DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: February 21, 2005
Decision: MTHO #177
Tax Collector: City of Phoenix
Hearing Date: September 20, 2004

DISCUSSION

Introduction

On January 26, 2004, ***Taxpayer*** ("Taxpayer") filed a protest of a tax assessment made by the City of Phoenix ("City"). After review, the City concluded on February 10, 2004, that the protest was timely and in the proper form. On February 19, 2004, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to file a response to the protest on or before April 5, 2004. On February 24, 2004, the Taxpayer filed supplemental information. On March 12, 2004, the City filed a response to the protest. On March 18, 2004, the Hearing Officer ordered the Taxpayer to provide additional information to the City on or before April 8, 2004 and the City would file any comments/recommendations on or before April 22, 2004. The Taxpayer filed additional information with the City on April 7, 2004. After review, the City filed additional comments/recommendations on April 22, 2004. On April 30, 2004, the Hearing Officer ordered the Taxpayer to file any reply on or before May 21, 2004. On May 19, 2004, a Notice of Tax Hearing ("Notice") was issued setting the matter for hearing commencing on June 25, 2004. On May 20, 2004, the Taxpayer requested an extension for the reply deadline. On May 21, 2004, the Hearing Officer granted the Taxpayer an extension until June 11, 2004. On June 3, 2004, the Hearing Officer continued the hearing date at the request of the City. On June 11, 2004, the Taxpayer filed a reply to the City. On August 23, 2004, a Notice was issued rescheduling the hearing to commence on September 20, 2004. Both parties appeared and presented evidence at the September 20, 2004 hearing. On September 22, 2004, the Hearing Officer indicated the City would file a Closing Brief on or before October 27, 2004 and the Taxpayer would file a Reply Brief on or before November 26, 2004. On October 20, 2004, the City filed additional information/documents and on October 21, 2004, the City filed a Closing Brief. On November 11, 2004, the Taxpayer requested an extension for its Reply Brief. On November 12, 2004, the Hearing Officer granted the extension up through December 30, 2004. On December 29, 2004, the Taxpayer filed its Reply Brief. On January 15, 2005, the Hearing Officer indicated the record was now closed and a written decision would be issued on or before March 1, 2004.

City Position

The City conducted an audit of the Taxpayer for the period April 1999 through September 2002. As a result, the City concluded the Taxpayer overpaid privilege tax on construction contracting in the amount of $35,411.38. The City concluded the Taxpayer underpaid privilege tax on licensing for use of tangible personal property and retail sales in the amounts of $25,816.83 and

$52,931.72, respectively. The net amount of underpaid privilege taxes for the audit period was $42,337.17. The City also concluded the Taxpayer had underpaid use tax in the amount of $88.71. The City assessed interest up through November 2003 in the amount of $14,069.24 and assessed penalties totaling $1,852.53.

The City asserted that the Taxpayer designs, sells and installs audio/video and/or lighting systems for institutional customers such as businesses and churches. According to the City, the price quoted by the Taxpayer to a potential customer includes both the equipment and installation. While the Taxpayer classified the revenues from such customers as construction contracting, the City argued such classification was in error. City Code Regulations 14-415.2 (d) ("Regulation 415") and 14-460.1 (e) ("Regulation 460") provide as follows:

> "Installation or removal of tangible personal property which has independent functional utility is considered a retail activity." Independent functional utility means the tangible personal property "… must be able to perform its function(s) without attachment to real property. 'Attachment to real property' must include more than connection to water, power, gas, communication, or other service."

The City indicated the majority of the Taxpayer's contracts with its customers were for equipment such as video cameras, cassette decks, microphones, amplifiers and similar equipment. The City argued these items have independent functional utility and are taxable as the sale of retail goods. According to the City, a small percentage of the equipment (such as flush-mounted speakers) does not have independent functional utility. The City agreed those items would be properly taxable as construction contracting.

On the income the City reclassified from contracting to retail sales, the City disallowed the standard 35 percent contractor's deduction that had been taken by the Taxpayer. The City acknowledged that the Taxpayer would be allowed to deduct the labor charges if the amounts were separately billed to the customer and separately maintained in the Taxpayer's records as specified in City Code Section 14-100 ("Section 100"). The City indicated that where the amounts were itemized, the deductions were allowed.

The City asserted that City Regulation 14-415.2 ("Regulation 415") provides guidance as to the types of transactions which would fall into the contracting classification and those that fall within the retail classification:

> (c) Sale of consumable goods incorporated into or applied to real property is considered a retail sale and not construction contracting. Examples of consumable goods are lubricants, faucet washers, and air conditioning coolant, but not paint.
>
> (d) Installation or removal of tangible personal property which has independent functional utility is considered a retail activity.

The City argued that the Regulations enacted by the City are not the same as the Regulations enacted by the Arizona Department of Revenue ("DOR") and as such the City is not bound by the DOR Regulations. According to the City, there is no ambiguity in the City Code and

Regulations and thus there is no reason to look to case law. The City asserted that the auditor only treated items which had independent functional utility as retail transactions. The City argued the burden of proof is on the Taxpayer pursuant to City Code Section 14-460 (b) ("Section 460") to demonstrate that a sale of tangible personal property is not a taxable retail sale. Further the City indicated it is the duty of the Taxpayer to keep records of taxable activity pursuant to City Code Section 14-350 ("Section 350"), 14-360 ("Section 360"), and 14-370 ("Section 370") and Regulation 14-350.1 ("Regulation 350").

The City argued that the Taxpayer transactions involving the provision of sound and light equipment are taxable as licensing for use pursuant to City Code Section 14-450 ("Section 450"). The City notes that the Taxpayer relied on a written opinion from the DOR that the transactions in question were not rental of tangible personal property. The City asserts that the State Statutes and City Code are different because the State does not tax licensing for use. City Code Section 100 provides as follows:

> *Licensing (for use)* means **any agreement** between the user ("licensee") and the owner or the owner's agent ("licensor") for the use of the licensor's property whereby the licensor receives consideration, where such agreement does not qualify as a "sale" or "lease" or "rental" agreement.

Further, the City noted that City Regulation 14-450.1 (a) ("Regulation 450.1") provides that rental, leasing, or licensing of any tangible personal property with an operator shall be deemed rental, leasing, or licensing of tangible personal property. The City argued that the agreements whereby the Taxpayer provided audio, video and lighting equipment (with technicians) to concerts/events do not qualify as a "sale" or "lease" or "rental" agreement. As a result, the City argued the transactions by definition would be "licensing for use" agreements and thus taxable pursuant to Section 450. The City asserted that City Regulation 14-450.3 ("Regulation 450.3") does provide that the charge for the operator shall not be includable in the gross income if the charge for the operator and the charge for the use of the equipment are separately itemized to the lessee and separately maintained on the books and records of the lessor. According to the City, the deductions were allowed where the records reviewed itemized such charges; otherwise, the entire amount invoiced was considered taxable.

The City assessed a use tax on a fixed asset purchased by the Taxpayer from an Ohio company. According to the City, the Taxpayer paid a combined state and county Ohio tax but no city tax. The City calculated a use tax of $88.71. Subsequently, the City determined the calculation was in error and revised the use tax to $83.50.

The City assessed a penalty for failure to time pay all taxes. After meeting with the Taxpayer's representative, the City concluded the Taxpayer had good cause to believe the activity was contracting and that the Taxpayer had not been previously audited by the City. As a result, the City concluded the Taxpayer met the requirements of City Code Section 14-540 (f) ("Section 540 (f))) and recommended the abatement of penalties.

Taxpayer Position

The Taxpayer asserted that it was engaged in the separate business activities: (1) contracting and (2) mixing sound and lights at concerts and other events requiring sophisticated sound and light effects. On the contracting side of the business, the Taxpayer indicated it was engaged to provide and install high-end sound systems, almost exclusively to institutional customers like schools and churches. According to the Taxpayer the contracts with its customers provide that the Taxpayer must both provide and install equipment that includes speakers, amplifiers and related installation hardware, wire, connectors, couplings, etc. The Taxpayer indicated it has a contractor's license because its business requires it to frequently drill holes, cut through walls and/or ceilings, attached and/or flush mount speakers to walls and/or ceilings, run and attach wires to and through walls and ceilings. The Taxpayer asserted that while it did not generally separate the labor costs, such costs were a significant portion of the Taxpayer's income from the type of business. According to the Taxpayer, it paid tax under the construction contracting classification on 65 percent of gross proceeds from this line of business.

The Taxpayer argued that the City's assessment of additional tax under the retail classification should be abated because the Taxpayer properly reported and paid tax under the contracting classification. The Taxpayer indicated that City Tax Code Section 14-100 ("Section 100") provides as follows:

> **"Construction Contractor" means a person** who undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or **does himself or by or through others**, construct, **alter,** repair, **add to, subtract from, improve,** move, wreck, or demolish **any building,** highway, road, railroad excavation, **or other structure,** project, development, or improvement to real property, **or to do any part thereof** . . .

The Taxpayer argued that it is a construction contractor under the plain meaning of that term because it alters, adds to, subtracts from or improves buildings or other structures when it cuts and drills holes in walls, ceilings and floors, attaches speakers, wires and other items, removes portions of its customer ceilings and walls when it flush mounts speakers. The Taxpayer argued that the Arizona Department of Revenue ("DOR") definition of "contractor" found in ARS Section 42-5075 (J)(2) ("Section 5075") is for all intents and purposes the same as the City's definition. According to the Taxpayer, when the DOR and City statutes are the same and the DOR has issued written guidance, the DOR's interpretation is binding on the City pursuant to ARS Section 6005(D) ("Section 6005") and City Tax Code Section 14-500 ("Section 500"). The DOR provided written guidance in Arizona Administrative Code Regulation 15-5-614 ("Regulation 614") that gave examples of contracting activities which included the installation of electrical wiring. The Taxpayer asserted that since it adds and/or replaces wires, speakers and other equipment and materials, that it is engaged in contracting. The Taxpayer also noted that the DOR concluded that the Taxpayer was engaged in contracting rather than retail sales. The DOR relied on A.A.C. R15-5-615 ("Regulation 615") which provided that: "Public address, communication, intercommunication, and security alarm systems installed in a structure by a contractor are taxable." The Taxpayer indicated that City Regulations 415.2 (b) (1) and 460 (b) (1) ("Regulation 415 and 460") provide that: "When an item is attached or installed on real

property, it is a construction contracting activity and any subsequent repairs, removal, or replacement of that item is construction contracting." As a result, the Taxpayer argued that when it attaches or installs speakers, wires and other items to real property it is clearly engaged in a contracting activity. Even if it is concluded that the Taxpayer was engaged in a retail activity, the Taxpayer argued it should be allowed a reasonable deduction pursuant to City Tax Code Section 14-465 (c) ("Section 465") for delivery, installation and other direct customer services. According to the Taxpayer, the installations typically took at least one day and the labor would equal or exceed the standard 35 percent contractor deduction.

The Taxpayer argued that the City's assessment of additional tax under the licensing classification of the code was erroneous. The Taxpayer noted that "licensing for use" is defined in the City's tax code Section 100 as:

> **any agreement** between the user ("licensee") and the owner or owner's a gent "(licensor") **for the use of the licensor's property** whereby the licensor receives consideration, where such agreement does not qualify as a "sale" or "lease" or "rental" agreement.

The Taxpayer indicated that because the equipment is expensive, delicate and sophisticated, the Taxpayer does not allow the customers to take possession or control the equipment. The Taxpayer asserted that it always delivers, sets up, controls, takes down and retrieves the equipment. In addition, the Taxpayer indicated it always provides at least one employee to control the equipment. As a result, the Taxpayer argued that it was not licensing the use of its equipment because it did not agree to let the customers use the equipment. Even if it is concluded that the Taxpayer was in the business of licensing the use of its equipment, the Taxpayer asserted it should be allowed a reasonable deduction for the portion of gross receipts related to delivery, installation and operation of the equipment. While the Taxpayer acknowledged that it did not always separately state such amounts, the Taxpayer indicated it was operating under the reasonable assumption that it was not engaged in a taxable business and would not need such separation.

The Taxpayer agreed with the City's adjustments to the use tax assessment contained in the City's March 12, 2004 response. The Taxpayer noted that the City agreed at a February 10, 2004 meeting to abate the penalties. The Taxpayer asserted the penalty abatement was reasonable since the Taxpayer (1) had a reasonable basis to believe the taxes did not apply, (2) the Taxpayer has never been audited by the City for the tax and had relied in good faith on the DOR and (3) the Taxpayer has cited numerous court cases stating the transactions are not subject to tax.

ANALYSIS

Contracting vs. Retail

During the audit period, the Taxpayer was engaged to provide and install high-end sound systems to primarily institutional customers. The Taxpayer in reliance on the DOR, treated all those installations as contracting and utilized the standard 35 percent labor deduction. For most of the projects, the Taxpayer did not provide any itemized breakdown between labor and

materials. After review, the City concluded the Taxpayer was involved in both contracting and retail sales. There were substantial differences in the amount of taxes because of the Taxpayer's failure to itemize the labor amounts and there were substantial differences in the proper city to tax the project depending on whether it was considered as contracting or retail.

In review, the contractor definition of the City and the State, we find they are substantially the same. It is also clear under Sections 6005 and 500 that when the DOR and the City Codes are the same and the DOR has issued written guidance, the DOR interpretation is binding on the City. The DOR has Regulation 615 which provides that public address, communication, intercommunication, and security alarm systems installed in a structure by a contractor are taxable. In this case, the Taxpayer was a licensed contractor performing such installations.

While the City has argued they have Regulations that would result in a difference conclusion, we find in this case that Regulation 615 is controlling and that the Taxpayer was properly paying taxes under the contracting category. We do note that our decision may have been different if there was evidence that the Taxpayer was attempting to evade taxes by placing retail sales, with little or no labor involvement, in the contracting category. We did not find such evidence.

Licensing for Use

Clearly, any reliance the Taxpayer had on a written opinion from the DOR is not relevant since the State does not tax "licensing for use". We do find the facts in this case demonstrate that the Taxpayer entered into agreements with customers whereby the customers would have the use of the Taxpayer's equipment for a consideration. Since the Taxpayer maintained control of the equipment, there would be no "lease" or "rental". As a result, the agreement would be for "licensing for use" pursuant to Section 100 and thus taxable pursuant to Section 450 and Regulation 450.1. We find that the entire invoiced amounts are taxable when the charge for the operator is not separately itemized on the customers invoice.

Use Tax/Interest/Penalties

The parties were in agreement that a use tax assessment in the amount of $83.50 was proper. Any interest on taxes that were abated are also abated pursuant to Section 540. The Taxpayer has also demonstrated reasonable cause for any taxes not timely paid and as a result all penalties are waived.

FINDINGS OF FACT

1. On January 26, 2004, the Taxpayer filed a protest of a tax assessment made by the City.

2. After review the City concluded on February 10, 2004, that the protest was timely and in proper form.

3. On February 19, 2004, the Hearing Officer ordered the City to file a response to the protest on or before April 5, 2004.

4. On February 24, 2004, the Taxpayer filed supplemental information.

5. On March 12, 2004, the City filed a response to the protest.

6. On March 18, 2004, the Hearing Officer ordered the Taxpayer to provide additional information to the City on or before April 8, 2004 and the City would file any comments/recommendations on or before April 22, 2004.

7. The Taxpayer filed additional information with the City on April 7, 2004..

8. After review, the City filed additional comments/recommendations on April 22, 2004.

9. On April 30, 2004 the Hearing Officer ordered the Taxpayer to file any reply on or before May 4, 2004.

10. On May 19, 2004, a Notice was issued setting the matter for hearing commencing on June 25, 2004.

11. On May 20, 2004, the Taxpayer requested an extension for the reply deadline.

12. On May 21, 2004, the Hearing Officer granted the Taxpayer an extension until June 11, 2004.

13. On June 3, 2004, the Hearing Officer continued the hearing date at the request of the City.

14. On June 11, 2004, the Taxpayer filed a reply to the City.

15. On August 23, 2004, a Notice was issued rescheduling the hearing to commence on September 20, 2004.

16. Both parties appeared and presented evidence at the September 20, 2004 hearing.

17. On September 22, 2004, the Hearing Officer indicated the City would file a Closing Brief on or before October 27, 2004 and the Taxpayer would file a Reply Brief on or before November 26, 2004.

18. On October 20, 2004, the City filed additional information/documents and on October 21, 2004, the City filed a Closing Brief.

19. On November 11, 2004, the Taxpayer requested an extension for its Reply Brief.

20. On November 12, 2004, the Hearing Officer granted the extension up through December 30, 2004.

21. On December 29, 2004, the Taxpayer filed its Reply Brief.

22. On January 15, 2005, the Hearing Officer indicated the record was closed and a written decision would be issued on or before March 1, 2005.

23. The City conducted an audit of the Taxpayer for the period April 1999 through September 2002.

24. The City concluded the Taxpayer overpaid privilege tax on construction contracting in the amount of $35,411.38.

25. The City concluded the Taxpayer underpaid privilege tax on licensing for use of tangible personal property and retail sales in the amounts of $25,816.83 and $52,931.72, respectively.

26. The net amount of underpaid privilege taxes for the audit period was $43,337.17.

27. The City concluded the Taxpayer had underpaid use tax in the amount of $88.71.

28. The City assessed interest up through November 2003 in the amount of $14,069.24 and assessed penalties totaling $1,852.53.

29. The Taxpayer designs, sells and installs audio/video and/or lighting systems for institutional customers such as businesses and churches.

30. The price quoted by the Taxpayer to a potential customer includes both the equipment and installation.

31. The Taxpayer provided audio, video and lighting equipment (with technicians) to customers for consideration.

32. The Taxpayer did not allow customers to take possession or control the equipment.

33. The Taxpayer did not always separately itemize the charge for the operator and the charge for the use of the equipment.

34. The Taxpayer paid a combined state and county tax on a fixed asset purchased from an Ohio company.

35. The Taxpayer had not been previously audited by the City.

36. The Taxpayer has a contractors license because its business requires it to frequently drill holes, cut through walls and/or ceilings, attach and/or flush mount speakers to walls and/or ceilings, run and attach wires to and through walls and ceilings.

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. During the audit period, the Taxpayer was engaged in contracting pursuant to Sections 100, 415, 500, and Regulation 615.

3. During the audit period, the Taxpayer was engaged in the licensing for use of tangible personal property pursuant to Sections 100 and 450 and Regulations 450.1 and 450.3.

4. The Taxpayer has demonstrated reasonable cause for the abatement of all penalties.

5. The Taxpayer's protest should be granted in part and denied in part, consistent with the Discussion, Findings, and Conclusions, herein.

ORDER

It is therefore ordered that the January 26, 2004 protest by ***Taxpayer*** of a tax assessment made by the City of Phoenix is hereby granted in part and denied in part consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Phoenix shall revise its assessment to reflect the determination that ***Taxpayer*** was in the contracting business and not the business of retail sales.

It is further ordered that the City of Phoenix shall revise its use tax assessment to the amount of $83.50.

It is further ordered that the City of Phoenix shall revise its assessment by removal of all penalties.

It is further ordered that this Decision is effective immediately.