Jerry Rudibaugh
Municipal Tax Hearing Officer

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: September 8, 2003
Decision: MTHO #97
Tax Collector: City of Flagstaff
Hearing Date: June 4, 2003

DISCUSSION

Introduction

On January 21, 2003, ***Taxpayer*** ("Taxpayer") filed a protest of a tax assessment made by the City of Flagstaff ("City"). After review, the City concluded on January 23, 2003 that the protest was timely and in the proper form. On January 28, 2003, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to file a response to the protest on or before March 14, 2003. The City filed its response on March 12, 2003. On March 19, 2003, the Hearing ordered the Taxpayer to file any reply on or before April 9, 2003. On March 27 and 31, 2003 a Notice of Tax Hearing ("Notice") set the matter for hearing on May 7, 2003. On April 2, 2003, a Notice rescheduled the hearing for May 7, 2003. On April 21, 2003, the Taxpayer requested the hearing be rescheduled. On May 5, 2003, the Hearing Officer granted the Taxpayer's request. On May 8, 2003, a Notice rescheduled the hearing until June 4, 2003. Both the Taxpayer and City appeared and presented evidence at the June 4, 2003 hearing. On June 6, 2003, the Hearing Officer filed a letter indicating the City would provide additional information to the Taxpayer on or before June 9, 2003, the Taxpayer would file an opening brief on or before June 23, 2003, the City would file a response brief on or before July 11, 2003, the Taxpayer would file a reply brief on or before July 25, 2003, and a written decision would be issued on or before September 8, 2003.

The Taxpayer is in the business of selling manufactured homes. The City performed an audit for the period August 1998 through July 2002. The City assessed the Taxpayer for $64,033.30, which included additional tax due plus interest and penalties.

City Position

The audit assessed tax on the sales of manufactured buildings pursuant to City Code Section 3-5-427 (Section 427"). The audit disallowed deductions taken by the Taxpayer for out-of-City and out-of-State sales. The City exempts out-of-State sales if the sales qualify under the definition set forth in City Code Section 3-5-100 ("Section 100"). Section 100 requires all of the following to occur:

(1) the order is placed from without the State of Arizona; and

(2) the order is placed by other than a resident of the State to be determined similar to "resides within the City", and

(3) the property is delivered to the buyer at a location outside the State; and (4) the property is purchased for use outside the State.

In its original audit, the City had disallowed a deduction for sales to the ***ABC*** School District ("District") since the Taxpayer had failed to provide sufficient proof that the order had been placed from out-of-State. Subsequently, the Taxpayer provided documentation showing the orders had been placed from out-of-State. As a result, the City revised the original assessment from $64,033.30 to $59,669.33.

The City also disallowed deductions for sales claimed to be made to Native Americans that reside on the reservation. Pursuant to City Regulation 3-5-100.4 ("Regulation 100.4"), sales to Native Americans are deemed to be sales within the City, unless all of the following conditions are met:

(1) The vendor has properly accounted for such sales, in a manner similar to the record keeping requirements for out-of-city-sales: and
(2) All of the following elements of the sale exist:
(A) solicitation and placement of the order occurs on the reservation; and
(B) delivery is made to the reservation; and
(C) payment originates from the reservation.

The City did not dispute that the deliveries were made to the reservation and the payments originated from the reservation. The City also acknowledged that since the Taxpayer advertised on the reservation that solicitation probably occurred on the reservation. However, the City asserted the actual placement of the order occurred at the Taxpayer's sales office located in the City. As a result, the City concluded that the Taxpayer had failed to meet all of the conditions set forth in Regulation 100.4 and thus the claimed deductions must be disallowed.

In response to the Taxpayer's argument that the City is preempted by federal law from collecting transaction privilege taxes, the City argued there was no such preemption. According to the City, the Indian Trader Statutes provide the Commission of Indian Affairs ("Commission") with "the sole power and authority to appoint traders to the Indian tribes and to make such rules and regulations as he may deem just and proper specifying the kind and quantity of goods and the prices at which such goods shall be sold to the Indians." The City asserted that the Taxpayer provided testimony that the Taxpayer never had any kind of license to conduct business on the reservation. As a result, the Taxpayer was not able to enforce a contract signed on the reservation. For that reason, the Taxpayer had all the contracts signed at its office in the City. Further, the Taxpayer's manufactured building license required that contracts be signed at the office of the Taxpayer. As to the cases cited by the Taxpayer to support its position, the City argued those cases involved sales on the reservation, unlike this case. According to the City, the tax was not assessed on Native Americans. Instead, the tax was assessed on the Taxpayer for being in the business of selling manufactured homes.

The City disputed the Taxpayer's argument that the sampling was not an accurate method of establishing unreported income. According to the City, use of sampling in an audit is a necessity due to the time and cost of performing the audit. The City asserted that during the audit the

Taxpayer was given the sample months approximately one month in advance. According to the City, the Taxpayer did not dispute the months selected or the use of a sample. The City asserted the use of a sampling approach was necessitated by the Taxpayer's failure to keep the minimum records required to document the gross income of the Taxpayer attributable to any activity occurring in whole or in part in the City, to document the gross income taxable and divided into categories as stated in the office City tax return, and to document the gross income claimed to be exempt or deductible in the manner required by Regulation 3-5-350.1 ("Regulation 350.1").

Taxpayer Position

The Taxpayer argued that the out-of-State sales to the District should not be taxed pursuant to Section 100. The Taxpayer provided additional documentation after receiving the assessment and the City subsequently agreed the sales to the District were exempt under Section 100.

The Taxpayer also argued that the tax imposed by the City on sales to Native Americans is pre-empted by federal law. According to the Taxpayer, the U.S. Supreme Court ("Court") has ruled that the State of Arizona has no jurisdiction to tax sales that intimately affect reservation residents. The Taxpayer did not dispute that it failed to meet the requirement of placing the order on the reservation as set forth in Regulation 100.4. Instead, the Taxpayer argued against the legality of Regulation 100.4 since it would result in the City taxing Native Americans. The Taxpayer also relied on an Arizona Department of Revenue Transaction Privilege Tax Ruling 95-11 ("TPR 95-11"). In TPR 95-11, the State set forth criteria for sales to Native Americans. The Taxpayer asserted there was no requirement that the contract be signed on the reservation. Based on all the above, the Taxpayer argued the City tax on sales to Native Americans is pre-empted.

The City sampled nine months of the 48-month audit period and found six of the months had a discrepancy. One of the months had a large discrepancy and the City concluded it was an anomaly and sampled the months before and after that month. The City then calculated an error rate and applied that to the entire audit period resulting in a tax assessment of $5,609 plus penalty and interest. The Taxpayer argued that there was no justifiable basis for a "sampling" assessment in this case. According to the Taxpayer, the City offered no accounting guidelines or support for its sampling method. As a result, the Taxpayer requested the "sampling" assessment be denied.

ANALYSIS

Clearly, the Taxpayer has met its burden of proof that the sales to the District were exempt out-of-State sales and the deduction should be allowed. The City has proposed a revision to the original audit to reflect the sales to the District were exempt.

As to the sales to the Native Americans that reside on the reservation, the Taxpayer has not complied with Regulation 100.4 that requires the order to be placed on the reservation. In this case, all the orders were placed at the Taxpayer's office location in the City. While the Taxpayer

relied on the State's TPR 95-11, we don't find TPR 95-11 to control over Regulation 100.4. The Taxpayer has also provided case law that the City is pre-empted from taxing sales on the reservation. We do not find any of the cases cited to be right on point with the facts of this case. The Native Americans chose to go to the City to do business with the Taxpayer. Based on the record, there weren't any privilege taxes separately charged on the sales to the Native Americans. Based on all the above, we must conclude that the Taxpayer has not complied with the requirements of Regulation 100.4 and the case law cited does not convince us that Regulation 100.4 is not lawful.

Since the Taxpayer failed to keep the minimum records required by Regulation 350.1, the City was authorized to make a reasonable estimate. A properly conducted sampling is a reasonable method of obtaining an estimate. While the Taxpayer has argued the sampling was not an accurate method of establishing unreported income, they failed to provide documentation to demonstrate the sample was not accurate. Nor have they provided any explanation of why the sample month's chosen would result in some sort of error or bias in representing the whole population. The Taxpayer did not dispute that they had an opportunity to challenge the sample months chosen prior to the actual sampling. As a result, we must conclude the City's sample was a reasonable estimate and should be approved.

FINDINGS OF FACT

1. On January 21, 2003, the Taxpayer filed a protest of a tax assessment made by the City.

2. After review, the City concluded on January 23, 2003 that the protest was timely and in proper form.

3. On January 28, 2003, the Hearing Officer ordered the City to file a response to the protest on or before March 14, 2003.

4. The City filed its response on March 12, 2003.

5. On March 19, 2003, the Hearing Officer ordered the Taxpayer to file any reply on or before April 9, 2003.

6. On March27 and 31, 2003, a Notice set the matter for hearing on May 7, 2003.

7. On April 2, 2003, a Notice rescheduled the hearing for May 7, 2003.

8. On April 21, 2003, the Taxpayer requested the hearing be rescheduled.

9. On May 5, 2003, the Hearing Officer granted the Taxpayer's request.

10. On May 8, 2003, a Notice rescheduled the hearing until June 4, 2003.

11. Both the Taxpayer and the City appeared and presented evidence at the June 4, 2003 hearing.

12. On June 6, 2003, the Hearing Officer filed a letter indicating the City would provide additional information to the Taxpayer on or before June 9, 2003, the Taxpayer would file an opening brief on or before June 23, 2003, the City would file a response brief on or before July 11, 2003, the Taxpayer would file a reply brief on or before July 25, 2003, and a written decision would be issued on or before September 8, 2003.

13. The Taxpayer is in the business of selling manufactured homes.

14. The City performed an audit for the period August 1998 through July 2002.

15. The City assessed the Taxpayer for $64,033.30 that included additional tax due plus interest and penalties.

16. The audit disallowed deductions taken by the Taxpayer for out-of-City and out-of-State sales.

17. In its original audit, the City had disallowed a deduction for sales to the District because the Taxpayer had failed to provide sufficient proof that the order had been placed from out-of-State.

18. Subsequently, the Taxpayer provided documentation showing the orders had been placed from out-of-State.

19. The City revised its assessment and allowed the deduction for sales to the District resulting in the assessment being reduced from $64,033.30 to $59,669.33.

20. The City disallowed deductions for sales claimed to be made to Native Americans that reside on the reservation.

21. The sales to the Native Americans were placed at the Taxpayer's business location in the City.

22. In order to save time and cost of performing the audit, the City sampled nine months out of the 48-month audit period.

23. The City calculated an error rate for the nine sample months and applied that error rate to the entire 48-month audit period.

24. The City provided a list of the sample months to the Taxpayer approximately one month in advance of the audit.

25. Prior to the audit, the Taxpayer did not object to the use of a sampling approach or to the months selected.

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. Sales of manufactured buildings are taxable pursuant to Section 427.

3. The sales to the District were exempt out-of-State sales.

4. The sales to the Native Americans did not comply with Regulation 100.4 since the orders were placed at the Taxpayer's business office in the City.

5. There was no case law cited that was directly on point to demonstrate Regulation 100.4 was not a proper law.

6. The Taxpayer failed to keep the minimum records required by Regulation 350.1.

7. Based on the record, the City's sampling method provided a reasonable estimate of an error rate for the entire 48-month audit period.

8. The Taxpayer has failed to provide sufficient documentation to demonstrate the City's sampling method was not reasonable.

9. The Taxpayer's protest should be denied with the exception of the sales to the District.

ORDER

It is therefore ordered that with the exception of the sales to the ***ABC*** School District, the January 20, 2003 protest of ***Taxpayer*** of a tax assessment by the City of Flagstaff is hereby denied.

It is further ordered that the City of Flagstaff shall revise its assessment to allow the deductions for the ***ABC*** School District.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer