for Taxpayer to receive the total costs of the **Marketplace** project plus a contractor’s fee.
22. The agreement with **ABC Company** provided that Taxpayer had the full responsibility for performance of the work and direction of the work force.
23. The agreement provided that Taxpayer was solely responsible for the methods and means of accomplishing the work.
24. Each trade contractor completed a Form 5005 indicating responsibility for payment of privilege taxes.
25. Taxpayer requested an exemption for \$702,920.51 of claimed remediation costs.
26. Taxpayer utilized a broader definition for remediation costs than the definition set forth in Section 100.
27. The City calculated a use tax error rate of 17.67 percent which was subsequently revised to a rate of 13.3 percent.
28. Taxpayer received a fee of \$781,800.00 for the **Marketplace** project.

29. Taxpayer did not provide any of the trade contractors with a written declaration that Taxpayer would be responsible for tax for the *Marketplace* project.
30. Each of the trade contractors signed a Form 5005 indicating each trade contractor would be liable for the City taxes on the *Marketplace* project.
31. Taxpayer entered into contracts directly with the trade contractors.
32. The work of the trade contractors had to be acceptable to Taxpayer.

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. Pursuant to Section 100 and the *Ormond* case, Taxpayer was a construction contractor.
3. Taxpayer was obligated to pay the trade contractors pursuant to the contracts between Taxpayer and each trade contractor.
4. The City's determination of a 13.3 percent error rate for use tax calculations was reasonable.
5. The amounts Taxpayer contracted to pay the trade contractors was properly included in Taxpayer's gross income by the City.
6. Taxpayer failed to meet its burden of proof pursuant to Section 360 that it should be allowed an exemption for \$702,920.51 of alleged remediation costs.
7. Failure to provide Taxpayer with a tax credit of \$187,082.63 for City taxes paid by the trade contractors for work on the *Marketplace* project will result in the City collecting that amount of taxes twice for the same work.
8. Issuing of subpoenas will not change the amount of the tax credit and as a result would not change our Decision.
9. Taxpayer would be guilty of perjury if the trade contractor(s) received a written declaration from Taxpayer pursuant to Section 415.
10. Since Taxpayer failed to timely pay taxes, the City was authorized to assess penalties for late payment.

11. Section 540 does not permit any waiver of interest unless the underlying taxes are abated.
12. With the exception of the \$781,800.00 fee collected by Taxpayer, we conclude Taxpayer has presented reasonable cause to have the penalties for late payment waived.
13. Taxpayer did not prevail on the most significant issue in this matter.
14. Taxpayer's protest should be partly granted and partly denied consistent with the Discussion, Findings, and conclusions, herein.

ORDER

It is therefore ordered that the December 14, 2007 protest by *Taxpayer* of a tax assessment made by the City of Tempe is hereby partially granted and partially denied, consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Tempe shall credit *Taxpayer* for taxes paid by the trade contractors in the amount of \$187,082.00.

It is further ordered that the City of Tempe shall waive all late payment penalties except for those assessed on the fee amount of \$781,800.00.

It is further ordered that this Decision is effective immediately.

Municipal Tax Hearing Officer