

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: February 13, 2013

Decision: MTHO # 716

Taxpayer:

Tax Collector: City of Phoenix

Hearing Date: November 6, 2012

DISCUSSION

Introduction

On March 12, 2012, ***Taxpayer*** filed a letter of protest for a tax assessment made by the City of Phoenix (“City”). A hearing was commenced before the Municipal Tax Hearing Officer (“Hearing Officer”) on November 6, 2012. Appearing for the City was ***Assistant City Attorney***, the ***Tax Auditor*** and a ***Senior Tax Auditor***. Taxpayer failed to make an appearance. At the conclusion of the hearing, Taxpayer was granted until December 7, 2012 in which to file any additional information. On December 31, 2012, the Hearing Officer indicated no response had been received. As a result, the Hearing Officer closed the record and indicated a written decision would be issued to the parties on or before February 14, 2013.

DECISION

On February 14, 2012, the City issued an assessment to Taxpayer for additional taxes in the amount of \$16,086.34, interest up through January 2012 in the amount of \$1,926.15, and penalties in the amount of \$3,984.57. The audit period was from June 2006 through December 2011. The City assessed Taxpayer for taxes pursuant to City Code Section 14-445 (“Section 445”) on the gross income from the business activity of engaging in the business of leasing or renting real property within the City. Additionally, the City assessed additional taxes pursuant to City Code Section 14-446 (“Section 446”) on the gross income from the business activity of engaging in renting or leasing nonresidential property.

On March 1, 2006, Taxpayer was formed as a domestic limited liability company by ***Taxpayer #1***, and ***Taxpayer #2*** (“***Both Taxpayers***”). ***Both Taxpayers*** had previously formed the ***A O Corporation*** (“***AOC***”) on January 4, 2006. On May 30, 2006, Taxpayer purchased a convenience store from ***BPWCP, LLC*** (“***BPWCP***”). The purchase was

financed by a \$2,225,000.00 loan from *Small Capital, LLC* (“*SM*”). Taxpayer asserted that *SM* required it to create an LLC separate from *AOC* in order to shield the land from any and all liabilities *AOC* might incur. *SM* would not loan any funds to purchase the convenience store and the land without the creation of the LLC.

On May 30, 2006, Taxpayer entered into an Assignment of Leases and Rents (“Assignment”) with *SM*. The Assignment assigned all leases to the convenience store to *SM*. This was done to secure the loan being provided by *SM*. On May 31, 2006, Taxpayer, the landlord, entered into a ten year Commercial Net Lease for Entire Building (“Lease”) with *AOC*, the tenant. The terms of the lease were for ten years with an option to extend for another ten years. Tenant was to pay \$1.00 per month for rent. Tenant was to operate a gas station business on the premises.

Taxpayer had protested the assessment arguing that *AOC* had never paid Taxpayer any money. In addition, Taxpayer protested the penalties and interest that has accrued.

After review of the evidence, the Hearing Officer concludes that Taxpayer was indirectly receiving rents from *AOC*. Based on the Assignment and the Lease, *AOC* made payments to *SM* to pay for the loan from *SM* to Taxpayer. The payments could have been made from *AOC* to Taxpayer and then Taxpayer would pay *SM*. However the parties set it up as a one step process with *AOC* paying *SM* on behalf of Taxpayer. As a result, we conclude that Taxpayer was in the business of renting nonresidential real property pursuant to Sections 445 and 446. While the lease agreement between Taxpayer and *AOC* referred to monthly payments of \$1.00, City Code Section 14-210 (“Section 210”) indicates that transactions between affiliated companies where the gross income from the transactions are not indicative of the market value, the City is authorized to determine a market value upon which the City taxes will be levied. The market value is to correspond to similar transactions of like quality. In this case, the City utilized a comparable commercial rental business within the same zip code as Taxpayer. City Code Section 14-540 (“Section 540”) requires the City estimate to be based on a reasonable basis. In this case, we conclude the City’s use of a comparable commercial rental within the same zip code to be a reasonable basis. Section 540 provides that a taxpayer may prove a city estimate is not reasonable by submission of sufficient documentation to demonstrate the estimate was not reasonable. We conclude Taxpayer has failed its burden of proof of submitting sufficient documentation. We note that Subsection 445(s) provides an exemption for commercial leases in which a corporation leases real property to an affiliated corporation. Unfortunately for Taxpayer, it does not meet the criteria of being a lease from a corporation to a corporation. Taxpayer is an LLC and does not meet the definition of an affiliated corporation pursuant to Subsection 445(s)(1). Based on all the above, we conclude that the City’s tax assessment was proper. Accordingly, Taxpayer’s protest of the tax assessment is denied.

Taxpayer protested the City’s assessment of penalties for failure to file and failure to pay taxes pursuant to City Code Section 14-540 (“Section 540”). Taxpayer noted that Section 540 permits the penalties to be waived if the failure is due to reasonable cause. Section

540 defines reasonable cause to mean a reasonable basis for the taxpayer to believe that the tax did not apply to the business activity. Taxpayer asserted that the only reason it was formed was to meet a requirement of the lender in order to shield the land. Further, neither of Taxpayer's CPA's advised Taxpayer that it needed to file transaction privilege tax returns or pay taxes to the City. Based on the above, Taxpayer has demonstrated reasonable cause to have all penalties waived. We note Taxpayer had also requested waiver of interest. Section 540 provides that interest can only be waived if the underlying tax is waived. In this case, the underlying tax has been upheld. As a result, Taxpayer's request to have interest waived must be denied. Taxpayer's protest should be partly granted and partly denied, consistent with the Discussion, Findings, and Conclusions, herein.

FINDINGS OF FACT

1. On March 12, 2012, Taxpayer filed a letter of protest for a tax assessment made by the City.
2. On February 14 2012, the City issued an assessment to Taxpayer for additional taxes in the amount of \$16,086.34, interest up through January 2012 in the amount of \$1,926.15, and penalties in the amount of \$3,984.57.
3. The audit period was from June 2006 through December 2011.
4. The assessment was based on unreported income from the business activity of engaging in the renting of real property within the City.
5. On March 1, 2006, Taxpayer was formed as a domestic limited liability company by **both Taxpayers**.
6. **Both Taxpayers** had previously formed **AOC** on January 4, 2006.
7. On May 30, 2006, Taxpayer purchased a convenience store from **BPWCP**.
8. The purchase was financed by a \$2,225,000.00 loan from **SM**.
9. **SM** required Taxpayer to create an LLC separate from **AOC** in order to shield the land from any and all liabilities **AOC** might occur.
10. **SM** would not loan any funds to purchase the convenience store and the land without the creation of the LLC.

11. On May 30, 2006, Taxpayer entered into an Assignment with *SM*.
12. The Assignment assigned all leases to the convenience store to *SM*.
13. The Assignment was done to secure the loan being provided by *SM*.
14. On May 31, 2006, Taxpayer, the landlord, entered into a ten year Lease with *AOC*, the tenant.
15. The terms of the lease were for ten years with an option to extend for another ten years.
16. Tenant was to pay \$1.00 per month for rent.
17. Tenant was to operate a gas station business on the premises.
18. Neither of Taxpayer's CPAs advised Taxpayer that transaction privilege tax returns had to be filed or taxes paid to the City.

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. Sections 445 and 446 impose a tax on the business activity of engaging in the business of leasing or renting of real property within the City.
3. Based on the Assignment and Lease, *AOC* made payments to *SM* to pay for the loan from *SM* to Taxpayer.
4. The payments made by *SM* represented lease payments to Taxpayer and were taxable pursuant to Sections 445 and 446.
5. Section 210 indicates that transactions between affiliated companies where the gross income from the transactions was not indicative of the market value, the City was authorized to determine a market value upon which the City taxes will be levied.

6. Taxpayer and *SM* were affiliated companies.
7. The \$1.00 payments as set forth in the Lease did not represent a fair market value.
8. The City's use of a comparable commercial rental business within the same zip code as Taxpayer was a reasonable basis on which to determine fair market value.
9. Taxpayer failed to submit sufficient documentation to demonstrate the City estimate was not reasonable.
10. Taxpayer does not meet the criteria set forth in Subsection 445(s) for an exemption between two affiliated corporations.
11. The City was authorized pursuant to Section 540 to assess penalties as Taxpayer had failed to file tax reports and failed to pay City transaction privilege taxes.
12. Taxpayer has demonstrated reasonable cause to have all penalties waived in this matter.
13. Since the underlying taxes have been upheld, interest cannot be waived in this matter.
14. Taxpayers protest should be partly granted and partly denied, consistent with the Discussion, Findings, and Conclusions, herein.
15. The parties have timely appeal rights pursuant to Model City Tax Code Section 575.

ORDER

It is therefore ordered that the May 12, 2012 protest by *Taxpayer* of a tax assessment made by the City of Phoenix is hereby partly granted and partly denied, consistent with the Discussion, Findings, and Conclusions, herein.

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

It is further ordered that this Decision is effective immediately.

Municipal Tax Hearing Officer