DECISION OF MUNICIPAL TAX HEARING OFFICER

June 12, 2013

Taxpayers
Taxpayer's address

Taxpayers
MTHO #775

Dear Taxpayers,

We have reviewed the evidence presented by ***Taxpayers*** and the City of Sedona (Tax Collector or City) at the hearing on May 17, 2013. The review period covered was January 2005 through April 2011. Taxpayers' protest, Tax Collector's response, and our findings and ruling follow.

Taxpayers' Protest

Taxpayers are individuals and own a limited liability company (LLC) that operates a restaurant. Taxpayers own the real property used by the restaurant. Taxpayers were assessed City of Sedona privilege tax under the commercial lease classification for the lease of real property owned by Taxpayers to the LLC. Because Taxpayers are the sole owners of the LLC, they are not leasing the property to another person. The state legislature recently passed an exemption of leases between related entities from city tax showing that the legislature did not intend these transactions to be taxed. Also, the City waited an unreasonable amount of time to audit Taxpayers. Finally, the City's estimates of the rental value and the square footage of the property were over stated.

Tax Collector's Response

Taxpayers own the property used by their LLC. Under the City tax code the LLC is a separate taxable entity. Taxpayers are therefore taxable on that lease. Taxpayers do not qualify for any of the exemption under the code. Because Taxpayers were not licensed and did not file returns during the review period, there was no statute of limitation. The assessment was timely. The assessment was based on the estimated market value of the rent. The new state statute does not indicate a legislative intent to exempt leases to LLCs for periods prior to its effective date. The assessment should be upheld.

Discussion

Taxpayers owned the real property at issue. The property was used by their wholly owned LLC to operate a restaurant. The LLC paid the mortgage and other related expenses on behalf of Taxpayers. The Tax Collector conducted an audit of Taxpayers for the period January 2005 through April 2011 and issued an assessment. The Tax Collector considered Taxpayers taxable under the commercial lease classification. Taxpayers timely protested the assessment contending:

- Taxpayers are not taxable because they were leasing to their wholly owned LLC.

- The City delayed unreasonably in auditing Taxpayers.
- New state law shows the legislature did not intend these transactions to be taxed.
- The City's estimate of rental value and square footage was too high.

Taxpayers and the LLC are separate persons under the tax code.

Taxpayers argue that they were 100% owners of the lessee LLC. Had they operated the business as a sole proprietor, there would have been no issue. Taxpayers were not in the business of renting commercial property but were an owner-occupied business establishment.

Taxpayers established the LLC on the advice of their accountant to provide a level of protection. Taxpayers are free to use whatever form of business they choose, but in choosing a form they must accept its advantages and disadvantages. *Higgins* v. *Smith***,** 308 U.S. 473 (1940). While Taxpayers may have owned the LLC, the LLC was a separate legal entity.

STC § 100 defines "person" broadly to mean an individual, firm, partnership, joint venture, association, corporation, estate, trust, receiver, syndicate, broker, the Federal Government, this State, or any political subdivision or agency of this State. The definition further provides that a person is to be considered a distinct and separate person from any general or limited partnership or joint venture or other association with which such person is affiliated.

While STC § 100 does not specifically include the term "limited liability company" in the definition of "person", under A.R.S. § 29-857, except for state income tax purposes, LLC's are to be taxed or treated as a limited partnership. Partnerships are specifically included in the definition of "person" in STC § 100.

Taxpayers' lease of the property to their LLC is subject to privilege tax.

Sedona Tax Code (STC) § 8-445 imposes the City privilege tax on the business activity of leasing real property located in the City for a consideration. The occupancy of premises by one person with the consent or permission of the owner can create between the parties the relation of landlord and tenant. *Kransky v. Hensleigh*, 146 Mont. 486, 490, 409 P.2d 537, 539 (1965). Here, Taxpayers owned the property and another entity, the LLC, used the property. The LLC paid the mortgage and other expenses on behalf of Taxpayers. Making these payments was a benefit to Taxpayers and constituted consideration.

STC § 8-100 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. STC § 8-100 defines "casual activities" as not including the rental or lease of real property. Under the language of the STC, Taxpayers were engaged in the business activity of leasing or renting real property within the City for a consideration and were therefore subject to the City privilege tax.

Taxpayers are not exempt from the tax.

