DECISION OF MUNICIPAL TAX HEARING OFFICER

February 16, 2012

Taxpayer's Representative
Representative's Address

Taxpayer
#AA, #BB and #CC
MTHO ##666, 667 & 668

Dear Representative:

We have reviewed the arguments presented by ***Taxpayer*** in its protest, by the City of Mesa (Tax Collector or City) in its Response to the Protest and at the hearing held on January 25, 2012. The review period covered was December 2005 through July 2010 (audit period). Taxpayer's protest, Tax Collector's response, and our findings and ruling follow.

Taxpayer's Protest

Both Taxpayer and its lessee are subsidiaries of a common parent corporation. Taxpayer does not have any employees or office space. Taxpayer does not maintain the properties or provide any services to the lessee. The lessee is responsible for property taxes, maintenance, insurance, improvements, parking and infrastructure. The Arizona Court of Appeals decided in *Construction Developers Inc v. City of Phoenix,* 194 Ariz. 165, 978 P.2d 650 (App. 1998) (*CDI*) that the city privilege tax did not apply to a commercial lease between a parent and its wholly owned subsidiary. There are no significant differences between *CDI* and this case. Taxpayer is therefore not engaged in business for City privilege tax purposes and no City privilege taxes are due.

Tax Collector's Response

There is a taxable transaction between Taxpayer and its lessee. This case is distinguishable from *CDI* because, unlike in *CDI*, here the parties had written lease agreements, Taxpayer received consideration in the form of rental payments and Taxpayer was not a dormant shell corporation. Taxpayer engaged in business within the meaning of the Mesa Tax Code (MTC) and is therefore subject to tax on its commercial leasing activities. The City's assessment should be upheld.

Discussion

Taxpayer is the owner of three parcels of real property in the City that it leases to ***Taxpayer A.*** ***Taxpayer A*** is owned by Taxpayer. Both Taxpayer and ***Taxpayer A*** are subsidiaries of ***Taxpayer B***. ***Taxpayer A*** operates a restaurant at each location.

Taxpayer and ***Taxpayer A*** entered into written lease agreements for each of the locations. During the audit period ***Taxpayer A*** made yearly lease payments to Taxpayer for the leases of the properties. ***Taxpayer A*** is also responsible for property taxes, maintenance, insurance, improvements, parking and infrastructure. Taxpayer does not maintain the properties or provide any services to the lessee. Taxpayer does not have separate employees or a separate business

location apart from its parent. Taxpayer maintains a separate bank account and pays dividends to its shareholders.

Taxpayer did not pay the City privilege tax during the audit period. After reviewing Taxpayer's activities, the Tax Collector issued an assessment for each property to Taxpayer under the commercial leasing classification for the period December 2005 through July 2010. The assessments included the rental payments and the payments made by ***Taxpayer A*** for property taxes, maintenance, insurance, improvements, parking and infrastructure. There is no dispute between the parties as to the numbers used in the assessments.

Taxpayer timely protested the assessments contending that it was not engaged in the business of leasing or renting real property. Citing *CDI,* Taxpayer contends that because both Taxpayer and ***Taxpayer #2*** are subsidiaries of the same parent, Taxpayer does not have any employees or office space and Taxpayer does not maintain the properties or provide any services to the lessee, Taxpayer is involved in a passive activity and is not engaged in business within the meaning of the MTC.

The Tax Collector contends that Taxpayer's activities are taxable under the MTC. Taxpayer entered into written lease agreements and received rent payments. Taxpayer and its lessee are separate persons under the MTC. Taxpayer's activity of leasing the real property for a consideration is thus a taxable activity and Taxpayer is liable for the taxes that were assessed. The Tax Collector further argues that *CDI* is distinguishable on its facts.

For the reasons that follow, we hold that Taxpayer was engaged in the business of leasing or renting real property within the City for a consideration and therefore Taxpayer is liable for the taxes that were assessed.

Taxpayer's activities are taxable under the Mesa Tax Code.

MTC § 5-10-445 imposes the privilege tax on the business activity of renting, leasing or licensing for use real property located in the City to the tenant in actual possession or to the final licensee for a consideration. Each element is met.

It is not disputed that Taxpayer leased real property in the City to the tenant in actual possession and that Taxpayer received rental payments. The rental payments constitute consideration. The only question is whether Taxpayer was involved in the business activity of leasing the real property.

MTC § 5-10-100 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. MTC § 5-10-100 defines "casual activities" as not including the rental or lease of real property. MTC § 5-10-100 defines the term "Engaging", when used with reference to engaging or continuing in business, to include the exercise of corporate or franchise powers.

Taxpayer exercised corporate powers by entering into the lease agreements and collecting rental payments for the properties. Taxpayer also received a benefit when it received the rental payments. Under the language of the MTC, Taxpayer was engaged in the business activity of leasing or renting real property within the City for a consideration.

Construction Developers, Inc. v. City of Phoenix **is distinguishable.**

Taxpayer relied on *CDI* to argue that Taxpayer is not engaged in business in the City and its activities should not trigger the application of the City transaction privilege tax. The Tax Collector

contends that *CDI* is distinguishable on its facts. While the Tax Collector cited numerous differences, the most significant are:

- CDI was a dormant shell corporation,
- There was no written lease agreement between CDI and its parent and CDI never collected rent or other revenues, and
- CDI did not receive consideration.

Taxpayer was not a dormant shell corporation.

CDI was a subsidiary established to hold title to property used by its parent in the parent's business. Third-party lenders had required the parent to place title to the properties it acquired in a separate entity. More than a year before the audit period in *CDI*, the parent had ceased obtaining outside financing for store property acquisitions. Although the parent no longer had a reason to place title to acquired stores or properties in CDI, it continued to do so, apparently out of habit.

In its opinion, the Court of Appeals distinguished cases cited by the city because those cases did not involve a dormant shell subsidiary like CDI. The court thus considered the distinction relevant. Taxpayer here is not a dormant shell corporation.

At the minimum, Taxpayer received gain, benefit or advantage by receiving rental payments.

The court in *CDI* stated that that the city never brought forward any admissible evidence tending to establish that CDI engaged in conduct for some direct or indirect benefit. CDI had not entered into any lease agreements, never collected rents or other revenues and there was no evidence that CDI exercised any corporate powers during the audit period. Here, Taxpayer received a benefit in the form of rental payments and also exercised corporate powers by entering into the lease agreements and collecting rents.

Taxpayer received consideration.

The court in *CDI* also stated that it could not sustain the city's assessment unless the court also determined that CDI leased to the parent for a consideration. In this case Taxpayer had leases with ***Taxpayer A*** and received rent payments under the leases. The rent payments clearly constitute consideration.

Because Taxpayer is not a dormant shell corporation, received benefits and consideration and exercised corporate powers, *CDI* is distinguishable.

***Arizona State Tax Commission v. First Bank Building Corp.* is not applicable.**

Taxpayer also relied on *Arizona State Tax Commission v. First Bank Building Corp.*, 5 Ariz. App. 594, 429 P.2d 481 (1967) to argue that a building owner was not engaged in business even though it received funds from its tenants. Taxpayer misreads the *First Bank Building* case.

First Bank involved state transaction privilege taxes on the rental and use of several properties owned by First Bank. After reviewing the leases and properties at issue, the court first considered whether First Bank was engaged in business. The definitions of "business" and "engaging" were similar to those in the MTC. The court held that First Bank was organized for the purpose of doing business and actually was engaged in such activities by acquiring property, erecting buildings, executing leases and collecting rents. First Bank exercised corporate powers, taking in substantial gross receipts that benefited the corporation. The court concluded that First Bank's activities were not casual and were done for gain, benefit or advantage. That part of *First Bank*

supports the Tax Collector's position that Taxpayer is engaged in business by executing leases and collecting rents.

After concluding that First Bank was engaged in business, the court separately considered the properties and leases involved to determine whether First Bank was engaging in the taxable business of "office buildings" or "parking lots". Thus the court's holding in *First Bank* was not that First Bank was not engaged in business, but that it was not engaged in the business of "office buildings" or "paring lots" with some of its leases.

In its opinion the Court interpreted the meaning of "office buildings" and "parking lots" as meaning that the tax is on any person who runs, operates or engages in a business that rents offices or parking space in parking lots. The tax here is imposed on the rental or leasing of real property, not on the more limited business of office buildings or parking lots. As a result *First Bank* does not support Taxpayer's position.

Based on all the above, we conclude Taxpayer's protest should be denied. The City's privilege tax assessment against Taxpayer was proper.

Findings of Fact

1. Taxpayer is the owner of real property in the City.
2. Taxpayer is a subsidiary of ***Taxpayer B***.
3. ***Taxpayer B*** also owns ***Taxpayer #2***.
4. ***Taxpayer #2*** owns ***Taxpayer A.***
5. During the audit period Taxpayer leased three properties in the City to ***Taxpayer A***.
6. ***Taxpayer A*** operated restaurants at the three locations.
7. Taxpayer and ***Taxpayer A*** entered into written lease agreements for each of the locations. Copies of the leases were not submitted into the record.
8. During the audit period ***Taxpayer A*** made yearly lease payments to Taxpayer for the leases of the properties.
9. Taxpayer maintains a separate bank account and pays dividends to its shareholders.
10. Taxpayer does not maintain the properties or provide any services to ***Taxpayer A***.
11. ***Taxpayer A*** is also responsible for property taxes, maintenance, insurance, improvements, parking and infrastructure.
12. Taxpayer does not have separate employees or a separate business location apart from its parent.
13. During the audit period Taxpayer did not pay privilege tax on its leases.
14. The City reviewed Taxpayer's activities in the City for the period December 2005 through July 2010.
15. The Tax Collector issued assessments to Taxpayer under the commercial leasing classification for its leases to ***Taxpayer A*** for the period December 2005 through July 2010.
16. There is no dispute between the parties as to the numbers used in the assessment. The sole issue is whether Taxpayer is subject to the City privilege tax during the audit period on its leases of real properties.

17. Taxpayer has paid the assessments.

18. Taxpayer timely protested the assessments contending that it was not engaged in the business of leasing or renting real property.

Conclusions of Law

1. MTC § 5-10-445 imposes a privilege tax on the business activity of renting, leasing or licensing for use real property located in the City to the tenant in actual possession or to the final licensee for a consideration.

2. MTC § 5-10-100 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 ***Taxpayer A*** were separate "persons" pursuant to MTC § 5-10-100.

4. Taxpayer's activities of leasing properties and receiving lease payments resulted in gain, benefit or advantage for Taxpayer.

5. MTC § 5-10-100 defines "casual activities" not including sales, rental, or lease of real property.

6. Pursuant to MTC § 5-10-100, Taxpayer's activities regarding the leases with ***Taxpayer A*** were not a casual activities.

7. MTC § 5-10-100 defines the term "Engaging", when used with reference to engaging or continuing in business, to include the exercise of corporate or franchise powers.

8. Taxpayer exercised corporate powers by entering into lease agreements and receiving rents for the properties it leased within the City.

9. Taxpayer received consideration for its lease of the properties in the form of lease payments and by ***Taxpayer A*** being responsible for property taxes, maintenance, insurance, improvements, parking and infrastructure.

10. During the audit period, Taxpayer was engaged in the business of leasing or renting real property within the City for a consideration.

11. Taxpayer was subject to the City privilege tax under the commercial lease classification.

12. The amount of the tax is measured by the income Taxpayer receives from the business activity. MTC § 5-10-445(a).

13. Taxable income from the business activity of leasing or renting real property includes payments by the tenant for property taxes, repairs, maintenance, insurance and other services that may normally be provided by a landlord in connection with the lease. MTC § 5-10-445(a)(1).

14. The Tax Collector's assessments to Taxpayer were proper.

Ruling

Taxpayer's protests of the assessments made by the City of Mesa for the period December 2005 through July 2010 is denied.

The Tax Collector's Notices of Assessment to Taxpayer for the period December 2005 through July 2010 are upheld.

The Taxpayer has timely rights of appeal to the Arizona Tax Court pursuant to Model City Tax Code Section –575.

Sincerely,

Hearing Officer

HO/7100.doc/10/03

c: Tax Administrator
Municipal Tax Hearing Office