

## DECISION OF MUNICIPAL TAX HEARING OFFICER

May 16, 2012

*Taxpayers*  
*Taxpayer's Address*

MTHO #680

*Dear Taxpayers:*

We have reviewed the evidence presented by *Taxpayers* and the City of Tucson (Tax Collector or City) at the hearing on February 27, 2012 and in post-hearing memoranda. The review period covered was August 2007 through July 2011. Taxpayers' protest, Tax Collector's response, and our findings and ruling follow.

### Taxpayer's Protest

Taxpayers were assessed City of Tucson privilege tax under the commercial lease classification for the lease of real property owned by them to their corporation. Taxpayers were not aware of the City's tax on commercial leases. Taxpayers question the date commercial leasing became taxable by the City, why the audit report did not match the billing from the City and why the billing for the license fee for 2008 was \$70.00 while the fee for years 2009 through 2011 was for \$45.00.

### Tax Collector's Response

The City adopted the Model City Tax Code in 1987. The City does not have an exemption for leases by individual shareholders to their corporation or single commercial leases of property. Taxpayers are therefore taxable. The auditor had provided Taxpayers with a pamphlet relating to the commercial lease classification. The pamphlet was dated July 1, 2008. That is not, however, the effective date of the tax. The preliminary audit report provided to Taxpayers had allowed Taxpayers a deduction for factored tax which was not allowed in the final assessment. Finally, Taxpayers were charged a license fee for each year of the audit as well as a one time processing fee. That is why the fee for the first year was higher.

### Discussion

Taxpayers owned real property in the City (Property). Taxpayers also owned a corporation which operated their business (Corporation). Taxpayers leased the Property to the Corporation. Taxpayers were not aware of the City's privilege tax on commercial leasing and therefore did not get a privilege tax license and did not file returns or pay the City privilege tax.

The Tax Collector audited Taxpayers and issued an assessment under the commercial lease classification. Taxpayers timely protested the assessment. After the hearing on Taxpayers' protest, the parties were allowed to provide post hearing memoranda. Taxpayers stated in their post hearing reply that if the City code was effective June 2006, Taxpayers will agree to pay the tax and license fees assessed, but not the interest and combined penalties included in the

assessment. Thereafter Taxpayers submitted a supplement to their reply that their lease to the Corporation was exempt under A.R.S. § 42-6004(A)(11) passed by the Arizona State Legislature in 2010. The questions to be decided are

- Did the City code tax single leases of commercial property to an individual's wholly owned corporation during the audit period?
- Is Taxpayers' lease exempt under A.R.S. § 42-6004(A)(11)?
- May penalties and interest be abated in this case?

**The City Code Imposed the Privilege Tax on Taxpayers' Single Lease of Commercial Property during the audit period.**

The City adopted its privilege tax code from the Model City Tax Code in 1987. Section 445 of the Model City Tax Code allows cities to adopt various options to exempt from the privilege tax commercial leases, single leases of commercial property or leases to a corporation owned 80% or more by the lessor. Model City Tax Code § 445, subsections (g), (i) and (m).

The Tax Collector submitted a copy of Tucson City Code (TCC) § 19-445 as amended by Ordinance No. 10287 in June, 2006 and in effect during the audit period. TCC § 19-445 did not adopt any of those Model City Tax Code options. Subsections (g), (i) and (m) of TCC § 19-445 indicate that those subsections were reserved. The City's later amendment to TCC § 19-445 in 2011, effective July 7, 2010 added a new subsection (s) that is not relevant here.

Based on the evidence presented, the City code did not exempt Taxpayers' lease of the Property to the Corporation. The Tax Collector's privilege tax assessment is therefore upheld.

**A.R.S. § 42-6004(A)(11) is not applicable.**

Taxpayers contend in their supplement to the post-hearing reply that the lease is exempt from the privilege tax by A.R.S. § 42-6004(A)(11). A.R.S. § 42-6004 excludes certain activities for city privilege taxes. In 2010 the state legislature added paragraph (A)(11) that precludes a city from levying a privilege tax on income from a commercial lease by a reciprocal insurer or a corporation to an affiliated corporation. That paragraph is not applicable here.

