

## DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: May 14, 2009

Decision: MTHO #475

Taxpayer: *Taxpayer*

Tax Collector: City of Mesa

Hearing Date: None

### DISCUSSION

#### Introduction

On September 29, 2008, *Taxpayer* (“Taxpayer”) filed a protest of a tax assessment made by the City of Mesa (“City”). After review, the City concluded on December 30, 2008 that the protest was timely and in the proper form. On January 8, 2009, the Municipal Tax Hearing Officer (“Hearing Officer”) classified the matter as a hearing and ordered that City to file any response to the protest on or before February 23, 2009. On January 8, 2009, the Municipal Tax Hearing Officer (“Hearing Officer”) classified the matter as a hearing and ordered the City to file any response to the protest on or before February 23, 2009. On January 12, 2009, Taxpayer requested the matter be reclassified as a redetermination. On January 14, 2009, the Hearing Officer reclassified the matter from a hearing to a redetermination. The City sent a February 18, 2009 email requesting an extension to file a response in order to allow the City time to review additional documentation being provided by Taxpayer. On February 19, 2009, the Hearing Officer granted the City an extension until April 10, 2009. On April 9, 2009, the City filed a response to the protest. On April 12, 2009, the Hearing Officer granted Taxpayer until May 13, 2009 to file any reply. On April 20, 2009, Taxpayer filed a reply. On April 25, 2009, the Hearing Officer indicated that the record was closed and that a written decision would be issued on or before June 9, 2009.

#### City Position

The City performed an audit of Taxpayer for the period of September 2003 through September 2007. As a result of the audit, the City assessed Taxpayer for additional taxes in the amount of \$4,660.67, and interest up through August 2008 in the amount of \$1,026.90.

The City indicated that Taxpayer is the owner of real property located at **123 and 456 W. Mesa Street** (“*Mesa Property 1*”) in the City. According to the City, a related company to Taxpayer, *Tenant 1* occupies a portion of the shopping center at the *Mesa Property 1*. The City asserted that Taxpayer’s records showed that \$1,500.00 in rental income was reported for the transaction in some months, but in most months no rental income was reported.

As part of the audit, the City obtained a copy of a lease agreement between Taxpayer and **Tenant 1**. According to the City, **Tenant 1** was to pay Taxpayer for the following items: (A) All common area maintenance (“CAM”) charges for the entire shopping center; (B) 3.5% of the gross profits from the **Tenant 1** business; and, (C) \$1,500.00 per month if **Tenant 1** used any additional space. The City indicated that during the audit, Taxpayer was requested to provide accounting records regarding these payments. The City opined that no records were provided.

The City assessed Taxpayer on the gross income from the business activity of engaging in the business of leasing or renting real property located within the City pursuant to City Code Section 5-10-445 (“Section 445”). The City noted that City Code Section 5-10-210 (“Section 210”) allows the City to determine gross income involving transactions between affiliated companies by using “market value.” The City indicated that City Code Section 5-10-545 (b) (“Section 545(b)”) authorizes the City to estimate gross income based on a reasonable basis. Section 545(b) also states that it is the responsibility of the taxpayer to prove the City’s estimate is not reasonable and correct. In this case, the City estimated gross income based on the market value because Taxpayer failed to provide information related to the lease. According to the City, the space that **Tenant 1** occupies is split into retail space of 5,758 square feet and warehouse space of 9,242 square feet. The City estimated the market value of the retail space to be seventy-five cents per square foot per month or \$3,193.50 (5,758 square feet times seventy-five cents). The City obtained the seventy-five cents amount from a lease Taxpayer has with **Tenant 2**. The City indicated that based on discussions during the audit period with Taxpayer, the **Tenant 2** space was similar to the retail space occupied by **Tenant 1**. The City determined that the **Tenant 2** lease was \$2,249.50 per month for 2,984 or seventy-five cents per square foot. The City estimated the warehouse space to be fifty cents per square foot. The City indicated the fifty cent amount was based on discussions with Taxpayer on its previous rental of warehouse space at **Mesa Property 2** in which Taxpayer paid fifty cents per square foot. The City was provided with an October 24, 2008 letter from **Real Estate Company**, a retail commercial real estate firm. While **Real Estate Company** concluded that Taxpayer’s lease terms were “very fair,” the City was unable to determine what records were reviewed by **Real Estate Company** to reach its conclusion. The City argued that Taxpayer has failed to meet its burden of proving the City’s estimate was not reasonable.

### **Taxpayer Position**

Taxpayer protested the amount of the assessment. Taxpayer asserted the warehouse in question was built exclusively for the use of **Tenant 1**. Taxpayer argued that the building has no rental value to anyone else due to the fact that it has no front entrance and the utilities are connected to air conditioning units on the rental side of the building. According to Taxpayer, there is no access to the warehouse without going through the front store and thus has no use to anyone but **Tenant 1**.

While Taxpayer acknowledged that **Tenant 2** paid seventy-five cents per square foot for retail space, Taxpayer asserted that twenty-five cents was for rent and fifty cents was for CAM charges. As a result, Taxpayer argued the estimate for rental income should be based on the twenty-five cent amount. Taxpayer argued that the City's use of fifty cents per square foot for warehouse space was excessive. According to Taxpayer, twenty-five cents was for common area and the other twenty-five cents was for warehouse space. Taxpayer indicated **Tenant 1** pays for the common area for the entire center.

Taxpayer provided a letter from **Real Estate Company** regarding the lease values for the **Mesa Property 1**. **Real Estate Company** concluded that the lease rate of \$1,500.00 per month, plus all CAM charges, plus 3.5% percent of the profit was a very fair rate to be paid by **Tenant 1**. According to Taxpayer, the average CAM charges to run a center the size of the **Mesa Property 1** would be fifty cents per square foot.

### ANALYSIS

There was no dispute that Taxpayer and **Tenant 1** were separate "persons" as defined in City Code Section 5-10-100 ("Section 100"). As a result, Taxpayer was in the business of leasing or renting the **Mesa Property 1** to **Tenant 1** pursuant to Section 445. The only issue we have in this matter is what was the amount of the monthly gross income for the leasing or renting of the **Mesa Property 1**. Section 445 provides that the amount of gross income includes payments made by the lessee for property taxes, repairs, or improvements. The gross income also includes charges for utilities. The lease agreement provided for **Tenant 1** to pay for all CAM charges plus 3.5% of the gross profit plus an additional \$1500.00 per month if additional space was used by **Tenant 1**.

The City requested documentation from Taxpayer to determine the actual amounts paid by **Tenant 1** for the lease. City Code Section 5-10-350 ("Section 350") places a duty on each taxpayer to keep and preserve suitable books and records to determine the amount of tax the taxpayer is liable for. In this case, Taxpayer failed to provide requested books and records in order to determine the amount of gross income pursuant to Section 445. As a result, the City was authorized pursuant to Section 545(b) to make an estimate based on a reasonable basis. We must decide if the City's estimate was based on a reasonable basis. For the retail space occupied by **Tenant 1**, the City utilized the same rate paid by another tenant to Taxpayer for similar retail space. We conclude that method was reasonable. For the warehouse space, the City utilized the rental amount that Taxpayer had previously paid. We conclude the City's estimate for the warehouse space was based on a reasonable method and conclude the estimate was reasonable. Section 545(b) provides that another reasonable basis would not invalidate the City's estimate. However, a taxpayer may provide documentation to prove the City's estimate was not reasonable.

Taxpayer provided documentation from a realty group that concluded that Taxpayer's lease with **Tenant 1** was very fair. Taxpayer also asserted that CAM charges to run a center like the **Mesa Property 1** would be approximately fifty cents per square foot. If we use the fifty cents per square foot CAM number times 15,000 square feet, we arrive at a

monthly rental of \$7500.00 for the combined warehouse and retail space. The City had indicated that Taxpayer's records showed that \$1,500.00 of rental income was reported in some months. As a result, we conclude there were some months in which *Tenant 1* utilized additional space and had to pay the extra \$1,500.00 per month. Taxpayer also provided IRS Form 1120's for 2004 and 2005 which showed *Tenant 1* having gross profits. We note the 2006 and 2007 Form 1120's showed losses. Based on the above, Taxpayer's documentation would support a monthly rental of \$7500.00 plus additional rental for additional space plus an addition for gross profits for two years. The City's combined monthly rental totaled \$8,939.50. As a result, we are unable to conclude that the City's estimate was not reasonable. Taxpayer failed to meet its burden of proof pursuant to Section 545(b) of demonstrating the City's estimate was not reasonable. Taxpayer's protest should be denied.

### **FINDINGS OF FACT**

1. On September 29, 2008, Taxpayer filed a protest of a tax assessment made by the City.
2. After review, the City concluded on December 30, 2008 that the protest was timely and in the proper form.
3. On January 8, 2009, the Hearing Officer classified the matter as a hearing and ordered the City to file any response to the protest on or before February 23, 2009.
4. On January 12, 2009, Taxpayer requested the matter be reclassified as a redetermination.
5. On January 14, 2009, the Hearing Officer reclassified the matter from a hearing to a redetermination.
6. On February 18, 2009, the City sent an email requesting an extension to file a response in order to allow the City time to review additional documentation being provided by Taxpayer.
7. On February 19, 2009, the Hearing Officer granted the City an extension until April 10, 2009 to file a response.
8. On April 9, 2009, the City filed a response to the protest.
9. On April 13, 2009, the Hearing Officer granted Taxpayer until May 13, 2009 to file any reply.
10. On April, 20, 2009, Taxpayer filed a reply.

11. On April 25, 2009, the Hearing Officer indicated the record was closed and a written decision would be issued on or before June 9, 2009.
12. The City performed an audit of Taxpayer for the period of September 2003 through September 2007.
13. The City assessed Taxpayer for additional taxes in the amount of \$4,660.67, and interest up through August 2008 in the amount of \$1,026.90.
14. Taxpayer is the owner of real property located at the *Mesa Property 1* in the City.
15. A related company to Taxpayer, *Tenant 1*, occupies a portion of the shopping center at the *Mesa Property 1*.
16. Taxpayer's records showed that \$1,500.00 in rental income was reported for the transaction in some months, but in most months no rental income was reported.
17. The City obtained a copy of a lease agreement between Taxpayer and *Tenant 1*.
18. The lease agreement provided that *Tenant 1* was to pay Taxpayer for the following items: (A) All CAM charges for the entire shopping center; (B) 3.5% of the gross profits from the *Tenant 1* business; and, (C) \$1,500.00 per month if *Tenant 1* used any additional space.
19. As part of the audit, the City had requested Taxpayer provide accounting records regarding the payments from *Tenant 1*.
20. Taxpayer failed to provide the records requested by the City.
21. *Tenant 1* occupies retail space of 5,758 square feet and warehouse space of 9,242 square feet.
22. During the audit period, *Tenant 2* paid Taxpayer seventy-five cents per square foot for retail space.
23. The City estimated the cost of the warehouse space to be fifty cents per square foot based on Taxpayer's previous rental of warehouse space at *Mesa Property 2*.
24. *Real Estate Company* concluded in an October 24, 2008 letter that the Taxpayer lease terms were "very fair."
25. The warehouse had no front entrance and the utilities are connected to air conditioning units on the retail side of the building.

## 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 and *Tenant 1* were separate “persons” pursuant to Section 100.
3. During the audit period, Taxpayer was in the business of leasing or renting the *Mesa Property 1* to *Tenant 1* pursuant to Section 445.
4. The City’s estimation of monthly rental income for the combined warehouse and retail space for the *Mesa Property 1* was based on a reasonable methodology pursuant to Section 545(b).
5. Taxpayer has failed to prove pursuant to Section 545(b) that the City’s estimate was not reasonable.
6. Taxpayer’s protest should be denied.

## ORDER

It is therefore ordered that the September 29, 2008 protest by *Taxpayer* of a tax assessment made by the City of Mesa is hereby denied consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh  
Municipal Tax Hearing Officer