DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: August 13, 2004
Decision: MTHO #151
Tax Collector: Cities of Peoria, Tempe, and Scottsdale
Hearing Date: April 5, 2004

DISCUSSION

Introduction

On August 11, 2003, the ***Taxpayer*** ("Taxpayer") filed protests of tax assessments made by the Cities of Peoria and Scottsdale. On September 11, 2003, the Taxpayer filed a protest of a tax assessment made by the City of Tempe (Collectively, City of Peoria, City of Scottsdale, and City of Tempe, hereafter referred to as "Cities"). After review, the City of Scottsdale concluded on September 18, 2003 that the protest was timely and in the proper form. After review, the City of Tempe concluded on October 10, 2003, that the protest was timely and in the proper form. On November 5, 2003, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the Cities of Tempe and Scottsdale to file a response to the protests on or before December 22, 2003. After review, the City of Peoria concluded on December 12, 2003, that the protest was timely and in the proper form. On December 17, 2003, the Hearing Officer ordered the City of Peoria to file a response to the protest on or before February 2, 2004 and extended the deadline for the Cities of Scottsdale and Tempe to February 2, 2004. On January 27, 2004, the Cities filed a consolidated response. On January 31, 2004, the Hearing Officer ordered the Taxpayer to file any reply on or before February 23, 2004. On February 16, 2004, the Taxpayer filed a reply. On February 20, 2004, the Cities filed an objection to certain documents filed by the Taxpayer. On March 3, 2004, the Hearing Officer ordered the Taxpayer to file any response to the objection on or before March 13, 2004. On March 10, 2004, the Taxpayer filed a response. On March 15, 2004, a Notice of Tax Hearing ("Notice") was issued setting the matter for hearing commencing on April 5, 2004. On March 22, 2004, the Taxpayer filed an objection to holding the hearing in the City of Peoria. On March 25, 2004, the Hearing Officer heard oral arguments on the objections. On March 29, 2004, the Hearing Officer denied the objections. The Cities and Taxpayer both appeared and presented evidence at the hearing. On April 12, 2004, the Hearing Officer ordered the Cities to provide additional information to the Taxpayer. The Taxpayer was ordered to file any response to the additional information and its closing brief on or before May 21, 2004, the Cities would file a response brief on or before June 4, 2004, and the Taxpayer would file a reply brief on or before June 18, 2004. The Taxpayer filed its closing brief on May 20, 2004. The City filed a response brief on June 3, 2004. The Taxpayer filed a reply brief on June 17, 2004. On June 29, 2004, the Hearing Officer indicated the record was closed and a written decision would be issued on or before August 13, 2004.

A multi-jurisdictional audit of the Taxpayer was conducted on behalf of the Cities. The Audit period for the City of Peoria was March 2000 to October 2001. The audit period for the City of Scottsdale was October 2000 to September 2001. The audit period for the City of Tempe was September 1999 to September 2001. The Taxpayer was assessed additional taxes by the City of Peoria in the amount of $64,732.83, plus penalties in the amount of $6,473.28, along with interest on the additional tax due. The Taxpayer was assessed additional taxes by the City of Tempe in the amount of $7,996.95, plus penalties in the amount of $799.69, along with interest on the additional tax due. The Taxpayer was assessed additional taxes by the City of Scottsdale in the amount of $4,185.47, plus penalties in the amount of $837.10, along with interest on the additional tax due. The City of Scottsdale subsequently waived the penalties.

City Position

1. Disallowed Resales

   The City argued that the Taxpayer was precluded from raising the issue of disallowed resales because the Model City Tax Code Section 570(b)(1) ("Section 570(b)(1)") provides that a taxpayer has forty-five days following a notice of determination to file a petition. In this case, the notice of determination was dated June 25, 2003 and the Taxpayer never raised the resale issue until March 11, 2004. Even if it is determined the protest of disallowed sales was timely, the City argued that the claim is without merit because the exemption is from the tax imposed by Model City Tax Code Section 460 ("Section 460") for retail sales. The City argued that the Taxpayer is properly taxed as a restaurant pursuant to Model City Tax Code Section 455 ("Section 455") and thus the exemption claim is not applicable. Additionally, the City argued that the amounts deducted on the Taxpayer's report cannot be reconciled with the monthly sales reports that reflect large volume sales to their "account" customers. As a result, the City argued those exemption claims must be disallowed since the burden of proof is on the Taxpayer pursuant to Model City Tax Code Section 360(a) ("Section 360(a)") to demonstrate the claim for resale is valid.

2. Restaurant Classification

   The Cities argued that the Taxpayer was in the restaurant business. The City of Scottsdale License Application defined the business as a "Restaurant/Bar." The Cities indicated that Model City Tax Code Section 455 ("Section 455") levies a tax upon the "gross income from the business activity upon every person engaging or continuing in the business of preparing or serving food or beverage in a bar, cocktail lounge, restaurant, or similar establishment where articles of food or drink are prepared or served for consumption on or off the premises."

   By contrast, Model City Tax Code Section 460 ("Section 460") levies a tax upon gross income from the business activity upon every person engaging or continuing in the business of selling tangible personal property at retail. The Cities argued that the difference between Sections 455 and 460 is whether the property sold is "prepared or served" or not, and whether provided for "consumption on or off premises." As an example, the Cities indicated that the portion of a grocery preparing and serving food, often with a seating area, is taxed as a restaurant while the portion selling foods and other goods not prepared or served are taxed at the retail rate. According to the Cities, even a bakery that serves food for consumption on-premises would be a restaurant.

The Cities asserted that the definition in Model City Tax Code Section 100 ("Section 100") emphasizes the drafter's intent that the restaurant category be interpreted broadly, saying, "Restaurant' means any business activity where articles of food, drink, or condiment are customarily prepared or served to patrons for consumption on or off the premises, also including bars, cocktail lounges, the dining rooms of hotels, and all caterers. For the purposes of this Chapter, a 'fast food' business, which includes street vendors and mobile vendors selling in public areas or at entertainment or sports or similar events, who prepares or sells food or drink for consumption on or off the premised is considered a 'restaurant' and not a 'retailer'." As a result, the Cities requested the claim regarding the taxing classification be dismissed.

3. Use Tax On Doughnut Making Equipment

The Cities asserted that Model City Tax Code Section 660(g) ("Section 660(g)") exempts from use tax "machinery or equipment used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms 'manufacturing', 'processing', 'fabricating', 'job printing', 'refining', and 'metallurgical' as used in this paragraph refer to and include those operations commonly understood within their ordinary meaning." The Cities argued that donuts produced by the donut-making machines are not manufactured within the ordinary meaning of the word. The donuts are baked and fried and prepared for immediate consumption.

The Cities acknowledged that there is an exemption from use tax pursuant to Model City Code Section 650 ("Section 650"). The Cities argued that the exemption is only available when such equipment was actually taxed a transaction privilege tax, not when such equipment is merely taxable. Subsequent to the hearing, the City of Scottsdale reviewed the use tax assessment and concluded there was a calculation error. The original use tax assessment was $3,747.77. The City of Scottsdale recommended it be recalculated to be $3,632.69.

4. Penalties

The Cities argued that pursuant to Model City Tax Code Section 540(b) ("Section 540(b)") penalties of twenty percent are appropriate whenever, "A taxpayer…fails to pay the tax within the time prescribed…[and such failure is] due to negligence, but without regard for intent to defraud." The Cities asserted that the Taxpayer did not pay tax at the lawful (restaurant) rate. The Cities argued that the Taxpayer negligently maintained its records and failed to adhere to the Language of the Code. Based on all the above, the Cities requested the penalties be upheld.

5. Reimbursement of Fees and Cost

The City asserted that Model City Tax Code Section 578(c) ("Section 578(c)") establishes a method for a taxpayer to request a reimbursement of costs by submitting a request to the Taxpayer Problem Resolution Officer ("Resolution Officer") after the Hearing Officer makes a decision. The Cities requested the Hearing Officer find that the Cities position is substantially justified, that the Taxpayer has not prevailed as to the most significant issue or set of issues, and that the claim regarding an award of fees and costs be dismissed.

6. Limitation Period

The City of Tempe argued that the limitation period of four years does not apply to the use tax assessment. The audit assessment was delivered four years and two months after the return was filed. However, the City asserted that the Model City Tax Code Section 550(a)(2) ("Section 550(a)(2)") extends the limitation period to six years when a "taxpayer does not report an amount properly reportable which is in excess of twenty-five percent of the taxable amount stated on the return. In this case, the Taxpayer reported use tax due in the amount of $235,863.85 and failed to report an additional $306,718.24 of use tax due.

While the Code does not define whether the "taxable amount" of Section 550(a)(2) is the total taxable amount in all taxable categories or the taxable amount in each category of tax, the City argued the purpose of the twenty-five percent figure is to give proportion to the egregiousness of the failure to report. According to the City, it would frustrate the intent of the drafters to fail to extend the limitations period where significant underreporting is found.

Taxpayer Position

1. Disallowed Resales

The auditor disallowed claimed resale sales for the City of Peoria in the amount of $556,228.56 resulting in additional taxes due in the amount of $13,905.72. The Taxpayer provided testimony and documents at the hearing to demonstrate these were customers who purchased large volumes of doughnuts on a regular basis for the purpose of reselling the doughnuts in the normal course of their retail business. Examples of such "account" customers were ***Customer A, Customer B, Customer C, and Customer D***. The Taxpayer provided supporting documentation to the City for their review after the hearing. According to the Taxpayer, the City concluded that the Taxpayer's documentation supported 63 percent of its claimed resale sales, which would reduce the tax to $4,794.32. The Taxpayer argued that the City should have also allowed the claimed resales for the sample month of November 2000. The Taxpayer provided a list of these wholesale sales totaling $20,657.66 for the month of November 2000. The Taxpayer asserted that if the resales for the month of November 2000 are allowed, the allowance percentage would increase to 72.29 percent with a corresponding reduction in taxes due. While the Taxpayer acknowledged they did not have the invoices for November 2000, the Taxpayer argued they had provided detailed weekly sheets showing resale sale deductions.

In reply to the City's arguments, the Taxpayer asserted they had protested the entire amount of the assessment, which would have included the sales for resale. In addition, the Taxpayer argued that the Model City Tax Code Section 570(b)(3)(A) ("Section 570(b)(3)(A)") permits the Taxpayer amend its petition at any time prior to resting its case at the hearing.

2. Restaurant Classification

According to the Taxpayer, each of its stores sell doughnuts and drinks. The doughnuts are packaged to go either in a bag or a box. While the stores have some tables and chairs, there is no tableware or table service. Nothing is prepared to order as the customer chooses from an inventory of doughnuts already prepared. The Taxpayer indicated that most doughnuts are sold by the dozen. The Taxpayer argued that Arizona courts have determined that there is a

difference between a restaurant and a bakery. The courts have concluded that bakeries are businesses, "which at the completion of their processing, have available to the public an inventory of a product, much like a manufacturer." The Taxpayer asserted they are like a bakery in that they manufacture an inventory of doughnuts that can be purchased in various quantities by its customers. According to the Taxpayer, it is commonly understood that its shops are retail bakeries and not restaurants. The Taxpayer argued that under rules issued by the Arizona Department of Revenue ("DOR"), food, which is generally selected by the customer from available displays and then taken to a checkout stand for payment, is not considered to be served by the retailer. The Taxpayer also noted that the definition of "restaurant" in Section 100 specifies that fast food restaurants are included but bakeries are not specifically included. The Taxpayer argued that ambiguities in tax statutes are to be interpreted in favor of the taxpayer.

3. Use Tax On Doughnut Making Equipment

The Taxpayer purchased the donut-making equipment from ***Parent Company*** Equipment Services ("Equipment Services") based in _____. The equipment was installed at the various store locations by the designer and manufacturer of the equipment, ***Parent Company*** Equipment Manufacturing ("Equipment Manufacturer"). As a result, the Taxpayer argued that if any tax was due on the equipment, it should be imposed on the Equipment Manufacturer in the form of a privilege tax. However, the Taxpayer's primary argument was that the equipment is exempt from tax as income producing capital equipment pursuant to Section 660(g).

4. Penalties

The Taxpayer indicated it expects the penalties to be automatically abated when improper taxes are reversed. To the extent any taxes are upheld, the Taxpayer requests any penalties be abated for reasonable cause. According to the Taxpayer, it is sufficient penalty to have to pay taxes out of its own pocket because it cannot provide sufficient documentation on sales it reasonable believed were exempt.

5. Reimbursement of Fees and Costs

The Taxpayer argued that it had to defend itself against the improper taxes imposed by the Cities and to respond to their incorrect arguments. As a result, the Taxpayer requested it be reimbursed pursuant to Section 578 for all fees and other costs to this process.

6. Limitation Period

According to the Taxpayer, the City has conceded that the use tax assessment for the equipment purchased by the Tempe location in June of 1999 is outside the four-year statute of limitations provided by Section 550. The Taxpayer asserted that the use tax that was supposedly due in June of 1999, but not paid, was less than twenty-five percent of the total tax paid in that month. The Taxpayer argued that the position of the City that the six-year statute of limitations should apply because the use tax was underreported by twenty-five percent is a bizarre analysis of the term "taxable amount stated on the return." The Taxpayer argued that "taxable amount" clearly refers to amounts subject to either use tax or sales tax.

ANALYSIS

1. Disallowed Resales

Section 570(b)(3)(A) does permit the Taxpayer to amend its petition at any time prior to resting its case at the hearing. As a result, the Hearing Officer does find that the Taxpayer properly raised the issue. Further, the Cities were given an opportunity to review the additional documentation provided by the Taxpayer and submit their findings. Based on the analysis of the Cities, the Taxpayer did provide documentation to demonstrate that the additional taxes due for claimed resale sales should be reduced from $13,905.72 to $4,794.32. While the Taxpayer did provide a monthly report for the month of November 2000, the Hearing Officer concurs with the Cities that the report cannot be reconciled with the monthly sheets showing resale sale deductions. The burden of proof is on the Taxpayer pursuant to Section 360(a) to demonstrate the claim for resale is valid; we find the Taxpayer has failed to meet that burden for the month of November 2000. Accordingly, the remaining disallowed resales are upheld.

2. Restaurant Classification

The Cities argued that the Taxpayer was properly taxed under the restaurant classification while the Taxpayer argued it should be taxed under the retail sale classification. The argument exists because the City of Peoria has a higher tax rate for restaurants than for retail sales. In our analysis, we shall focus on the terms "in the business of preparing or serving good or beverage". We also note that since the Taxpayer's primary business is the sale of doughnuts, our focus will be on those sales. Because the customer is selecting doughnuts from an inventory of doughnuts, we do not find the Taxpayer is preparing food for a customer in the normal understanding of preparing food. Even through the Taxpayer may have tables and chairs where one can sit down and eat a doughnut; we do not find that the Taxpayer is serving food. While the arguments presented by the Cities have some merit, we must agree with the Taxpayer that it is ambiguous as to whether the Taxpayer would fall under the broad definition of "restaurant" set forth in Section 100. Based on all the above, we do not find the Taxpayer is in the restaurant business pursuant to Section 455.

3. Use Tax on Doughnut Making Equipment

The issue here is whether or not equipment used to prepare doughnuts would be "manufacturing" or "processing" as those terms are commonly understood within their ordinary meaning. Because it is a requested exemption, we find that the burden of proof is on the Taxpayer to clearly demonstrate that it is entitled to the exemption. We find the Taxpayer has failed to meet that requirement. Based on the evidence, we are unable to conclude that doughnut making equipment would be either "manufacturing" or "processing" within the common understanding meaning of those terms. Accordingly, we must deny the Taxpayer's exemption request. We note that there was no evidence of any transaction privilege tax being paid on the doughnut making equipment and as such we conclude the use tax assessment on the Taxpayer was proper. We also note that based on the City of Scottsdale's recalculation, the City of Scottsdale use tax assessment should be reduced from $3,747.77 to $3,632.69.

4. Penalties

The Cities are authorized to assess penalties for failure to timely pay taxes. In this case, the Taxpayer has failed to pay some taxes in a timely manner. However, the penalties can be waived if the Taxpayer can demonstrate reasonable cause for failing to timely pay the taxes. We find in this case that the Taxpayer has presented a reasonable basis for failing to pay all the taxes in a timely manner. As a result, we find it is proper to waive all penalties assessed in this matter.

5. Reimbursement of Fees and Costs

Section 578 does provide a method in which Taxpayer's may request a reimbursement of fees and cost. While the Cities did not prevail on all matters, we do find their positions were substantially justified. As a result, we must deny any request for reimbursement of fees and costs.

6. Limitation Period

The use tax assessment for the equipment purchased by the Tempe location in June of 1999 was outside the four-year statute of limitation. The only issue is whether or not the period could be extended to six-years pursuant to Section 550(a)(2). The determination in this case is based on whether the term "taxable amount stated on the return" refers to each category of tax or all taxable categories. We agree with the Taxpayer that a reasonable interpretation is that it refers to all taxable categories. If the Cities meant it to refer to each category of tax, it was in their power to clearly state that in the statute. Based on the above, we find the appropriate statute of limitation period was four years.

FINDINGS OF FACT

1. On August11, 2003, the Taxpayer filed protests of tax assessments made by the Cities of Peoria and Scottsdale.

2. On September 11, 1003, the Taxpayer filed a protest of a tax assessment made by the City of Tempe.

3. After review, the City of Scottsdale concluded on September 18, 2003 that the protest was timely and in proper form.

4. After review, the City of Tempe concluded on October 10, 2003 that the protest was timely and in proper form

5. On November 5, 2003, the Hearing Officer ordered the Cities of Tempe and Scottsdale to file a response to the protests on or before December 22, 2003.

6. After review, the City of Peoria concluded on December 12, 2003 that the protest was timely and in the proper form.

7. On December 17, 2003, the Hearing Officer ordered the City of Peoria to file a response to the protest on or before February 2, 2004 and extended the deadline for the Cities of Scottsdale and Tempe to February 2, 2004.

8. On January 27, 2004, the Cities filed a consolidated response.

9. On January 31, 2004, the Hearing Officer ordered the Taxpayer to file any reply on or before February 23, 2004.

10. On February 16, 2004, the Taxpayer filed a reply.

11. On February 20, 2004, the Cities filed an objection to certain documents filed by the Taxpayer.

12. On March 3, 200, the Hearing Officer ordered the Taxpayer to file any response to the objection on or before March 13, 2004.

13. On March 10, 2004, the Taxpayer filed a response.

14. On March 15, 2004, a Notice was issued setting the matter for hearing commencing on April 5, 2004.

15. On March 22, 2004, the Taxpayer filed an objection to holding the hearing in the City of Peoria.

16. On March 25, 2004, the Hearing Officer heard oral arguments on the objections.

17. On March 29, 2004, the Hearing Officer denied the objections.

18. The Cities and Taxpayer both appeared and presented evidence at the hearing.

19. On April 12, 2004, the Hearing Officer ordered the Cities to provide additional information to the Taxpayer.

20. The Taxpayer was ordered to file any response to the additional information and its closing brief on or before May 21, 2004, the Cities would file a response brief on or before June 4, 2004, and the Taxpayer would file a reply brief on or before June 18, 2004.

21. The Taxpayer filed its closing brief on May 20, 2004.

22. The City filed a response brief on June 3, 2004.

23. The Taxpayer filed a reply brief on June 17, 2004.

24. On June 29, 2004, the Hearing Officer indicated the record was closed and a written decision would be issued on or before august 13, 2004.

25. A multi-jurisdictional audit of the Taxpayer was conducted on behalf of the Cities.

26. The audit period for the City of Peoria was March 2000 to October 2001.

27. The audit period for the City of Scottsdale was October 2000 to September 2001.

28. The audit period for the City of Tempe was September 1999 to September 2001.

29. The Taxpayer was assessed additional taxes by the City of Peoria in the amount of $64,732.83, plus penalties in the amount of $6,473.28, along with interest on the additional tax due.

30. The Taxpayer was assessed additional taxes by the City of Tempe in the amount of $7,996.95, plus penalties in the amount of $799.69, along with interest on the additional tax due.

31. The Taxpayer was assessed additional taxes by the City of Scottsdale in the amount of $4,185.47, plus penalties in the amount of $837.10, along with interest on the additional tax due.

32. The City of Scottsdale subsequently waived the penalties.

33. The auditor disallowed claimed resale sales for the City of Peoria in the amount of $556,228.56 resulting in additional taxes due in the amount of $13,905.72.

34. The Taxpayer provided testimony and documents at the hearing to demonstrate there were customers who purchased large volumes of doughnuts on a regular basis for the purpose of reselling the doughnuts in the normal course of their retail business.

35. The Taxpayer's documentation supported 63 percent of its claimed resale sales which would reduce the taxes due to $4,794.32.

36. Each of the stores of the Taxpayer sells doughnuts and drinks.

37. The doughnuts are packaged to go either in a bag or a box.

38. The stores have tables and chairs but no tableware or table services.

39. Most doughnuts are sold by the dozen.

40. Customers choose doughnuts from an inventory of doughnuts.

41. There was no evidence that any transaction privilege tax has been paid on the donut making equipment purchased by the Taxpayer.

42. The donut making equipment is utilized to prepare donuts.

43. The use tax assessment for the equipment purchased by the Tempe location in June of 1999 is outside the four year statute of limitations.

44. The use tax that was due in June of 1999 was more than twenty-five percent of the use tax due for that month but less than twenty-five percent of the combined transaction privilege tax and use tax for that month.

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 570(b)(3)(A) permits a taxpayer to amend its petition at any time prior to resting its case at the hearing.

3. The Taxpayer properly raised the issue of disallowed resales.

4. The burden of proof is on the Taxpayer to demonstrate a claim for resale is valid.

5. The Taxpayer has demonstrated that 63 percent of the claimed resale sales were valid and that the additional tax should be reduced from $13,905.72 to $4,794.32.

6. The Taxpayer was not in the business of preparing or serving food pursuant to Section 455.

7. Doughnut making equipment would not be “manufacturing” or “processing” within the common understanding of those terms.

8. The City of Scottsdale’s use tax assessment should be reduced from $3,747.77 to $3,632.69.

9. The Taxpayer has demonstrated a reasonable cause for failing to pay all taxes in a timely manner and that all penalties should be abated.

10. The Taxpayer’s request for reimbursement of fees and cost should be denied pursuant to Section 578 as the positions argued by the Cities were substantially justified.

11. The normal statute of limitations is for four years.

12. The appropriate statute of limitation period for the use tax assessment by the City of Tempe for June of 1999 was four years.

ORDER

It is therefore ordered that the August 11, 2003 protest of ***ABC*** Corporation DBA ***Taxpayer*** of tax assessments made by the Cities of Peoria, Scottsdale, and Tempe is hereby granted in part, and denied in part, consistent with the Discussion herein.

It is further ordered that the City of Peoria shall revise the additional taxes due from claimed resale sales from $13,905.72 to $4,794.32.

It is further ordered that the City of Peoria shall change the taxing classification from restaurant to retail sales and revise the tax assessment accordingly.

It is further ordered that the City of Scottsdale shall revise its use tax assessment on doughnut making equipment from $3,747.77 to $3,632.69.

It is further ordered that the City of Peoria and the City of Tempe shall abate all penalties assessed.

It is further ordered that the request for reimbursement of fees and cost is hereby denied.

It is further ordered that the City of Tempe shall revise its assessment by removing the use tax assessment for June of 1999.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer