

DECISION OF MUNICIPAL TAX HEARING OFFICER

March 25, 2011

Taxpayers
Taxpayer's Address

Taxpayers
MTHO #608

Dear Taxpayers:

We have reviewed the evidence submitted for redetermination by *Taxpayers* and the City of Scottsdale (Tax Collector or City). The review period covered was June 2008. Taxpayers' protest, Tax Collector's response, and our findings and ruling follow.

Taxpayers' Protest

Taxpayers were assessed City of Scottsdale privilege tax under the speculative builder classification based on the foreclosure and trustee's sale of a home Taxpayers were constructing in the City. Taxpayers had obtained financing to construct the home. The contractor hired to build the home had received funds for work not completed. The bank did not accept responsibility for releasing funds for work not completed and would not release more funds to complete the home. The home went into foreclosure and Taxpayers filed Chapter 7 Bankruptcy. Taxpayers did not sell the home and were not speculative builders. The bank that foreclosed the property was the speculative builder. Also, the amounts paid the contractor included sales taxes that the contractor should have paid to the City.

Tax Collector's Response

Taxpayers were the owners of record to the property on which the home was being constructed. Taxpayers contracted to have the home built and were therefore owner-builders. When the home was transferred by Trustee's deed, Taxpayers became speculative builders. The sale of improved real property includes any form of transaction which in substance is a transfer of title to improved real property. Taxpayers met the definition of a speculative builder. The Tax Collector cannot take into consideration Taxpayers' special circumstances leading to the foreclosure of the home. Taxpayers are liable for the tax that was assessed.

Discussion

Taxpayers acquired vacant land and contracted with a contractor to build a single-family residence on the land. Taxpayers also obtained financing from *Best Bank* to build the home. During the course of the construction, the contractor received funds for work not completed. The bank did not accept responsibility for releasing funds for work not completed. Before the construction of the home was finished, the bank stopped releasing funds for the completion of the home. Taxpayers could not complete the construction of the home.

The home was foreclosed by the bank and sold at a Trustee's sale on June 4, 2008 to **Best Bank** for \$1,418,580. Payment was made by the partial satisfaction of the debt secured by the Deed of Trust on the property.

The Tax Collector conducted an audit assessment of Taxpayers for the period June 2008 and issued an assessment to Taxpayers under the speculative builder classification. The assessment was based on the sales price at the Trustee's sale with allowable deductions and credits. Taxpayers timely protested the assessment.

The Scottsdale Tax Code (STC) governs whether and to what extent a person is taxable. Taxpayers were assessed as speculative builders. A speculative builder is defined by the Code as including an owner-builder who sells, at any time, improved real property consisting of custom homes regardless of the stage of completion. To be a speculative builder, a person has to be an owner-builder and the property sold has to be improved real property.

An owner-builder is defined as an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs any improvement to real property. Improved real property includes any real property upon which a structure has been constructed. Taxpayers owned the real property, contracted for a house to be built on the property and the house was partially completed. Taxpayers were owner-builders.

The question presented is whether Taxpayers became speculative builders when the home was foreclosed and sold at a Trustee's sale. The City argues that when the home was foreclosed and sold at a Trustee's sale, title transferred from Taxpayers to the purchaser. At that point Taxpayers became speculative builders subject to the City's privilege tax.

STC § 416 provides that the sale of improved real property includes any form of transaction which in substance is a transfer of title of improved real property. There clearly was a transfer of title when the property was sold at the Trustee's sale. The foreclosure and sale of the property resulted in the partial satisfaction of Taxpayers' obligation under the Deed of Trust. This is no different than if Taxpayers had sold the property and used the proceeds to pay the Deed of Trust. Taxpayers were speculative builders and the privilege tax was measured by the amount realized at the Trustee's sale.

Taxpayer's discharge in bankruptcy did not discharge the tax debt to the City. Taxpayers did not file a privilege tax return for the period June 2008. A bankruptcy discharge does not discharge an individual debtor from a debt for a tax with respect to which a return was not filed.

Taxpayers also stated in their protest that the amounts paid the contractor included sales taxes that the contractor should have paid to the City. STC § 416(c)(3)(B) allows a credit for taxes paid by the contractor to the City or charged separately to the speculative builder on the gross income derived by the contractor from the construction of any improvement to the real property. The documents presented by Taxpayers did not show that amounts received by the contractor included an amount for City privilege tax or that the contractor paid any tax to the City on the construction of the home.

The assessment also included failure to file and failure to pay penalties in the amount of \$3,727.20. The Tax Collector is authorized to assess penalties pursuant to STC § 540. Those penalties may be waived if a taxpayer demonstrates reasonable cause for failure to file and failure to timely pay taxes. The term "reasonable cause" is defined as a taxpayer having a reasonable basis for believing that the tax did not apply.

Taxpayers did not know about the speculative builder tax, the home was foreclosed by the bank and not voluntarily sold by Taxpayers and STC § 416 does not directly address the application of the tax in the event of a foreclosure. Given the totality of the circumstances, Taxpayers have shown reasonable cause for their failure to file a return and pay the tax assessed.

