

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: November 28, 2005

Decision: MTHO #239

Tax Collector: City of Mesa

Hearing Date: October 5, 2005

DISCUSSION

Introduction

On March 29, 2005, *Principal*, *Principal* Properties LLC, and *Principal* Consulting LLC (Collectively, hereafter referred to as “Taxpayers”) filed a protest of a tax assessment made by the City of Mesa (“City”). After review, the City concluded on April 14, 2005, that the protest was timely and in the proper form. On April 20, 2005, the Municipal Tax Hearing Officer (“Hearing Officer”) ordered the City to file a response to the protest on or before June 6, 2005. The City requested an extension to file its response. On June 3, 2005, the Hearing Officer granted the City an extension until June 23, 2005. On June 16, 2005, the City filed a response to the protest. On June 20, 2005, the Hearing Officer ordered the Taxpayers to file any reply on or before July, 11, 2005. On June 29, 2005, the Taxpayers requested an extension to file its reply. On July 7, 2005, the Hearing Officer granted the Taxpayers an extension until August 19, 2005, to file its reply. On July 21, 2005, a Notice of Tax Hearing (“Notice”) scheduled the matter for hearing commencing on October 5, 2005. On August 18, 2005, the Taxpayers filed a reply to the City. On August 22, 2005, the Taxpayers requested an extension to file a supplement to its reply. On August 22, 2005, the Hearing Officer granted the extension to file a supplement. On August 25, 2005, the Taxpayers filed a supplement to the City reply. Both parties appeared and presented evidence at the October 5, 2005 hearing. On October 10, 2005, the Hearing Officer inducted that the Taxpayers had been granted until October 12, 2005 to file any comments/disagreements with the City’s Hearing Exhibit No. 3. On October 12, 2005, the Taxpayers filed comment disagreement with Exhibit No. 3. On October 10, 2005 the Hearing Officer indicated the record would be closed as of October 12, 2005 and a written decision would be issued on or before November 28, 2005.

City Position

The City conducted an audit of three selected entities: *Principal* (“*Principal*”); *Principal* Properties LLC (“*Properties*”); and, *Principal* Consulting (“*Consulting*”). The audit period for *Principal* was August 1998 through April, 2003 and the audit period for both *Properties* and *Consulting* was May 2003 through January 2005. As a result of the audit, each of the Taxpayers was assessed taxes for engaging in the business of leasing or renting used property pursuant to City Code Section 5-10-445 (“*Section 445*”). *Principal* was assessed taxes of \$2,497.47, interest up through February of 2005 in the amount of \$1,026.39, and a license fee of \$25.00. *Properties* was assessed taxes of \$3,909.78, interest up through February of 2005 in the amount of \$390.98, and a license fee of \$50.00. *Consulting* was assessed taxes in the amount of \$645.75, interest up through February 2005 in the amount of \$64.60, and the license fee of \$50.00.

The City indicated that during the audit period *Principal* owned real property located at _____ (“*Address 1*”) and _____ (“*Address 2*”). According to the City, the *Address 1* property was occupied by an unrelated company, *Tenant 1*, Inc. (“*Tenant 1*”), during the period from August 1998 through December 2000. The City indicated that from January 2001 through April 2003 the *Address 1* property was occupied by a related company, *Tenant 2* LLC (“*Tenant 2*”). The members of *Tenant 2* were *Member 1* and the *Principal* Family Revocable Trust (“Trust”). The City determined that the *Address 2* property was occupied during the period of January 2003 through April 2003 by another related company, *Tenant 3* LLC (“*Tenant 3*”). The members of *Tenant 3* were *Member 2* and the Trust.

In May 2003, Properties acquired the *Address 2* property. According to the City, the property continued to be occupied through the audit period by *Tenant 3*. The City indicated that the only member of Properties was the Trust.

In May 2003, Consulting acquired the *Address 1* property. According to the City, the property continued to be occupied by *Tenant 2* through the audit period. The only member of Consulting was the Trust.

The City argued that the Taxpayers were considered to be in business because they derived a gain, benefit, or advantage from the relationship with the occupying entities. According to the City, the occupying entities paid costs such as property taxes, insurance, repairs, and maintenance on behalf of the Taxpayers. The City asserted that such payments would constitute consideration as required pursuant to Section 445. The City also relied on the following definitions contained in City Code Section 5-10-100 (“Section 100”):

“Business” means 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.

“Casual Activity or Sale” means a transaction of an isolated nature made by a person who neither represents himself to be, nor is engaged in a business subject to a tax imposed by this Chapter. However, no sale, rental, license for use, or lease transaction concerning real property nor any activity entered into by a business taxable by this Chapter shall be treated, or be exempt, as casual. This definition shall include sales of used capital assets, provided that the volume and frequency of such sales do not indicate that the seller regularly engages in selling such property.

“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. For the purposes of this Chapter, a person shall 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. A subsidiary corporation shall be considered a separate person from its parent corporation for purposes of taxation of transactions with its parent corporation.

The City asserted that the transactions between the Taxpayers and the occupying entities cannot be considered casual because they involved rental or lease of real property. The City argued that each occupying entity was considered a distinct and separate person from the Taxpayers pursuant to the definition of “person”.

The City asserted that City Code Section 5-10-210 (“Section 210”) allows the City to determine gross income involving transactions between affiliated companies or persons by using “market value”. In this case, the City indicated the “market value” was determined using information provided by the Taxpayers. According to the City, the Taxpayers had contacted a local commercial property manager and obtained a range of rental rates for comparable rental properties. The City utilized the mid-range amount to estimate gross income for each of the Taxpayers. According to the City, the Taxpayers did not provide any documentation for the transaction between *Principal* and *Tenant 1* during the audit and as a result the City also estimated that gross income amount. Based on all the above, the City requested the assessment be upheld.

Taxpayers Position

The Taxpayers protested the full amount of the assessment. The Taxpayers argued that there was no lease agreement and rent was non-existent. The Taxpayers asserted the City unfairly used information which the Taxpayers were forced to supply to determine a fair market rent value. The Taxpayers provided a letter from the owner of *Tenant 1* indicating *Principal* had been paid rent of \$1,000 per month for the *Address 1* property from August 1998 through December 2000.

The Taxpayers argued that the various entities were established for convenience, protection, and estate planning purposes and there were no economic benefits to the property owner. The Taxpayers asserted the intent and purpose of the transaction privilege tax statute is to tax business transactions entered into for monetary gain, benefit, or advantage. In this case, the Taxpayers argue there was no monetary benefit or advantage. According to the Taxpayers, this was an arrangement done merely to protect assets from liability. Lastly, the Taxpayers argued that the definition of a “person” in Section 100 does not include a limited liability company. The Taxpayers indicated it is a well-settled maxim that tax statutes are to be strictly construed against the taxing authority.

Analysis

It is clear that the monthly rent paid by *Tenant 1* to *Principal* was taxable pursuant to Section 445. The City’s estimation method for the monthly rental was reasonable at the time of the audit. However, we find *Principal* subsequently provided reliable evidence that the actual monthly rental was \$1,000 per month. Accordingly, the assessment will need to be adjusted to reflect the \$1,000 per month amount. In January of 2001, *Tenant 2* replaced *Tenant 1* as the occupier of the *Address 1*. Again this is clearly a taxable transaction pursuant to Section 445 as a monthly rental between *Principal* and the occupier which was some type of a partnership/joint venture/association between *Member 1* and the Trust. We would agree with the City that the transaction would meet the “business” definition pursuant to Section 100 since *Principal* would be benefited by the occupier paying costs such as property taxes, insurance, repairs, and maintenance on behalf of *Principal*. As to the amount of monthly rental, we note the City’s estimation of \$2,090.95 was significantly higher than the \$1,000 per month previously paid by *Tenant 1* for the same property. That causes us to have some concern that the City’s estimate may be too high. Under the circumstances of this case, we find that a more reasonable monthly rental value would be \$1,000 per month or the low end of the monthly “market values” provided by *Principal*, whichever amount is higher. In January of 2003, *Principal* purchased the *Address 2* property which was occupied by *Tenant 3*. For the same reasons set forth above regarding the transactions between *Principal* and *Tenant 2*, we conclude the transactions between *Principal* and *Tenant 3* would be taxable pursuant to Section 445. In this case, the only evidence we have as to a reasonable monthly rental amount would be

the City's estimation. We conclude that the City's use of an average of the high and low amounts, provided by the Taxpayers, would be a reasonable amount and will approve the City's estimated amount.

In May of 2003, Properties acquired the *Address 2* property, which continued to be occupied by the *Tenant 3*. The single member of Properties was the Trust. The Taxpayers have argued that a single member LLC is not a "person" pursuant to Section 100. While an LLC is not specified in Section 100, we find that the fact the single member is a trust which is specified in the definition of a "person" in Section 100 is sufficient to conclude the single member LLC is a "person" pursuant to Section 100. For the reasons set forth previously, we also conclude that the transaction would meet the definition of "business" set forth in Section 100. Furthermore, we find the City's use of an average of the high and low amounts provided by the Taxpayers would be a reasonable rental amount and will approve the City's estimated amount.

In May of 2003, Consulting acquired the *Address 1* property which continued to be occupied by *Tenant 2*. The single member of Consulting was the Trust. Similarly to the previous transactions discussed above, we have a transaction in which the owner of the property is a different person than the occupier of the property. For the same reasons previously set forth, we find this would be a taxable transaction. For the same reasons previously set forth, we would find the reasonable monthly rental value would be \$1,000 per month or the low end of the monthly rental values provided by the Taxpayers, whichever amount is higher.

FINDINGS OF FACT

1. On March 29, 2005, the Taxpayers filed a protest of a tax assessment made by the City.
2. After review, the City concluded on April 14, 2005 that the protest was timely and in the proper form.
3. On April 20, 2005, the Hearing Officer ordered the City to file a response to the protest on or before June 6, 2005.
4. On June 1, 2005, the City requested an extension to file a response.
5. On June 20, 2005, the Hearing Officer granted the City an extension until June 23, 2005.
6. On June 16, 2005, the City filed a response to the protest.
7. On June 20, 2005, the Hearing Officer ordered the Taxpayers to file any reply on or before June 11, 2005.
8. On June 29, 2005, the Taxpayers requested an extension to file a reply.
9. On July 7, 2005, the Hearing Officer granted the Taxpayers an extension until August 19, 2005, to file its reply.
10. On July 21, 2005, a Notice scheduled the matter for hearing commencing on October 5, 2005.

11. On August 18, 2005, the Taxpayers filed a reply to the City.
12. On August 22, 2005, the Taxpayers requested an extension to file a supplement to its reply.
13. On August 22, 2005, the Hearing Officer granted the extension to file a supplement.
14. On August 25, 2005, the Taxpayers filed a supplement to its reply to the City.
15. Both parties appeared and presented evidence at the October 5, 2005 hearing.
16. On October 10, 2005, the Hearing Officer indicated that the Taxpayers had been granted until October 12, 2005, to file any comments/disagreements with the City's Hearing Exhibit No. 3.
17. On October 12, 2005, the Taxpayers filed comments/disagreements with Exhibit No. 3.
18. On October 10, 2005, the Hearing Officer indicated the record would be closed as of October 12, 2005, and a written decision would be issued on or before November 28, 2005.
19. The City conducted an audit of three selected entities: **Principal**; Properties; and Consulting.
20. The audit period for **Principal** was August 1998 through April 2003 and the audit period for both Properties and Consulting was May 2003 through January 2005.
21. **Principal** was assessed taxes of \$2, 497.47, interest up through February 2005 in the amount of \$1,026.39, and a license fee of \$25.00.
22. Properties was assessed taxes of \$3,909.78, interest up through February 2005 in the amount of \$390.98, and a license fee of \$50.00.
23. Consulting was assessed taxes in the amount of \$645.75; interest up through February 2005 in the amount of \$64.60, and a license fee of \$50.00.
24. During the audit period, **Principal** owned real property located at **Address 1** and **Address 2**.
25. The **Address 1** property was occupied by an unrelated entity, **Tenant 1**, during the period from August 1998 through December 2000.
26. The **Address 1** property was occupied by a related entity, **Tenant 2**, during the period from January 2001 through April 2003.
27. The members of **Tenant 2** were **Member 1** and the Trust.
28. The **Address 2** property was occupied during the period of January 2003 through April 2003 by another related company, **Tenant 3**.
29. The members of **Tenant 3** were **Member 2** and the Trust.