The exemption in STC § 8-445(s) only applies to leases in which a reciprocal insurer or a corporation leases real property to an affiliated corporation. Here, neither Taxpayers nor the LLC are corporations. Therefore the exemption under subsection (s) does not apply.

Taxpayers however cited a recent amendment passed by the state legislature in H.B. 2324. H.B. 2324 amended A.R.S. § 42-6004 to exempt from city privilege tax real property leases between affiliated persons. While H.B. 2324 was not retroactive and does not apply to the review period

at issue here, Taxpayers contend that H.B. 2324 reflects a legislative intent to exempt leases between affiliated persons.

The House of Representatives Fact Sheet for the bill as transmitted to the Governor stated that the bill expands the current municipal tax exemption for leases between affiliated corporations to include affiliated companies and businesses. The Fact Sheet recognized that A.R.S. § 42-6004 had previously only exempted leases between two affiliated corporations. H.B. 2324 does not reflect a contrary legislative intent for prior periods.

The Assessment was not barred.

Taxpayers argue that the City unreasonably delayed issuing the assessment. However, the assessment as issued was not barred by the audit statute of limitations. Taxpayers did not file returns during the review period. STC § 8-550(c) allows the Tax Collector to assess taxes for any month for which a return was not filed at any time without any reliance by the taxpayer on time limitations provided in the Code. The audit period selected by the Tax Collector was therefore allowable under the Code.

Even though there was no applicable statute of limitations, the City testified it limits such audits to six years. At the hearing the City agreed that any periods greater than six years may be abated. The review period in the assessment was January 2005 through April 2011. The assessment was issued June 3, 2011. Therefore periods before May 2005 (January through April 2005) were outside the six year period and should be removed from the assessment.

Taxpayers also contended at the hearing that the assessment was barred by laches. Taxpayers did not present facts or legal authority that the doctrine of laches could be applicable in this tax assessment.

The Tax Collector's Estimate was based on a reasonable basis.

The occupant of the property is Taxpayers' wholly owned LLC. Transactions in circumstances where the relationship between the parties is such that the gross income from the transaction is not indicative of the market value of the subject matter of the transaction are subject to tax based on market value. Market value is to correspond as nearly as possible to the gross income from similar transactions of like quality or character by other taxpayers where no common interest exists between the parties, but otherwise under similar circumstances and conditions.

The City estimated its assessment based on a square foot rental value derived from lease transactions of other taxpayers the City had reviewed. That information resulted in a per square foot rental value of $0.85. The City obtained the total square feet of the building from the County records. The City based the receipts on a value of $0.85 times the square feet reflected in the County records. The City's estimate was based on a reasonable basis.

Taxpayers questioned both the per square foot rental value and the City's calculation of total square feet. It is the responsibility of the taxpayer to prove that the Tax Collector's estimate is not reasonable and correct by providing sufficient documentation of the type and form required by the Code or satisfactory to the Tax Collector.

Taxpayers contend that the restaurant is not in a favorable location and therefore the rental value should be lower. Taxpayers however did not provide specific documentation showing that the Tax Collector's estimate of the per square foot rental value was not reasonable.

Taxpayers also contend the total square footage of the property used by the Tax Collector was greater than the square feet measured by Taxpayers. While Taxpayers presented total square foot numbers, no evidence was presented regarding how the property was measured or whether it was or was not consistent with how properties are generally measured. Based on the record here, we cannot conclude that the Tax Collector's estimate was not reasonable and correct.

Based on all the above, we conclude Taxpayers' protest should be denied in part and upheld in part. The Tax Collector shall remove the months of January through April 2005 from the assessment. The City's privilege tax assessment against Taxpayers is upheld in all other respects.

Findings of Fact

1. Taxpayers are individuals and own real property in the City.
2. Taxpayers are 100% owners of an LLC that operates a restaurant on Taxpayers' property.
3. The LLC was established on an accountant's advice to limit liability.
4. Neither Taxpayers nor the LLC are corporations.
5. The LLC pays the mortgage on the property and other expenses on behalf of Taxpayers.
6. It is the City's position that Taxpayers are leasing the property to the LLC.
7. Taxpayers did not file returns or pay City privilege tax on the lease of the property to the LLC.
8. The Tax Collector conducted an audit assessment of Taxpayers for the period January 2005 through April 2011 and issued an assessment on June 3, 2011.
9. The Tax Collector considered Taxpayers taxable under the commercial lease classification.
10. The assessment was based on the Tax Collector's estimate of the value of the lease from Taxpayers to the LLC.
11. Taxpayers timely protested the assessment.
12. Taxpayers believed the lease was exempt from the City privilege tax because they also owned the LLC, the review period was excessive and the City's estimate of the value of the lease is higher than it should be.
13. At the hearing the City agreed that any periods greater than six years from when the assessment was issued may be abated.

Conclusions of Law

1. STC § 8-445 imposes the City privilege tax on the business activity of renting, leasing or licensing for use real property located in the City.
2. The occupancy of premises by one person with the consent or permission of the owner may create between the parties an implied contract which yields the necessary foundation for a landlord and tenant relationship. *Kransky v. Hensleigh*, 146 Mont. 486, 490, 409 P.2d 537, 539 (1965)

3. Consideration is some right, interest, profit or benefit accruing to one party or some detriment, loss or responsibility, given, suffered or undertaken by the other. *Black's Law Dictionary*, Sixth Edition.

4. Taxpayers received consideration when the LLC paid the mortgage and other expenses on behalf of Taxpayers.

5. STC § 8-445(s) provides an exemption from the tax for gross proceeds of sales or gross income derived from a commercial lease in which a reciprocal insurer or a corporation leases real property to an affiliated corporation.

6. STC § 8-445(s) does not preclude the City from taxing Taxpayers on their lease of the property to the LLC.

7. Person means an individual, firm, partnership, joint venture, association, corporation, estate, trust, receiver, syndicate, broker, the Federal Government, this State, or any political subdivision or agency of this State. STC § 8-100.

8. A person is considered a distinct and separate person from any general or limited partnership or joint venture or other association with which such person is affiliated. STC § 8-100.

9. A limited liability company transacting business in Arizona is required to pay the taxes that are imposed by the laws of Arizona or any political subdivision of Arizona on domestic and foreign limited partnerships on an identical basis, except that, for purposes of Title 43, A.R.S. a domestic or foreign limited liability company and its members shall be taxed as if the limited liability company is either a partnership or a corporation or is disregarded as an entity as determined pursuant to the internal revenue code as defined in section 43-105. A.R.S. § 29-857.

10. Taxpayers are free to use whatever form of business they choose, but in choosing a form they must accept its advantages and disadvantages. *Higgins* v. *Smith***,** 308 U.S. 473 (1940).

11. Taxpayers and their LLC are separate and distinct persons from each other.

12. Taxpayers' lease of the property to the LLC is not exempt from the City privilege tax.

13. Transactions in circumstances where the relationship between the parties is such that the gross income from the transaction is not indicative of the market value of the subject matter of the transaction are subject to tax based on market value. STC § 8-210.

14. Market value is to correspond as nearly as possible to the gross income from similar transactions of like quality or character by other taxpayers where no common interest exists between the parties, but otherwise under similar circumstances and conditions. STC § 8-210.

15. The Tax Collector's estimate of market value of the lease was reasonable.

16. It is the responsibility of the taxpayer to prove that the Tax Collector's estimate is not reasonable and correct by providing sufficient documentation of the type and form required by the Code or satisfactory to the Tax Collector. STC § 8-545(b).

17. Taxpayers did not prove that the Tax Collector's estimate of gross receipts was not reasonable and correct.

18. The City may assess taxes for periods for which a return was not filed at any time without regard to audit statute of limitations. STC § 550(c).

19. Periods before May 2005 (January through April 2005) should be removed from the assessment as agreed to by the Tax Collector at the hearing.

20. The City's assessment for the review period May 2005 through April 2011 was within the allowable limitation period.

21. Taxpayers' protest is denied in part and upheld in part. The Tax Collector shall remove the months of January through April 2005 from the assessment. The City's privilege tax assessment against Taxpayers is upheld in all other respects.

Ruling

The protest by Taxpayers of an assessment made by the City of Sedona for the period January 2005 through April 2011 is denied in part and upheld in part.

The Tax Collector shall remove from the assessment the months of January, February, March and April 2005.

The Tax Collector's Notice of Assessment is upheld in all other respects.

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: ***City Auditor***
Municipal Tax Hearing Office