Based on all the above, Taxpayers' protest is denied regarding the assessment of privilege tax and interest and is granted regarding the waiver of late filing and late payment penalties.

Findings of Fact

1. Taxpayers purchased lot 28 of *Beautiful Village* from *Big & Lovely Homes* on September 7, 2005.
2. Taxpayers contracted with *Great Builders, LLC* for the construction of a home on the lot.
3. Taxpayers obtained financing from *Best Bank*, and entered into a Deed of Trust to secure the financing.
4. The Deed of Trust was recorded with the Maricopa County Recorder on February 17, 2006.
5. The home was not completed.
6. The property went into foreclosure.
7. The property was sold at public auction on June 4, 2008 for the amount of \$1,418,580.
8. The purchaser was *Best Bank*, the Grantee under the Deed of Trust.
9. The payment of the purchase price was made by the partial satisfaction of the obligations under the Deed of Trust.
10. Taxpayers filed for bankruptcy in December 2008 and a discharge under 11 U.S.C. § 727 was issued in March 2009.
11. The City was not listed as a creditor in Taxpayers' bankruptcy and the City did not file a proof of claim in the bankruptcy.
12. Taxpayers were not aware of the potential privilege tax obligation to the City.
13. Taxpayers did not file a privilege tax return for the period June 2008.
14. The Tax Collector conducted an audit assessment of Taxpayers for the period June 2008 and issued an assessment for city privilege tax under the speculative builder classification in the amount of \$14,908.79, penalties in the amount of \$3,727.20, interest through August 31, 2010 in the amount of \$1,420.31 and license fees and license fee penalties in the amount of \$291.75.
15. The assessment was based on the property's sales price at the Trustee's sale.¹
16. The assessment allowed an exemption for the cost of development fees, deductions for State tax paid by the developer on the original sale of the lot, City factored tax and the standard 35% deduction and a credit for the City tax paid by the developer.

¹ The assessment was based on gross receipts of \$1,408,730.62, an amount \$9, 849.38 less than the Property's sales price at the Trustee's sale. The City did not address the difference.

17. No evidence or documentation was presented showing that the contractor paid City privilege tax on the construction of the home.
18. The documents presented by the Taxpayers did not show that the amounts received by the contractor included a separately charged amount for the City privilege tax on the construction of the home.
19. Taxpayers timely protested the assessment and requested a redetermination.

Conclusions of Law

1. A speculative builder includes an owner-builder who sells, at any time, improved real property consisting of custom homes regardless of the stage of completion. STC § 100.
2. Improved real property includes any real property upon which a structure has been constructed. STC § 416(a)(2)(A).
3. Taxpayers' property was improved real property.
4. An owner-builder is defined as an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs any improvement to real property. STC § 100.
5. Taxpayers were the owners of the property and had an improvement constructed on the property by a contractor.
6. Taxpayers were owner-builders.
7. Sale of improved real property includes any form of transaction which in substance is a transfer of title of improved real property. STC § 416(a)(3).
8. The Trustee's sale transferred title to the property from Taxpayers to the bank.
9. The Trustee's sale was the sale of the property.
10. Taxpayers were speculative builders during the audit period subject to the City's privilege tax.
11. A credit is allowed for taxes paid by the contractor to the City or charged separately to the speculative builder on the gross income derived by the contractor from the construction of any improvement to the real property. STC § 416(c)(3)(B)
12. Taxpayers did not show that privilege taxes were paid to the City or were charged separately to Taxpayers.
13. A bankruptcy discharge under 11 U.S.C. § 727 does not discharge an individual debtor from a debt for a tax with respect to which a return was not filed. 11 U.S.C. § 523(a)(1)(B)(i).
14. Taxpayers' bankruptcy discharge in March 2009 did not discharge Taxpayers' City privilege tax obligation.
15. The City's assessment of privilege tax and interest against Taxpayers was proper.
16. The penalty for failure to file and to pay tax may be waived if the taxpayer can demonstrate reasonable cause for its failure to file a return or pay the tax. STC § 540.

17. Taxpayers demonstrated reasonable cause for their failure to file a return and to pay the tax that was assessed and the penalty in the amount of \$3,727.20 is abated.

Ruling

Taxpayers' protest of an assessment of privilege tax and interest made by the City of Scottsdale for the period June 2008 is denied consistent with Conclusion of Law number 15.

Taxpayers' protest of an assessment of late filing and late payment penalties made by the City of Scottsdale for the period June 2008 is granted consistent with Conclusion of Law number 17. The Tax Collector shall abate the penalties for failure to file and pay the tax that were included in assessment.

The Tax Collector's Notice of Assessment to Taxpayers for the period June 2008 is upheld.

Both parties have timely rights of appeal to the Arizona Tax Court pursuant to Model City Tax Code Section -575.

Sincerely,

Hearing Officer

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c: ***Tax Audit Manager***
Municipal Tax Hearing Office