30. In May 2003, Properties acquired the *Address 2* property.
31. The *Address 2* property continued to be occupied through the audit period by *Tenant 3*.
32. The only member of Properties was the Trust.
33. In May 2003, Consulting acquired the *Address 1* property.
34. The *Address 1* property continued to be occupied by *Tenant 2* through the audit period.
35. The only member of Consulting was the Trust.
36. The occupying entities of the *Address 1* and *Address 2* properties paid costs such as property taxes, insurance, repairs, and maintenance on behalf of the Taxpayers.
37. *Tenant 1* paid *Principal* rent of \$1000 per month for the *Address 1* property from August 1998 through December 2000.
38. The Taxpayers contacted a local commercial property manager and obtained a range of rental rates for comparable rental properties.
39. The City utilized the mid-range amounts provided by the Taxpayers to estimate gross income for each of the Taxpayers.

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. The monthly rental paid by *Tenant 1* to *Principal* was taxable pursuant to Section 445.
3. The City's estimation method for the monthly rental from *Tenant 1* was reasonable at the time of the audit.
4. *Principal* provided reliable evidence that the actual monthly rental paid by *Tenant 1* was \$1,000 per month and the assessment should be adjusted to reflect the \$1,000 amount.
5. The transaction between *Principal* and *Tenant 2* was a taxable transaction pursuant to Section 445.
6. *Principal* received a benefit by *Tenant 2* paying costs such as property taxes, insurance, repairs, and maintenance on behalf of *Principal*.
7. A reasonable monthly rental amount between *Principal* and *Tenant 2* was \$1,000 per month on the low end of the monthly rental values provided by *Principal*, whichever amount is higher.

8. The transaction between *Principal* and *Tenant 3* was a taxable transaction pursuant to Section 445.
9. The City's estimation of the monthly rental between *Principal* and *Tenant 3* was reasonable.
10. An LLC with a single member as a Trust satisfies the definition of "person" in Section 100.
11. The transaction between Properties and *Tenant 3* was a taxable transaction pursuant to Section 445.
12. The City's estimation of the monthly rental between Properties and *Tenant 3* was reasonable.
13. The transaction between Consulting and *Tenant 2* was a taxable transaction pursuant to Section 445.
14. A reasonable monthly rental between Consulting and *Tenant 2* was \$1,000 per month or the low end of the monthly rental values provided by Consulting, whichever amount is higher.

ORDER

It is therefore ordered that the March 29, 2005 protest of *Principal*, *Principal* Properties LLC, and *Principal* Consulting LLC of a tax assessment made by the City of Mesa is hereby denied, in part, and granted, in part, consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Mesa shall adjust the assessment for *Principal* for the rental to *Tenant 1* to reflect a monthly rental value of \$1,000 per month.

It is further ordered that the City of Mesa shall adjust the assessment for *Principal* for the rental to *Tenant 2* to reflect a monthly rental value of \$1,000 per month or the lower end of the monthly values provided by *Principal*, whichever amount is higher.

It is further ordered that the City of Mesa shall adjust the assessment for *Principal* Consulting LLC for the rental to *Tenant 2* to reflect a monthly rental value of \$1,000 per month or the lower end of the monthly values provided by *Principal* Consulting, whichever amount is higher.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer