

DECISION OF MUNICIPAL TAX HEARING OFFICER

December 27, 2011

Taxpayers

Taxpayer's Address

Scottsdale, AZ 85258-4807

Taxpayers

MTHO # 648

Dear Taxpayers:

We have reviewed the evidence and arguments presented by *Taxpayers* and the City of Scottsdale (Tax Collector or City) at the hearing on October 26, 2011 and in post-hearing memoranda. The review period covered was December 2009. Taxpayers' protest, Tax Collector's response, and our findings and ruling follow.

Taxpayers' Protest

Taxpayers were assessed City of Scottsdale privilege tax under the speculative builder classification for the sale of a residence constructed on a lot owned by Taxpayers. Taxpayers loaned money to the contractor that built the residence and Taxpayers received interest in return. Taxpayers are not in the business of building houses. Taxpayers were therefore not speculative builders.

Tax Collector's Response

Taxpayers were the owners of record to improved real property. Sale of improved real property includes any form of transaction which in substance is a transfer of title of improved real property. Taxpayers transferred title to the property to a purchaser. A speculative builder is one who sells improved real property. Here Taxpayers transferred title to the property. Taxpayers were speculative builders. Therefore the sale of Taxpayers' improved real property is subject to the privilege tax.

Discussion

Taxpayers purchased vacant land (Property), obtained a construction loan which provided funds to a contractor that built a single-family residence on the Property. After the residence was completed, the Property was sold. Taxpayers continued to hold title to the Property until it was sold.

No written agreement between Taxpayers and the contractor was submitted into the record. Taxpayers testified that they had entered into similar arrangements with the contractor previously and had written agreements such as promissory notes. However the arrangement for the Property at issue was a "handshake deal".

Taxpayers did not report the transaction or pay City privilege tax on the sale. The Tax Collector contacted Taxpayers to inquire regarding the sale. Based on information submitted by

Taxpayers, the Tax Collector issued an assessment under the speculative builder classification for the sale of the Property. The Tax Collector based the assessment on the sales price of the Property. Taxpayers timely protested the assessment stating that Taxpayers did not believe the transaction was taxable.

The Scottsdale Tax Code (STC) governs whether and to what extent a person is taxable. Taxpayers were assessed as speculative builders. A speculative builder includes an owner-builder who sells improved real property. Taxpayers do not dispute that they owned the Property, that they sold the Property or that the Property was improved real property.

Taxpayers contend they were not owner-builders when they sold the Property because they did not construct any of the improvements. The improvements were constructed by the contractor. If Taxpayers were not owner-builders, then Taxpayers do not fall within the definition of a speculative builder.

Taxpayers are correct that to be a speculative builder, a person has to be an owner-builder. An owner-builder is defined as an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs any improvement to real property. Under this definition the fact that Taxpayers owned the Property, provided financing and were aware of the construction of improvements does not necessarily mean Taxpayers constructed the improvement. The question therefore is whether the contractor was acting for or on behalf of Taxpayers in constructing the improvement. For the reasons that follow, we hold that under the facts of this case Taxpayers were speculative builders.

First, Taxpayers had entered into similar arrangements with the contractor in the past. While Taxpayers' intent appeared to be to provide funds to the contractor in return for interest, as Taxpayers recognized at the hearing, Taxpayers would not receive repayment if the property were not sold. This is an acknowledgement that the purpose of the arrangement was to build and sell the residence so that Taxpayers could recoup their investment.

Second, Taxpayers obtained a construction loan on the Property. The construction loan documents provided in Paragraph 2 that the construction mortgage secured an obligation incurred for the construction of improvements on the Property.

Third, no other person had an interest in the Property that could have authorized the construction of the improvement. Here, even in the absence of a written contract, the record suggests that Taxpayers did have the residence built by or through the contractor. Taxpayers therefore fall within the definition of owner-builders and are subject to the privilege tax.

Taxpayers' objective to earn interest on the funds they provided the contractor does not enter into consideration in determining whether the transaction was subject to tax. Taxpayers are free to use whatever form of business they choose, but in choosing a form they must accept its advantages and disadvantages. It is how the transaction was structured, not how it could have been structured, that determines taxability. Here Taxpayers chose to own the Property, obtain a construction loan and have an understanding with the contractor that an improvement would be constructed on the Property. Taxpayers are liable for the tax that was assessed.

Taxpayers also objected to the privilege license fee that was included in the assessment. Every person desiring to engage or continue in business activities within the City on which a privilege tax is imposed is required to obtain a license. Taxpayers' activities were subject to the City privilege tax. It was therefore appropriate for the Tax Collector to issue Taxpayers a license.

Based on all the above, we conclude Taxpayers' protest of the assessment of privilege tax, interest and license fee should be denied. The City's assessment of privilege tax and interest against Taxpayers was proper.

Findings of Fact

1. Taxpayers purchased vacant land on March 29, 2005.
2. A City building permit was issued for the construction of a single-family residence on the Property.
3. The building permit listed Taxpayers as the owners of the Property.
4. Taxpayers executed, as borrowers, a deed of trust and a construction loan agreement dated March 28, 2005.
5. The construction loan document provided in Paragraph 2 that the construction mortgage secured an obligation incurred for the construction of improvements on the Property.
6. The City issued a certificate of occupancy for the Property on February 21, 2007.
7. Taxpayers sold the Property for a contract sales price of \$1,700,000 on December 29, 2009.
8. Taxpayers did not have a privilege license and did not report the sale or pay a City privilege tax on the sale of the Property.
9. The Tax Collector conducted an audit assessment of Taxpayers for the period December 2009 and issued a Notice of Assessment for City privilege tax under the speculative builder classification in the amount of \$17,917.64, interest calculated through March 2011 in the amount of \$796.35 and license fees in the amount of \$397.50.
10. Taxpayers timely protested the assessment and requested a hearing.

Conclusions of Law

1. A speculative builder includes an owner-builder who sells, at any time, improved real property consisting of custom homes regardless of the stage of completion. STC § 100.
2. Improved real property includes any real property upon which a structure has been constructed. STC § 416(a)(2)(A).
3. The Property was improved real property.
4. An Owner-Builder is defined as an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs any improvement to real property. STC § 100.
5. Taxpayers were the owners of the Property.
6. Taxpayers obtained a construction loan on the Property which funded the construction.
7. An improvement was constructed on the property by a contractor.
8. The contractor was acting on behalf of Taxpayers in constructing the improvement.
9. Taxpayers were owner-builders.

10. Taxpayers were speculative builders during the audit period.
11. Taxpayers' sale of the Property was subject to the privilege tax on speculative builders.
12. Taxpayers are free to use whatever form of business they choose, but in choosing a form they must accept its advantages and disadvantages. *Higgins v. Smith*, 308 U.S. 473, 60 S.Ct. 355 (1940).
13. Persons engaging or continuing in business activities within the City on which a privilege tax is imposed are required to obtain a privilege license. STC § 300.
14. It is unlawful for a person who is required to obtain a privilege license to engage in business within the City without a license. STC § 330.
15. The City's assessment of privilege tax, interest and license fees against Taxpayers was proper.

Ruling

Taxpayer's protest of an assessment of privilege tax and interest made by the City of Scottsdale for the period December 2009 is denied.

The Tax Collector's Notice of Assessment to Taxpayer for the period December 2009 is upheld

Both parties have timely rights of appeal to the Arizona Tax Court pursuant to Model City Tax Code Section -575.

Sincerely,

Hearing Officer

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c: ***Scottsdale Tax Audit Manager***
Municipal Tax Hearing Office