DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: April 30, 2007
Decision: MTHO #330
Taxpayer: ***Taxpayer***
Tax Collector: City of Flagstaff
Hearing Date: February 2, 2007

DISCUSSION

Introduction

On October 3, 2006, ***Taxpayer*** ("Taxpayer") filed a protest of a tax assessment made by the City of Flagstaff ("City"). After review, the City concluded on October 16, 2006 that the protest was timely and in the proper form. On October 20, 2006, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to file any response to the protest on or before December 4, 2006. On November 29, 2006, the City filed a response to the protest. On December 7, 2006, the Hearing Officer ordered the Taxpayer to file a reply on or before December 28, 2007. On December 26, 2006, a Notice of Tax Hearing ("Notice") scheduled this matter for hearing commencing on January 31, 2007. On January 16, 2007, Taxpayer requested the hearing date to be changed. On January 18, 2007, a Notice rescheduled the hearing until February 2, 2007 at 10:00 a.m. On January 22, 2007, a Notice rescheduled the hearing for February 2, 2007 at 1:00 p.m. Both parties appeared and presented evidence at the February 2, 2007 hearing. On February 5, 2007, the Hearing Officer indicated the parties had agreed to the following briefing schedule: Taxpayer would file an opening brief on or before February 23, 2007; the City would file a response brief on or before March 16, 2007; and, Taxpayer would file a reply brief on or before March 30, 2007. Taxpayer filed an opening brief on February 23, 2007. The City filed a response brief on March 30, 2007. On April 9, 2007, the Hearing Officer indicated no reply brief had been filed and as a result the record was closed and a written decision would be issued on or before May 24, 2007.

City Position

The City audited the Taxpayer for the period October 1996 through March 2006. The City assessed the Taxpayer for additional taxes in the amount of $9,767.50, penalties in the amount of $2,439.37, and interest up through May 2006 in the amount of $4,811.68. The City asserted Taxpayer engaged in commercial rental activity by leasing premises it owned at ***"Location"*** in the City to ***a child care facility.*** The City argued that Taxpayer was subject to City Code Section 3-5-445 ("Section 445") as it existed during the audit period and City Regulation 3-5-445.1(b)(6) ("Regulation 445.1 (b)(6). Section 445 provides for a tax on the gross income from the business activity upon every person engaged in the business of leasing or renting real property located within the City.

Section 445(g) provided for a single unit/single tenant exemption as follows:

(a) Single-unit/single-tenant rental, leasing, or licensing. A person who has only one unit of commercial property rented or available for rent, lease, or license shall be deemed not to be in the business of rental, leasing, or licensing of real property, as provided by Regulation, and further provided that both the following conditions exist:

(1) such lessor has income from any other source; and

(2) the scope and degree of rental activity clearly indicates that it is an investment rather than a business activity of the lessor.

Regulation 445.1(b)(6) and (7) provide as follows:

(6) A corporation, or a partnership comprising other than individual members of the same immediate family, is considered to be in business, and therefore even if it has only one unit of real property rented or available for rent, it cannot be deemed to have made a non-business investment, and cannot claim such rental as "casual".

(7) Note that there are four (4) conditions for rental of commercial real property to be deemed "casual activity", which must be met. They are, in brief:

(A) The lessor has only one unit of commercial property rented or available for rent, counting any commercial property he occupies, if any; and

(B) The lessor has no lodging rented or available for rent; and

(C) The lessor has significant income from another source; and

(D) The scope of the rental activity is clearly a non-business investment.

In response to Taxpayer's arguments, the City asserted Taxpayer did not qualify for the single unit/single tenant exemption. According to the City, Regulation 445.1 (b) makes it clear that a corporation is not eligible for the "casual" activity exemption. The City disputed Taxpayer's argument that the four conditions listed in Regulation 445.1 (b)(7) were met. The City asserted that Taxpayer had one unit of commercial property rented and was deemed to be in the business of renting real property because Taxpayer had no income from any other source. The City argued that it was logically and legally inconsistent to argue that the corporation was exempt from taxation because its shareholders should be treated as a family partnership but that its shareholders should have protection from the liabilities of the corporation because they are legally separate. The City noted that Taxpayer was a "person" pursuant to City Code Section 3-5-100 ("Section 100") and thus subject to the City's tax on rental income.

The City argued that Taxpayer bore the initial burden of establishing a right to an exemption from taxation. According to the City, a tax statute granting a tax exemption must be strictly construed against an exemption from taxation. The City asserted Taxpayer did not introduce evidence legally sufficient to support an exemption from taxation.

The City included property tax payments paid by ***the child care facility*** and tenant improvements made by ***the child care facility*** as part of Taxpayer's taxable income. While the lease agreement between Taxpayer and ***the child care facility*** required ***the child care facility*** to pay all property taxes, the City noted that Section 445(a)(1) provides

that "Payments made by the lessee to, or on behalf of, the lessor for property taxes, repairs, or improvements are considered to be part of the taxable gross income." The City concluded the property tax payments were clearly a benefit to the property owner since the property owner was at risk if the taxes were not paid. The City also included $39,230 of tenant improvements made by ***the child care facility*** as part of Taxpayer's gross income. These improvements included an electrical upgrade to the air conditioner, remodeling the kitchen (cabinets, counters, sinks, range hood), and a ramp to meet the requirements of the Americans with Disabilities Act ("ADA"). According to the City, a child care facility is a place of public accommodation which must comply with the ADA. The City asserted that without construction of the ADA compliant entrance ramp, both the landlord and tenant would have been subject to enforcement actions by the Department of Justice. The City concluded these three improvements resulted in upgrades to the building in general, which would benefit the property owner.

In response to Taxpayer, the City argued that City Code Section 3-5-550(c) ("Section 550 (c)") states there is no statute of limitations ("SOL") period for assessing tax if the taxpayer has failed to file a tax return for any month. According to the City, Taxpayer did not have a City tax license prior to notification of the audit. As a result, the City asserted it was compelled to take the audit period back to the first month of the lease between Taxpayer and ***the child care facility***.

Taxpayer Position

The Taxpayer argued that the income from the commercial rent from ***the child care facility*** lease was exempt pursuant to Section 445. Taxpayer asserted that it was a corporation wholly owned by ***Owner***; that it was a Subchapter S Corporation ("Corporation") wherein its income and expenses were merged with its owners: its owners had an unrelated business for their primary income; and the rental was held for investment purposes. While the City argued Taxpayer cannot be exempt pursuant to Regulation 445.1(b)(6), Taxpayer argued the Regulation is contrary to the City ordinance definition of "Person" set forth in Section 100. According to Taxpayer, any contradiction between two different provisions of the City tax law would have to be resolved in favor of Taxpayer.

Taxpayer argued that payments of property taxes and tenant improvements by the tenant are not payments on behalf of Taxpayer and should not be included as part of the gross income of Taxpayer. According to Taxpayer, there was no evidence that Taxpayer received any benefit for the improvements made by ***the child care facility***.

Taxpayer asserted an examination of ten years of rental activity may be statutory but it seems unfair and excessive. Taxpayer argued that at the very least, the ordinances and regulations are confusing in this matter. In fact, the City indicated the one unit exemption was recently deleted because it was causing confusion. Accordingly, Taxpayer opined the penalties should be abated pursuant to City Code Section 3-5-540(f) ("Section 540(f)").

ANALYSIS

During the audit period, Taxpayer received gross income from the business activity of leasing real property located within the City which was taxable pursuant to Section 445. Taxpayer was a Corporation and as a result was a "person" pursuant to Section 445. During the audit period, there was a single-unit exemption for the rental/leasing tax assessed pursuant to Section 445. The burden of proof was on Taxpayer to demonstrate they fell within the exemption. We conclude Taxpayer failed to meet its burden of proof. Section 445 has two conditions that must exist for the exemption to apply. Those conditions are that the lessor has income from another source and the scope and degree of rental activity clearly indicates it is an investment rather than a business activity. In an effort to demonstrate these conditions were met, Taxpayer argued that the shareholders of Taxpayer met the conditions and therefore Taxpayer met the conditions. Unfortunately, we do not find the fact that the shareholders met the conditions to be relevant. Taxpayer was a separate legal entity and the only "person" that could meet the conditions set forth in the exemption. There was not evidence to demonstrate Taxpayer met either of the conditions and as a result the exemption did not apply.

While ***the child care facility*** paid the property taxes on the ***Location*** property, Section 445(a) makes it clear that payments made by the lessee to, or on behalf of, the lessor for property taxes were to be considered as part of the taxable gross income. We conclude the property taxes were the legal obligation of Taxpayer and as such the payments made by ***the child care facility*** would have been made on behalf of Taxpayer. As a result, the property tax payments were properly includable in Taxpayer's gross income. The improvements made by ***the child care facility*** for the electrical upgrade, the kitchen remodel, and the ramp to meet the ADA requirements would also be taxable if made on behalf of Taxpayer. We find there was not sufficient evidence to conclude those improvements were made on behalf of Taxpayer. As a result, those improvements will need to be removed from the assessment.

While the normal SOL period is four years, Section 550(c) authorizes the City to assess for an unlimited period when there have been no returns filed. Since Taxpayer failed to file any returns, the ten year audit period was proper pursuant to Section 550(c). Since Taxpayer failed to timely file returns or timely pay taxes, the City was authorized pursuant to Section 540 to assess penalties. These penalties may be waived if Taxpayer could demonstrate "reasonable cause" for failing to timely file and pay. Taxpayer argued that the penalties should be waived because of the confusion regarding the one unit exemption. We conclude that a taxpayer exercising "ordinary business care and prudence" could have reasonably believed they fell within the single-unit exemption and conclude they did not have to file and pay taxes. As a result, we conclude Taxpayer has demonstrated reasonable cause to have the penalties waived.

FINDINGS OF FACT

1. On October 3, 2006, Taxpayer filed a protest of a tax assessment made by the City.

2. After review, the City concluded on October 16, 2006, that the protest was timely and in the proper form.

3. On October 20, 2006, the Hearing Officer ordered the City to file any response on or before December 4, 2006.

4. On November 29, 2006, the City filed a response to the protest.

5. On December 7, 2006, the Hearing Officer ordered the Taxpayer to file a reply on or before December 28, 2006.

6. On December 26, 2006, a Notice scheduled the matter for hearing commencing on January 31, 2007.

7. On January 16, 2007, Taxpayer requested the hearing date to be rescheduled.

8. On January 18, 2007, a Notice rescheduled the hearing until February 2, 2007 at 10:00 a.m.

9. On January 22, 2007, a Notice rescheduled the hearing for February 2, 2007 at 1:00 p.m.

10. Both parties appeared and presented evidence at the February 2, 2007 hearing.

11. On February 5, 2007, the Hearing Officer indicated the parties had agreed to the following briefing schedule: Taxpayer would file an opening brief on or before February 23, 2007; the City would file a response brief on or before March 16, 2007; and, Taxpayer would file a reply brief on or before March 30, 2007.

12. Taxpayer filed an opening brief on February 23, 2007.

13. The City filed a response brief on March 30, 2007.

14. On April 9, 2007, the Hearing Officer indicated no reply brief had been filed and as a result the record was now closed and a written decision would be issued on or before May 24, 2007.

15. The City conducted an audit of Taxpayer for the period October 1996 through March 2006.

16. As a result of the audit, the City assessed Taxpayer for additional taxes in the

amount of $9,767.50, penalties in the amount of $2,439.37, and interest up through May 2006 in the amount of $4,811.68.

17. Taxpayer leased its ***Location*** property to ***the child care facility*** during the audit period.

18. Taxpayer was a Corporation.

19. Taxpayer had no income from any source other than the lease to ***the child care facility.***

20. The lease between Taxpayer and ***the child care facility*** required ***the child care facility*** to pay all property taxes on the ***Location*** property.

21. During the audit period, ***the child care facility*** made $39,230 of improvements to the ***Location*** property which included an electrical upgrade to the air conditioner, remodeling of the kitchen, and construction of a ramp to meet the requirements of the ADA.

22. After the audit period, the City deleted the one unit exemption because it was causing confusion.

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. Taxpayer was a "person" pursuant to Section 100.

3. During the audit period, Taxpayer had unreported gross income from the business activity of leasing real property.

4. Taxpayer's gross income for ***the child care facility*** lease was taxable pursuant to Section 445.

5. The property taxes paid by ***the child care facility*** on the ***Location*** property were paid on behalf of Taxpayer and were part of Taxpayer's taxable income pursuant to Section 445(a).

6. There was not sufficient evidence to demonstrate the improvements made for the electrical upgrade, the kitchen remodel, and the ramp were made on behalf of Taxpayer.

7. Taxpayer failed to meet its burden of proof of demonstrating it was entitled to the

single-unit exemption set forth in Section 445.

8. Section 550(c) authorized the City to assess for an unlimited period since Taxpayer failed to file any returns.

9. The City was authorized pursuant to Section 540 to assess penalties for failing to timely file returns and failing to timely pay taxes.

10. Taxpayer exercised "ordinary business care and prudence" in its belief that it fell within the single-unit exemption

11. Taxpayer demonstrated reasonable cause to have the penalties waived.

12. Taxpayer's protest should be partly denied and partly granted, consistent with the Discussion, Findings, and Conclusions, herein.

ORDER

It is therefore ordered that the October 3, 2006, protest of ***Taxpayer*** of a tax assessment made by the City of Flagstaff is hereby partly denied and partly granted consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Flagstaff shall revise the assessment by removing the income for the improvements made by t***he child care facility***. for the electrical upgrade, the kitchen remodel, and the ramp to meet the Americans with Disabilities Act.

It is further ordered that the City of Flagstaff shall revise the assessment by removing the penalties.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer