

## DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: January 29, 2010  
Decision: MTHO # 479  
Taxpayer: *Taxpayer*  
Tax Collector: City of Mesa  
Hearing Date: December 15, 2009

### DISCUSSION

#### Introduction

On December 11, 2008, a letter of protest was filed by *Taxpayer* of a tax assessment made by the City of Mesa (“City”). A hearing was commenced before the Municipal Tax Hearing Officer (“Hearing Officer”) on December 15, 2009. Appearing for Taxpayer were *Taxpayer Representatives*. Appearing for the City were *Assistant City Attorney*, *Tax Administrator*, and *Tax Audit Supervisor*. At the conclusion of the December 15, 2009 hearing, the record was closed and the Hearing Officer indicated a written decision would be issued on or before January 29, 2010.

### DECISION

The City conducted a non-audit compliance audit of Taxpayer for the periods of October 2004 through October 2007 and November 2007 through August 2008. The first period was for Taxpayer’s location at *Lesueur Property* and the second period was for Taxpayer’s location at *Onza Property*. As a result of that review, the City assessed Taxpayer for additional taxes for the *Lesueur Property* in the amount of \$15,255.39, interest up through September 2008 in the amount of \$2,711.18, penalties totaling \$3,813.89, and a license fee of \$50.00. Subsequently, Taxpayer provided a schedule of gross income for the assessment period. After review, the City revised the assessment for additional taxes of \$13,459.02, interest up through September 2008 of \$2,203.74, penalties of \$3,305.41, and a license fee of \$50.00. The City assessed the *Onza Property* for additional taxes due in the amount of \$5,051.60, interest up through September 2008 in the amount of \$105.94, penalties totaling \$1,185.87, and a license fee of \$50.00. Subsequently, Taxpayer provided a schedule of gross income for the assessment period. After review, the City revised the assessment for additional taxes due in the amount of \$8,073.12, interest up through September 2008 in the amount of \$177.85, penalties totaling \$1,914.07, and a license fee in the amount of \$50.00.

Taxpayer was in the business of operating, owning and managing a youth half-way house. Taxpayer was contracted and licensed by the State of Arizona (“State”) to do so as a “Child Welfare Agency”. ARS Section 8-501 (“Section 501”) defines a “child welfare agency” as: any agency or institution maintained by a person, firm, corporation, association or organization to receive children for care and maintenance or for twenty-four hour social, emotional or educational supervised care or who have been adjudicated as a delinquent or dependent child.” All the children are referred or placed through Child Protective Services (“CPS”). Once a child was placed with Taxpayer, Taxpayer was responsible for providing the child with everything that was needed. This included food, shelter, utilities, recreational activities, and transportation. Taxpayer received a lump sum from the State of \$99.00 per day for each child.

The City concluded that Taxpayer was engaged in the business of rental, leasing, and licensing for use of real property pursuant to City Code Section 5-10-445 (“Section 445”). According to the City, Taxpayer received a lump sum from the State for each child placed with Taxpayer. The City argued the lump sum amount covered the living space and associated services. The City noted that City Code Section 5-10-400 (“Section 400”) provides that all gross income is subject to the tax until the contrary is established by Taxpayer.

The issue in this matter is whether or not Taxpayer engaged in the business activity of leasing or renting real property or the licensing for use of real property located within the City pursuant to City Code Section 5-10-445 (“Section 445”). We note that while the assessments were based on the rental of real property, at the hearing the City expanded the assessment to include licensing for use of real property. If it’s determined Taxpayer was engaged in a taxable activity pursuant to Section 445, then we must determine how much of Taxpayer’s gross income would be attributable to the Section 445 activity.

Taxpayer had a contract with the State to provide twenty-four hour care and supervision of children who were dependent and were in the legal custody of the State. Pursuant to the State contract, Taxpayer was required to provide services that promoted coping, problem solving, and positive social behavior. Taxpayer was also required to provide transportation for the children to and from medical and dental examinations, school, court, therapy, visits and routine day to day activities. In addition to these services, Taxpayer was required to provide a “facility” which was defined as a living environment for the children. As a result, Taxpayer provided a home in which each child had a sleeping area with a bed and dresser or dresser equivalent as well as common areas for eating, studying, and bathroom facilities. The State contract required Taxpayer to provide space and furnishings to be arranged to enable Taxpayer to provide supervision while respecting the child’s right to privacy.

Section 445 imposes a tax on the gross income from every person engaged in the business activity of leasing or renting real property located within the City for a consideration to the tenant in actual possession or the licensing for use of real property to the final licensee located within the City for a consideration. In this case, the contract was

between Taxpayer and the State. The State pays Taxpayer \$99.00 per month for each child that is assigned to Taxpayer. As a result, the State provided the consideration to Taxpayer while the children would have been the tenant or licensee that would be in actual possession or using the real property. We note that State law requires tax statutes to be strictly construed against the taxing authority and in favor of the taxpayer. That raises the issue of whether or not the relationships between Taxpayer, the State, and the children clearly fit the Section 445 tax statutes. After careful consideration, we conclude the children are the wards of the State and as such are one and the same for the purposes of Section 445. We also find this would be consistent with the necessity of having the Section 445(q) exemption for assisted living facilities. If the assisted living facilities were not taxable, there would be no need for Section 445(q). We conclude Section 445(q) does not apply in this matter since Taxpayer was not an assisted living facility. Accordingly, we conclude Taxpayer was in the business of renting/licensing for use of real property pursuant to Section 445.

We are not left with the most difficult issue which is how much of Taxpayer's gross income was for the business activity set forth in Section 445. The City argued that Section 400 was controlling and that all gross income is presumed to be subject to the tax until the contrary is established by Taxpayer.

The City concluded that since there was no breakdown provided by the State allocating the lump sum of \$99.00 per month payment, then the entire amount was taxable. As part of its alternative argument, Taxpayer argued the amount of any rental/licensing for use income should be the amount of monthly rent paid by Taxpayer which would be allocated to cover only the bedroom areas of the homes. We find the City's conclusion to be simply too restrictive on its application of Section 400. In a more normal lessor/lessee or licensor/licensee application, the lessor/licensor would have control over the amount billed for the use of the real property. In this case, the State has set forth the Special Terms and Conditions ("Terms") that apply. Section 21 of those Terms specifies that payments shall be paid in a specified amount for each unit of service. This corroborates Taxpayer's argument that its primary business was providing non-taxable services. We conclude that Taxpayer has clearly established that not all of its gross income is subject to the Section 445 tax. Because the State required the contract amount to be a lump sum, we conclude it would not be fair to penalize Taxpayer and require the entire amount of the contract to be taxable when a separate for rental/licensing for use was not in Taxpayer's control. We conclude that Taxpayer should be taxed on the fair market value of the rental/licensing for use of real property. The only evidence presented for a fair market value was the monthly amounts paid by Taxpayer for the real properties used for homes. Those amounts were \$1,348.00 per month for the *Lesueur Property* and \$1,750.00 per month for the *Onza Property*. We reject Taxpayer's argument that the rental values should be allocated solely to the amount of bedroom space. Clearly, the children had the use of the entire house with the possible exception of office space for Taxpayer. Based on all the above, we conclude Taxpayer's taxable gross income pursuant to Section 445 and 400 for the audit period to be \$1,348.00 per month for the *Lesueur Property* and \$1,750.00 for the *Onza Property*.

Since Taxpayer failed to timely file reports or timely pay taxes, the City was authorized

pursuant to City Code Section 540 (“Section 540”) to assess penalties. Those penalties may be waived when a taxpayer demonstrates reasonable cause. We conclude that Taxpayer has demonstrated reasonable cause for failing to timely file reports and for failing to timely pay taxes. Accordingly, all penalties are waived. Taxpayer’s protest should be partly granted and partly denied, consistent with the Discussion, Findings, and conclusions, herein.

### **FINDINGS OF FACT**

1. On December 11, 2008, Taxpayer filed a protest of a tax assessment made by the City.
2. The City conducted a non-audit compliance review of Taxpayer for the periods of October 2004 through October 2007 and November 2007 through August 2008.
3. The first period was for Taxpayer’s location at the *Lesueur Property*.
4. The second period was for Taxpayer’s *Onza Property*.
5. The City assessed Taxpayer for additional taxes for the *Lesueur Property* in the amount of \$15,255.39, interest up through September 2008 in the amount of \$2,711.18, penalties totaling \$3,813.89, and a license fee of \$50.00.
6. Subsequently, the City reviewed additional documentation from Taxpayer and recommended the assessment be revised to additional taxes due in the amount of \$13,459.02, interest up through September 2008 in the amount of \$2,203.74, penalties totaling \$3,305.41, and a license fee of \$50.00.
7. The City assessed Taxpayer for additional taxes for the *Onza Property* in the amount of \$5,051.60, interest up through September 2008 in the amount of \$105.94, penalties totaling \$1,185.87, and a license fee of \$50.00.
8. Subsequently, the City reviewed additional documentation from the Taxpayer and recommended the assessment be revised to additional taxes due in the amount of \$8,073.12, interest up through September 2008 in the amount of \$177.85, penalties totaling \$1,914.07, and a license fee of \$50.00.
9. During the audit period, Taxpayer was in the business of operating, owning and managing a youth half-way house.
10. Taxpayer was contracted and licensed by the State.

11. All the children are referred or placed through CPS.
12. Once a child was placed with Taxpayer, Taxpayer was responsible for providing the child with food, shelter, utilities, recreational activities, and transportation.
13. Taxpayer received a lump sum from the State of \$99.00 per month for each child.
14. Pursuant to the State contract, Taxpayer was required to provide services that promoted coping, problem solving, and positive social behavior.
15. Taxpayer was required to provide transportation for the children to and from medical and dental examinations, school, court, therapy, visits and routine day to day activities.
16. Taxpayer was required to provide a “facility” which was defined as a living environment for the children.
17. Taxpayer provided a home in which each child had a sleeping area with a bed and dresser or dresser equivalent as well as common areas for eating, studying, and bathroom facilities.
18. Section 21 of the State Terms specified that payments shall be paid in a specified amount for each unit of service.
19. Taxpayer paid a monthly rent for the *Lesueur Property* of \$1,348.00 and for the *Onza Property* in the amount of \$1,750.00.
20. The children had the use of the entire house with the possible exception of the office space for Taxpayer.

### 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 children were the wards of the State and were one and the same for the purposes of Section 445.
3. Section 445(q) does not apply to this matter since Taxpayer was not an assisted living facility.
4. Taxpayer was in the service business and was in the business of renting/licensing

- for use of real property pursuant to Section 445.
5. Pursuant to Section 400, all gross income is presumed to be subject to the tax until the contrary is established by Taxpayer.
  6. The City's conclusion that the entire monthly lump sum of \$99.00 per child was taxable pursuant to Section 445 is too restrictive on the application of Section 400.
  7. In a normal lessor/lessee or licensor/licensee application, the lessor/licensor would have some control over the amount billed for the use of the real property.
  8. Section 21 of the State Terms corroborates Taxpayer's argument that its primary business was providing non-taxable services.
  9. Taxpayer clearly established that not all of its gross income is subject to the Section 445 tax.
  10. Since the State required the contract amount to be a lump sum, it would act as a penalty to assess Taxpayer on the entire amount of the contract pursuant to Section 445.
  11. Taxpayer should be taxed on the fair market value of the rental/licensing for use of real property.
  12. The only evidence presented for a fair market value were the monthly amounts paid by Taxpayer for the real properties used for homes.
  13. Taxpayer's taxable gross income pursuant to Sections 445 and 400 for the audit periods was \$1,348.00 per month for the *Lesueur Property* and \$1,750.00 for the *Onza Property*.
  14. Since Taxpayer failed to timely file reports or timely pay taxes, the City was authorized pursuant to Section 540 to assess penalties.
  15. Taxpayer demonstrated reasonable cause for failing to timely file reports or timely pay taxes.
  16. All penalties in this matter should be waived.
  17. Taxpayer's protest should be partly granted and partly denied, consistent with the Discussion, Findings, and Conclusions, herein.

## **ORDER**

It is therefore ordered that the December 11, 2008 protest by *Taxpayer* of a tax assessment made by the City of Mesa is hereby partly denied and partly granted, consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Mesa shall revise the assessment for the *Lesueur Property* to reflect a taxable gross income of \$1,348.00 per month and to revise the assessment to reflect a taxable gross income for the *Onza Property* of \$1,750.00 per month.

It is further ordered that the City of Mesa shall remove all penalties assessed in this matter.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh  
Municipal Tax Hearing Officer