DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: March 1, 2010
Decision: MTHO # 541
Taxpayer: ***Taxpayer***
Tax Collector: City of Tempe
Hearing Date: None

DISCUSSION

Introduction

On September 1, 2009, a letter of protest was filed by ***Taxpayer*** of a tax assessment made by the City of Tempe ("City"). At the request of Taxpayer, this matter was classified as a redetermination. After final submission of all memoranda by the parties, the Municipal Tax Hearing Officer ("Hearing Officer") closed the record on February 16, 2010 and indicated a written decision would be issued on or before April 2, 2010.

DECISION

On July 21, 2009, the City issued an audit assessment of Taxpayer for the period January 2007 through May 2009. The assessment was for additional taxes in the amount of $16,265.02, interest up through July 2009 in the amount of $1,461.57, penalties in the amount of $3,999.07, and licensing fees of $200.00. Subsequently, the City waived all the penalties. Taxpayer is a limited liability company ("LLC") formed on November 7, 2006. The sole member owning a twenty percent or greater interest in the capital or profits of the LLC was ***Family Trust***, ***Trustees***. ***Trustees*** were the appointed managers of Taxpayer. In December 2006, Taxpayer purchased the land and building located at ***University Property*** in the City. The ***University Property*** was to be used by ***Business*** to operate a membership buying club. ***Trustees*** were the only shareholders of the corporation holding more than twenty percent of the corporation's stock. Taxpayer had entered into a loan agreement with the Small Business Administration ("SBA") in order to purchase the ***University Property***. The SBA required a lease agreement be in place between Taxpayer and ***Business*** whereby ***Business*** would make monthly lease payments to Taxpayer equivalent to the loan payments made by Taxpayer to the SBA. Pursuant to the agreement between Taxpayer and **Business**, ***Business*** was responsible for all maintenance and upkeep of the ***University Property*** and would make the property tax payments. A Memorandum of Lease ("Memorandum") between Taxpayer and ***Business*** was recorded in connection with the SBA loan.

Taxpayer disputed the City's conclusion that it was "engaged in business". Taxpayer relied on the Arizona appellate decisions in Construction Developers, Inc. v. City of

Phoenix, 194 Ariz.165, 978 P.2d 650 (App. 1999) and/or Arizona State Tax Commission v. First Bank Building Corp., 5 Ariz. App. 594, 429 P.2d 481 (1967). Taxpayer argued that the mere receipt of monies and/or the relief from an obligation (e.g., payment of a mortgage or payment of ad valorem real property taxes) cannot, without more, be deemed to be in reality something it is not.

The City noted that City Code Section 16-100 ("Section 100") defines "business" as follows: Business means all activities or acts, personal or corporate, engaged in and caused to be engaged in with the object of gain, benefit or advantage, either direct or indirect, but not casual activities or sales. The City asserted that Taxpayer and ***Business*** had represented to the lending institutions involved and the SBA that Taxpayer was in business for the purposes of leasing commercial property to ***Business***. According to the City, Taxpayer and ***Business*** received the following benefits: Taxpayer received the benefit of having its prime SBA loan obligations paid by ***Business***; ***Business*** could transfer ownership of the operating company without affecting the real estate, and vice-versa; the ability to keep the debt associated with the real estate off the financial statements of the operating company; and, the ability to shield the real estate from the general liabilities, including potential tax liens, of the operating entity. The City concluded that Taxpayer was engaged in the business of owning, leasing, and borrowing against real estate which was business in nature and provided substantial gain, benefit, and advantage to its principals. The City disputed Taxpayer's reliance on the Construction Developers case and the First Bank Building case. The City noted that both of those cases involved transactions between a parent company and a wholly-owned subsidiary. The City indicated that while the Taxpayer and ***Business*** have common ownership, there was no direct ownership between the two entities. The Construction Developers case involved a dormant shell corporation and there was no outside financing involved or any leases between the parties. The City asserted that the First Bank Building case involved the application of State law and involved the business of renting office buildings and operating garages. The City noted that the Court had concluded that First Bank was engaged in business. In response to Taxpayer, the City argued that this case involved a simple SBA loan arrangement and was not a Synthetic Lease. The City asserted there were no provisions in the lease for transfer of title either during or upon expiration of the lease.

Taxpayer also argued that the leasing arrangement in this matter was a casual activity which would be exempt from tax. Taxpayer cited the decision in State v. Selby, 25 Ariz. App. 500, 544 P.2d 717(App. 1976), and the decision in Young v. Town of Vienna, 203 Va. 265, 123 S.E.2d 388 (1962) to support its position that the lease in this matter was a casual activity. The City noted that the Selby case was based on State law and that the State does not have a definition of "casual activities or sales". In response to Taxpayer, the City asserted the City Code makes no presumption that the lessor has agreed to accept any obligations other than the fact that it sought to obtain some type of gain, benefit, or advantage in leasing its real property. In response to Taxpayer, the City asserted the City's definition of casual activities does not give rise to any equal protection violation. Based on the above, the City requested the assessment be upheld.
The issue we have to resolve is whether or not Taxpayer had income from the business

activity of engaging in the business of leasing or renting real property pursuant to City Code Section 16-445 ("Section 445"). As noted above, Section 100 defines "business". Additionally, Section 100 defines "persons" to mean an individual, firm, partnership, joint venture, association, corporation, etc. Clearly, Taxpayer and ***Business*** were separate "persons" pursuant to Section 100. The parties were in general agreement as to the facts of this matter but were in disagreement as to the conclusions to be reached. As noted above, there was a Memorandum between Taxpayer and ***Business*** that was in place as a requirement for the SBA loan to Taxpayer. ***Business*** was responsible for all maintenance and upkeep of the ***University Property*** and would make the property payments. The SBA required a lease to be in place between Taxpayer and ***Business*** with the term of the lease to be at least the term of the loan. The lease payments must be no more than is necessary to amortize debt plus pay expenses related to holding the property and the rents are to be assigned to SBA/Southwestern Business Financing Corporation ("CDC"). It's clear from the SBA loan documents that the SBA required a lease to be in place between Taxpayer and ***Business***. We conclude that the December 15, 2006 Memorandum between Taxpayer and ***Business*** is clearly a lease as required by the SBA and as set forth in Section 445. Taxpayer has argued it is not a true lease because Taxpayer did not have any responsibility to maintain the structure or render services which would constitute the acts of a landlord. Taxpayer argued that the City has attempted to create an irrebuttable presumption that Taxpayer has indulged in recognized and customary activities attendant to an entity involved in a true leasing/rental business. In reviewing the City's response, we conclude the City has made no such claim regarding Taxpayer having maintenance responsibilities. In the Selby case, the Court had concluded that the activities of the Selby's (lessor) were entered into with the object of "gain, benefit or advantage," even though the lessee did 100 percent of the maintenance and upkeep of the premises. Consistent with Selby, the activities of Taxpayer were entered into for the object of "gain, benefit or advantage", even though ***Business*** was responsible for the maintenance and upkeep of the ***University Property***. It is clear that Taxpayer and ***Business*** have entered into a long term lease which obligates ***Business*** to make payments directly to the loan authority on behalf of Taxpayer. Additionally, ***Business*** took care of the maintenance and upkeep of the ***University Property*** on behalf of Taxpayer. The lease arrangement also permitted the parties to shield the real estate from the general liabilities of the operating entity. While the Court in the Selby case had concluded the activities of Selby resulted in gain, benefit or advantage, the Court also concluded the Selby's did not have enough activity to constitute doing "business" pursuant to A.R.S. Section 42-1309 ("Section 1309"). The Arizona Department of Revenue ("DOR") definition of "business" was the same as the City definition of "business" in that both made it clear that the definition did not include "casual activities". Since the DOR did not have a definition of "casual activities", the Court in Selby utilized Webster's International Dictionary to define "casual" and concluded the activities of the Selby's were casual and as a result did not rise to the level of constituting being "engaged in business". Unlike the DOR, the City has included a definition of "casual activities" in Section 100 which indicates no sale, rental, or lease transaction concerning real property shall be treated as casual. Because of that definition, we do not reach the same conclusion as in Selby. Based on the City's definition of casual, we conclude that Taxpayer in this matter was engaged in the business activity of leasing or renting real property pursuant to Section 445. While

Taxpayer has challenged the constitutionality of the City's definition of "casual", we consider all statutes as being constitutional until a court rules otherwise.

Taxpayer has also argued that because the DOR and the City have the same definition of "business", that pursuant to A.R.S. 42-6005(D) ("Section 6005"), the City must follow the DOR's interpretation when the DOR has issued written guidance. Taxpayer referred to written guidance set forth in ADOR LR03-002. We simply disagree with Taxpayer's conclusion that the definition of "business" is the same for the City and the DOR. While the language may appear to be the same, when one includes the City's definition of "casual", the definitions are different and Section 6005 does not apply. Additionally, pursuant to A.R.S Section 42-2101(F) ("Section 2101") the Hearing Officer is precluded from relying on a private taxpayer ruling. We concur with the City's analysis of the Construction Developers case and the distinctions to this matter. We also note that the Court concluded that it could not sustain the City's assessment unless the Court could also determine that CDI leased to Dillard's for a consideration. In this case, we have such a lease in place. In the First Bank Building case, the Court concluded that the Plaintiff was organized for the purpose of doing business and was engaged in such activities by acquiring property, erecting buildings, executing leases and collecting rents. In doing so, First Bank was exercising corporate powers, taking in substantial gross receipts which benefit the corporation. The Court then considered separately whether First Bank was involved in the business of renting of office buildings and the operation of parking garages. As a result, we concur with the City that the facts in this case are distinguishable from the facts in the First Bank Building case.

Lastly, we have Taxpayer's argument that there was no true lease between Taxpayer and ***Business***. Taxpayer argued that the arrangement between Taxpayer and ***Business*** was a "synthetic lease" financing agreement. We reviewed the documents between Taxpayer, ***Business***, and the SBA and could find no reference to any "synthetic lease". It is clear from those documents that the SBA relied on a true lease being in place between Taxpayer and ***Business*** in order to approve the loan to Taxpayer. Since the loan was approved, we conclude that the SBA was satisfied there was a true lease in place. The lease structure provided the SBA and Taxpayer with the ability to shield the real estate from the general liabilities of ***Business***. Accordingly, we conclude there was a true lease between Taxpayer and ***Business*** as required by the SBA. Based on all the above, we conclude that during the audit period, Taxpayer was in the business of leasing or renting real property within the City for a consideration. Accordingly, Taxpayer's protest should be denied.

FINDINGS OF FACT

1. On September 1, 2009, Taxpayer filed a protest of a tax assessment made by the City.

2. On July 21, 2009, the City issued an audit assessment of Taxpayer for the period of January 2007 through May 2009.

3. The City assessed Taxpayer for additional taxes in the amount of $16,265.02, interest up through July 2009 in the amount of $1,461.57, penalties totaling $3,999.07, and licensing fees of $200.00.

4. Subsequently, the City waived all penalties.

5. Taxpayer is an LLC formed on November 7, 2006.

6. The sole member owning a twenty percent or greater interest in the capital or profits of the LLC was ***Family Trust***, ***Trustees***.

7. ***Trustees*** were appointed the managers of Taxpayer.

8. In December 2006, Taxpayer purchased the land and building located at ***University Property*** in the City.

9. The ***University Property*** was to be used by ***Business*** to operate a membership buying club.

10. ***Trustees*** were the only shareholders of the corporation holding more than twenty percent of ***Business***'s stock.

11. Taxpayer had entered into a loan agreement with the SBA in order to purchase the ***University Property.***

12. The SBA required there to be a lease in place between Taxpayer and ***Business*** whereby ***Business*** would make monthly lease payments to Taxpayer equivalent to the loan payments made to Taxpayer to the SBA.

13. Pursuant to the agreement between Taxpayer and ***Business***, ***Business*** was responsible for all maintenance and upkeep of the ***University Property*** and would make the property tax payments.

14. A Memorandum between Taxpayer and ***Business*** was recorded in connection with the SBA loan.

15. There is no reference in the documents between Taxpayer, ***Business***, and the SBA of any "synthetic lease".

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 100 defines "business" to mean all activities or acts, personal or corporate, engaged in and caused to be engaged in with the object of gain, benefit or advantage, either direct or indirect, but not casual activities or sales.

3. Taxpayer and ***Business*** had represented to the lending institutions involved and the SBA that Taxpayer was in business for the purposes of leasing commercial property to ***Business***.

4. Taxpayer and ***Business*** were separate "persons" pursuant to Section 100.

5. Pursuant to the Memorandum between Taxpayer and ***Business*** and the SBA loan requirements, ***Business*** was obligated to pay Taxpayer a monthly lease amount for use of the ***University Property***.

6. While Taxpayer and ***Business*** had common ownership, there was no direct ownership between the two entities.

7. The activities of Taxpayer as set forth in the Memorandum with ***Business*** and the SBA documents resulted in gain, benefit or advantage for Taxpayer.

8. Section 100 defines "casual activities" to not include sales, rental, or lease of real property.

9. Pursuant to Section 100, Taxpayer's activities' regarding the lease with ***Business*** was not a casual activity.

10. The City's definition of business differs from the DOR and Section 6005 does not apply.

11. Section 2101 precludes the Hearing Officer from relying on a private taxpayer ruling.

12. During the audit period, Taxpayer was in the business of leasing or renting real property within the City for a consideration pursuant to Section 445.

13. Taxpayer's protest should be denied, consistent with the Discussion, Findings, and Conclusions, herein.

ORDER

It is therefore ordered that the September 1, 2009 protest by ***Taxpayer*** of a tax assessment made by the City of Tempe is hereby denied, consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer