

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: June 28, 2011

Decision: MTHO # 612

Taxpayer's Names

Tax Collector: City of Mesa

Hearing Date: May 19, 2011

DISCUSSION

Introduction

On November 29, 2010, a letter of protest was filed by *Taxpayers* of a tax assessment made by the City of Mesa ("City"). A hearing was commenced before the Municipal Tax Hearing Officer ("Hearing Officer") on May 19, 2011. Appearing for the City were the *Tax Audit Supervisor*, and *Senior Tax Auditor*. Appearing for Taxpayers were the *Taxpayer's Representative a CPA*, and *Taxpayer*. At the conclusion of the May 19, 2011 hearing, the parties were granted an opportunity to file post-hearing documentation. On June 25, 2011, the Hearing Officer indicated the record was closed and a written decision would be issued on or before August 9, 2011.

DECISION

On May 13, 2010, the City issued a non-audit compliance assessment of Taxpayers. The assessment was for the period of December 2004 through March 2010 ("Compliance Period"). The assessment was for additional taxes in the amount of \$3,063.79, interest up through April 2010 in the amount of \$471.96, penalties in the amount of \$758.98, and a license fee of \$110.00.

Taxpayers owned the property at *123 N. Best Street ("Best Property")* in the City. The *Best Property* was occupied during the Compliance Period by a related limited liability company (*Company BB, LLC ("BB United")*). Taxpayers indicated that *BB United* was a single member LLC, with *Taxpayers* as the only LLC members. As a result, Taxpayers urged the City to recognize the business as a sole proprietorship with no assessment of rent tax. Taxpayers also disputed the amount of the rent determined. Taxpayers indicated the business did not start until February 2006 and that the business was not operational from January through August 28, 2010. Taxpayers indicated that when the business was started, they had spoken to an employee of the City and were not informed of any tax liability associated with the business.

The City imposed a tax on Taxpayers on the gross income from the rental of real property pursuant to City Code Section 5-10-445 (“Section 445”). The City noted that City Code Section 5-10-210 (“Section 210”) permits the City to determine the gross income involving transactions between affiliated companies by determining the “market value”. The City concluded Taxpayers were in “business” as defined in City Code Section 5-10-100 (“Section 100”) since Taxpayers derived a gain, benefit, or advantage by having **BB United** pay the mortgage payment, property taxes, insurance and maintenance on the **Best Property**. The City utilized the “Fair Values for Commercial Rentals” by Cushman & Wakefield to estimate the monthly market values for rent. The City’s estimates for rents were in the range of \$2,500.00 to \$3,500.00 per month. Taxpayers argued for rental values of \$800.00 to \$900.00. In the City’s post-hearing response, the City agreed to reduce the monthly rental amounts to \$1,500.00 to cover the mortgage costs, property tax payments, insurance, and home improvements. Taxpayers argued that the rental amount should be reduced to \$1,100.00 per month to cover the mortgage, insurance, and property tax payments.

Taxpayers provided post-hearing documents that supported a start date for the bank business account for **BB United** to be March 2006 with initial occupancy of the building commencing in February 2006. Taxpayers asserted any assessment should not start until March 2006. The City provided documentation that the certificate of occupancy (“COO”) for the **Best Property** was issued on September 13, 2005 and that the start period for the assessment should be revised to September 2005.

Clearly, Taxpayers and **BB United** were separate persons pursuant to Section 100. Consequently, the transaction between Taxpayers and **BB United** resulted in the business of leasing or renting of real property in the City pursuant to Section 445. It also clear that because the parties to the transaction were related, it was proper for the City to utilize an estimate pursuant to Section 210. We further conclude that the City’s usage of Cushman & Wakefield values for commercial rentals was a reasonable estimation methodology pursuant to Section 545. The next issue is whether or not Taxpayers were able to provide sufficient documentation to demonstrate pursuant to City Code Section 545 (“Section 545”) that the City’s estimates were not reasonable. In this case, we conclude that Taxpayers did provide sufficient documentation to support a revision to the City’s estimate. Based on that documentation, the City has agreed to reduce the monthly rent amounts to \$1,500.00. While Taxpayers disputed that amount because it included costs for home improvements, we note that Section 445 provides that payments made by the lessee on behalf of the lessor for repairs or improvements are included in the taxable income. Accordingly, we approve the City’s revised monthly income amount of \$1,500.00. Next, we must decide the start date for the assessment. While the City has argued the start date should be the date the COO was issued, we conclude a more accurate date would be the initial occupancy date of February 2006. Accordingly, we approve an assessment period of February 2006 through March 2010.

Lastly, we have the matter of penalties. The City assessed Taxpayer for penalties

pursuant to City Code Section 5-10-540 (“Section 540”) for failure to file, and failure to timely pay. The penalties for failure to timely file and failure to timely pay may be waived for “reasonable cause”. Reasonable cause is defined in Section 540 that a taxpayer exercised ordinary business care and prudence, i.e., had a reasonable basis for believing that the tax did not apply to the business activity. While it is unclear as to the conversation between Taxpayers and the City when the business was started, we do conclude that Taxpayers did attempt to determine if there was any tax liability with their business set up. As a result, we conclude Taxpayers have demonstrated reasonable cause to have all penalties waived. Based on all the above, we conclude that Taxpayers protest should be partly, denied and partly granted, consistent with the Discussion, Findings, and Conclusions, herein.

FINDINGS OF FACT

1. On November 29, 2010, Taxpayers filed a protest of a tax assessment made by the City.
2. On May 13, 2010, the City issued an audit assessment of Taxpayers.
3. The assessment was for the period of December 2004 through March 2010 (“Compliance Period”).
4. The assessment was for additional taxes in the amount of \$3,063.79, interest up through April 2010 in the amount of \$471.96, penalties totaling \$758.98, and a license fee of \$110.00.
5. Taxpayers owned the **Best Property** in the City.
6. The **Best Property** was occupied during the Compliance Period by a related limited liability company, **BB United**.
7. **BB United** provided home care services for the elderly at the **Best Property**.
8. The City used “Fair Market Values for Commercial Rentals” by Cushman & Wakefield.
9. The estimated monthly rentals utilized by the City varied during the Compliance Period and ranged from \$2,500.00 to \$3,500.00 per month.
10. The monthly amounts to cover the mortgage costs, property tax payments, insurance, and maintenance repairs were \$1,500.00.

11. The bank business account for **BB United** was opened in March 2006.
12. The COO for the **Best Property** was issued on September 13, 2005.
13. The initial occupancy of the **Best Property** occurred in February 2006.
14. Taxpayers received verbal advice from the City when it opened the business in February 2006.

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. Section 445 imposes a tax on the gross income from the business activity of commercial rental.
3. Taxpayers' actions during the Compliance Period were taxable pursuant to Section 445.
4. Section 210 provides that when a transaction between affiliated companies is not indicative of the market value of the transaction, the City shall determine the market value upon which the City tax shall be levied. .
5. Because **BB United** and Taxpayers were related, it was proper for the City to utilize an estimate pursuant to Sections 210.
6. The City's usage of Wakefield and Cushman values for commercial rentals was a reasonable estimation methodology pursuant to Section 545.
7. Taxpayers provided sufficient documentation to demonstrate that the monthly rental amounts should be reduced to \$1,500.00 per month.
8. The initial occupancy date of February 2006 for the **Best Property** is the appropriate start date for the assessment period.
9. The City was authorized pursuant to Section 540 to assess penalties.
10. Taxpayer demonstrated reasonable cause to have the penalties waived for failing

to timely file or timely pay taxes.

11. Taxpayer's November 29, 2010 protest should be partly granted and partly denied, consistent with the Discussion, Findings, and Conclusions, herein.

ORDER

It is therefore ordered that the November 29, 2010 protest by *Taxpayers* of a tax assessment made by the City of Mesa should be partly granted and partly denied consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Mesa shall reduce the monthly rental amounts to \$1,500.00.

It is further ordered that the City of Mesa shall revise the assessment period to February 2006 through March 2010.

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.

Municipal Tax Hearing Officer