Paragraph (A)(11) exempts commercial lease transactions between affiliated corporations. The state also exempts from the state privilege tax leases by a corporation to an affiliated corporation. The City code provides that when the state statutes and Model City Tax Code are the same and where the Arizona department of revenue has issued written guidance, the department's interpretation is binding on cities and towns. The department of revenue has issued Transaction Privilege Ruling (TPR) 93-39 regarding leases between affiliated corporations. The ruling provides that there are no exemptions under the commercial lease classification which apply to affiliated parties other than corporations. Entities such as individuals, trusts, estates, partnerships, joint ventures, and associations are not considered to be corporations. One of the examples of a taxable transaction in the ruling was a lease between a corporation and its individual shareholders. Therefore A.R.S. § 42-6004(A)(11) did not preclude the City from taxing Taxpayers on their lease of the Property to the Corporation for periods after the effective date of paragraph (A)(11).<sup>1</sup>

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<sup>1</sup> In 2011 the legislature added paragraph (A)(12) to A.R.S. § 42-6004 that preempted city privilege tax on a commercial lease where a corporation leases real property to a corporation of which at least 80

**Interest Cannot be Waived.**

TCC § 19-540(a) imposes interest on any taxpayer who does not pay taxes which were due or found to be due before the delinquency date. Interest continues to accrue until the tax is paid. Interest is not a penalty but is compensation to the City for the lost time-value of money received after the due date. *See, Valencia Energy Co. v. Arizona Dep't of Revenue*, 191 Ariz. 565, 959 P.2d 1256, (1998) (Non-punitive interest is, after all, nothing more than compensation for the use of money. The taxpayer had the benefit of using the funds before paying the tax claim and, in the legal sense, suffers no loss by reason of paying interest on the money it retained in its possession).

Interest accrues if taxes are unpaid. As long as the taxes are unpaid, interest accrues. The assessment of interest is therefore upheld.

**Penalties Should be Waived in this Case.**

The proposed assessment included combined penalties for Taxpayers' failure to file and failure to pay. Taxpayers protested the entire assessment and in their post-hearing reply continued to disagree with the penalties. Taxpayers were aware that the state did not impose a privilege tax on their lease. Taxpayers were unaware that the City did impose its privilege tax on single commercial leases by shareholders to their corporation. The circumstances of this case demonstrate reasonable cause and not willful neglect by Taxpayers. For those reasons, the penalties included in the assessment should be abated.

Based on all the above, we conclude that the City's assessment of privilege tax and interest against Taxpayers was proper. The Tax Collector shall remove from the assessment the combined penalties that were imposed.

Findings of Fact

1. Taxpayers are individuals and the owners of *Taxpayers Business*, a corporation (Corporation).
2. Taxpayers owned real property (Property) within the City.
3. Taxpayers leased the Property to the Corporation.
4. Taxpayers did not have a privilege tax license or file returns or pay city privilege tax on their gross receipts from the lease of the Property to the Corporation.
5. The Tax Collector audited Taxpayers for the period August 2007 through July 2011 and issued an assessment for privilege taxes in the amount of \$1,113.44, interest through August 31, 2011 of \$99.41 and combined penalties of \$278.36.
6. The Tax Collector considered Taxpayers taxable under TCC § 19-445, the commercial lease classification.
7. Taxpayers timely protested the assessment because they believed the lease was not taxable until after July 1, 2008, the audit report did not match the billing from the City

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percent of the voting shares of each corporation are owned by the same shareholder. Paragraph (A)(12) is also inapplicable for the same reason.

and the billing for the license fee for 2008 was \$70.00 while the fee for years 2009 through 2011 was for \$45.00.

8. The auditor provided Taxpayers with a pamphlet relating to the commercial lease classification. The pamphlet was dated July 1, 2008.
9. The preliminary audit report provided to Taxpayers had allowed Taxpayers a deduction for factored tax which was not allowed in the final assessment.
10. Taxpayers were not aware of the City privilege tax on commercial leases during the audit period.
11. The state did not tax Taxpayers on their commercial lease to the Corporation.
12. The \$70.00 license fee billing for 2008 included a \$45.00 license fee and a \$25.00 one time processing fee.
13. Taxpayers stated in their post hearing reply that if the City code was effective June 2006, Taxpayers will agree to pay the tax and license fees assessed, but not the interest and combined penalties included in the assessment.
14. Taxpayers then submitted a supplement to their reply that their lease to the Corporation was exempt under A.R.S. § 42-6004(A)(11) passed by the Arizona State Legislature in 2010.

#### Conclusions of Law

1. TCC § 19-445 imposes the city privilege tax on the business activity of renting, leasing or licensing for use real property located in the city.
2. TCC § 19-445 was initially enacted in 1987 by Ordinance No. 6674.
3. TCC § 19-445 was amended by Ordinance No. 10287 in June, 2006.
4. TCC § 19-445 was amended by Ordinance No. 10911 in August 2011, effective July 7, 2010.
5. The amendment by Ordinance No. 10911 added subsection (s) relating to commercial leases by a reciprocal insurer or a corporation to an affiliated corporation.
6. The Tucson City tax code was adopted from the Model City Tax Code in 1987.
7. Section 445 of the Model City Tax Code allows cities to adopt various options to exempt from the privilege tax commercial leases, single leases of commercial property or leases to a corporation owned 80% or more by the lessor. Model City Tax Code § 445, subsections (g), (i) and (m).
8. TCC § 19-445 did not adopted any of those Model City Tax Code options and subsections (g), (i) and (m) of TCC § 19-445 indicate that those subsections had been reserved.
9. A.R.S. § 42-6004(A)(11) precludes a city from levying a privilege tax on income from a commercial lease by a reciprocal insurer or a corporation to an affiliated corporation.

10. A “reciprocal insurer” means an unincorporated aggregation of subscribers operating individually and collectively through an attorney-in-fact to provide reciprocal insurance among themselves. A.R.S. § 20-762.
11. Taxpayers are individuals and are not a reciprocal insurer or a corporation.
12. A corporation is an entity separate from its shareholders. *Modern Pioneers Insurance Co. v. Nandin*, 103 Ariz. 125, 437 P.2d 658 (1968).
13. When the state statutes and model city tax code are the same and where the department of revenue has issued written guidance, the department's interpretation is binding on cities and towns. A.R.S. § 42-6005.D.; CTC § 62-500(e)(2).
14. A.R.S. § 42-6004 was amended in 2010 by House Bill 2510 to add paragraph (A)(11).
15. The Legislative Fact sheet to H.B. 2510 provided in part that the state preempts cities from taxing certain activities and that currently there is an exemption from the state privilege tax for leases by a corporation to an affiliated corporation.
16. The state exemption for leases by a corporation to an affiliated corporation does not apply to leases by individuals to corporations they own. TPR 93-39.
17. Neither A.R.S. § 42-6004(A)(11) nor TCC § 19-445(s) preclude the City from taxing Taxpayers on their lease of the Property to the Corporation for periods after they became effective.
18. Taxpayers’ lease of the Property to their Corporation was subject to the City privilege tax during the audit period.
19. Taxpayers did not pay privilege taxes for the period August 2007 through July 2011.
20. Taxpayers were liable for City privilege taxes for the period August 2007 through July 2011.
21. TCC § 19-540(a) imposes interest on any taxpayer who fails to pay any of the taxes which were due or found to be due before the delinquency date until the tax is paid.
22. TCC § 19-540(a) recognizes the time value of money, and thus requires a taxpayer that is holding or using money that rightfully belongs to the City to pay interest for the use of that money. *See, Valencia Energy Co. v. Arizona Dep't of Revenue*, 191 Ariz. 565, 959 P.2d 1256, (1998).
23. Taxpayers are liable to pay interest on the taxes that are unpaid from the date the taxes were due until paid.
24. The City Code imposes a penalty for failure to file a timely return and for failure to timely pay taxes unless Taxpayers show that the failure is due to reasonable cause and not willful neglect.
25. Taxpayers were aware that the state did not impose a privilege tax on their lease.
26. Taxpayers were not aware that the City imposed its privilege tax on single commercial leases.
27. Taxpayers have demonstrated reasonable cause for failing to timely file tax returns and for failing to timely pay taxes on the lease of the Property.

28. Taxpayers' protest to the City's assessment is upheld in part and denied in part. The Tax Collector shall remove from the assessment the combined penalties.

Ruling

The protest by Taxpayers of an assessment made by the City of Tucson for the period August 2007 through July 2011 is upheld in part and denied in part.

The Tax Collector shall remove from the assessment the combined penalties. The remainder of the assessment is upheld.

The 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 Administrator***  
Municipal Tax Hearing Office