DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: October 8, 2005
Decision: MTHO #243
Taxpayer: ***Taxpayer***, LLC
Tax Collector: City of Peoria
Hearing Date: September 13, 2005

DISCUSSION

Introduction

On April 28, 2005, ***Taxpayer***, LLC ("Taxpayer") filed a protest of a tax assessment made by the City of Peoria ("City"). After review, the City concluded on May 4, 2005 that the protest was timely and in the proper form. On May 12, 2005, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to file a response to the protest on or before June 27, 2005.The City filed a response to the protest on June 21, 2005. On June 24, 2005, the Hearing Officer ordered the Taxpayer to file a reply on or before July 15, 2005. The Taxpayer filed a reply on July 12, 2005. On July 20, 2005, a Notice of Tax Hearing ("Notice") scheduled the matter for hearing commencing on August 24, 2005. On July 21, 2005 the Taxpayer requested the hearing be rescheduled because of a time conflict with other matters. On July 25, 2005, the Hearing Officer granted the request for the hearing to be rescheduled. On July 26, 2005, a Notice rescheduled the hearing to commence on September 13, 2005. Both parties appeared and presented evidence at the September 13, 2005 hearing. On September 19, 2005, the Hearing Officer indicated the record was now closed and a written decision would be issued on or before October 28, 2005.

City Position

The Taxpayer is in the business of selling timeshare interval interests. The City conducted an audit of the Taxpayer for the period of September 13, 2003 through February 2005. As a result of the audit, the City concluded the Taxpayer owed speculative builder tax pursuant to City Code Section 12-416 ("Section 416") in the amount of $186,189.13. The City also assessed the Taxpayer for use tax in the amount of $15,463.20, penalties for failing to timely pay taxes pursuant to City Code Section 12-540 (b) ("Section 540 (b)"), and interest pursuant to City Code Section 12-540 (a) ("Section 540 (a)").

In response to the Taxpayer's protest, the City argued the sale of timeshare interests must be based on the full sale price for purposes of determining gross income. According to the City, Section 416 does not provide any exceptions to this requirement. Further, the City asserted that City Code Section 12-200 (c) ("Section 200(c)") provides as follows: "No deduction or exclusion is allowed from gross income on account of the cost of the property sold, the time value of money, expense of any kind or nature, losses, or

materials used, labor or service performed, interest paid, or credits granted." The City asserted that under the timeshare agreements, each buyer acquires an individual interest in a specific timeshare unit. According to the City, there was no breakdown in the sales agreement as to any portion of the sales price being for intangible benefits.

The City disagreed with the Taxpayer's deduction for sales taxes paid to a construction contractor. The City asserted that Section 416 (c) (3) (B) requires a deduction from gross income for sales taxes paid to a construction contractor to be limited to the amount reported by the contractor. According to the City, the Taxpayer was incorrectly overcharged $50,000 by its contractor. The City asserted that the overcharge was a matter between the Taxpayer and its contractor.

In addition to the excess $50,000 tax collected, the City also disagreed with the Taxpayer on the timing of the deduction for the remaining taxes paid by the construction contractor. The City asserted that Section 416 (c) (3) (C) specifies that "[no] credits provided herein may be claimed until such time that the gross income against which said credits apply is reported." In this case, the City allocated the deductions for taxes paid by the contractor as the timeshares were sold based on a square footage basis.

The City asserted that the timeshare units are used for recreation or vacation purposes and are not intended to be a person's permanent residence or dwelling. The City indicated the buyer of a timeshare interval has no right to store belongings at the timeshare for other than the one-week interval purchased. The City argued that the buyer of a timeshare interval has a right to use the furnishings in the timeshare during the one-week interval but has no ownership or control over the furnishings.

The City argued that the Taxpayer was liable for use tax on furnishings and furniture included in timeshare units pursuant to City Code Section 12-620 ("Section 620"). According to the City, the furniture items were not included in the sales price of the timeshare units and thus must be taxed separately. The City noted that the sales affidavits prepared by the Taxpayer and signed by the individual buyers indicated the sale did not include any tangible personal property greater than five percent of the sales price.

Taxpayer Position

The Taxpayer argued that the City had erroneously taxed the total sales price of interval timeshare interests. According to the Taxpayer, the sale of timeshare interests included numerous and valuable non-real property elements that cannot be taxed as "sales price of improved real property." The Taxpayer asserted those non-real property elements include among other things: use of the furnishings inside the timeshare unit during the Use Period; use of the common area facilities during the Use Period; the right to exchange a Use Period at the timeshare for a Use Period at another facility; the going concern value of a trained and in place workforce to operate the Resort; extraordinary sales and marketing costs; financing costs; club memberships; and, vacation "hotel-type" convenience services. The Taxpayer argued that to use the sale of the interval interest

alone as the value of the "improved real property" would not be permissible. In London Bridge Resort, Inc. v. Mohave County, 200 Ariz. 462, 27 P. 3d 819 (Ct. App. 2001), the Court adopted a valuation method which valued timeshare condominium units at their sale price less a 68 percent discount factor to take into account non-real estate factors. The Taxpayer also noted that A.R.S. Section 42-12452 ("Section 12452") provides that the county assessor shall deduct a reasonable amount from the gross sales price of the timeshare interests to represent non-realty components of the gross sales price. Section 12452 presumes the amount of deductions to be 65 percent of the gross sales price of the timeshare interest.

The Taxpayer asserted that Section 416 authorizes a tax on the sale of improved real property. Further, City Code Section 12-200 (a) ("Section 200") states that gross income is the value proceeding or accruing from the sale of property…." The Taxpayer argued that construing these two Sections demonstrates they are not designed to tax personal property whether tangible or intangible.

The Taxpayer asserted that City Code Section 12-250 ("Section 250") provides that "gross income shall be exclusive of combined taxes" where "such tax has been added to the total price of the transaction." As a result, the Taxpayer indicated they were entitled to a deduction from gross income in the amount of $422,794.74 for actual State taxes paid during the audit period and a credit for the actual City taxes paid during the audit period in the amount of $100,665.04.

The Taxpayer disagreed with the City's argument that Section 416 (c) (3) (B) limits the deduction to the amount of taxes reported by the contractor. The Taxpayer argued that there is nothing in Section 250 that indicates it is subject to Section 416 (c) (3) (B). The Taxpayer asserted that Section 416 (c) (3) (B) applies to the tax credits of Section 416 (c).

The Taxpayer also argued that the City was not consistent in deferring the deduction and credits for taxes paid while treating the entire sale price of all sold timeshare intervals as current income. According to the Taxpayer, the City cannot concurrently include all income even though not received while denying a deduction/credit for a substantial portion of the taxes that were actually paid during the audit period. The Taxpayer noted that under the City's approach of allocating the deductions and credits based on a sold square footage basis, the Taxpayer would lose any deductions/credits that were not allocated within 24 months of substantial completion of the improved real property.

The Taxpayer argued that they were not liable for use tax on furnishings and furniture. According to the Taxpayer, the purchase price of the timeshare intervals includes an interest in the furnishings inside a unit as well as use of the common area furnishings. The Taxpayer also noted that the Affidavit of Property Value does not ask whether or not the sales price includes personal property that is less than five percent of the sales price.

At the hearing, the Taxpayer protested the penalties assessed. The Taxpayer did not know of the speculative builder tax until audited by the City.

ANALYSIS

As we have previously concluded in Decision MTHO# 71 that the sale of timeshare intervals would be taxable as a speculative builder pursuant to Section 416. Further, Paragraph Two of City Code Section 100 controls and the Taxpayer will cease being a speculative builder when more than twenty-four months have elapsed from the time the improvements to the real property were substantially complete. We note that in this case there was not sufficient evidence to determine when or if the improvements to the real property were substantially complete.

Section 416 provides that the tax is on the "total selling price from the sale of improved real property." We agree with the Taxpayer that any of the selling price of the timeshare intervals that can be attributed to non-real property should not be taxable pursuant to Section 416. However, the burden is on the Taxpayer to provide documentation and/or records to demonstrate how much, if any, of the selling price is not attributable to improved real property. We do not find the Taxpayer's reference to valuation for property tax purposes to be useful in determining what the selling price of improved real property would be. As we indicated in Decision MTHO #107, we find the most reliable value for the selling price of improved real property to be what the individual purchasers believe they have purchased. The Taxpayer can't inform purchasers the total selling price is for improved real property and then go to the taxing authority and argue that only 35 percent of the selling price is for improve real property. As we previously stated in Decision MTHO #107, the Taxpayer could easily have broken down the selling price into a proportion for improved real property and a proportion for intangibles. That was not done and as a result we can only speculate how much, if any, of the selling price was for non-improved real property. Accordingly, we concur with the City that the total selling price of each timeshare interval is subject to the speculative builder tax.

The City and Taxpayer disagreed on the amount of tax credits/deductions as well as the timing for such credits/deductions. The City authorized a deduction for sales taxes paid to a construction contractor pursuant to Section 250. The issue presented to the Hearing Officer was whether or not the limitation set forth in Section 416 (c) applies to such a deduction. We conclude it does not as the limitation in Section 416 (c) specifically refers to tax credits. Since the Taxpayer has agreed to report on the accrual basis, it was proper for the City to match the timing of the deductions with the recognition of the gross income based on square footage sold. While the Taxpayer may lose a portion of the deductions if the timeshare unit is not sold within the twenty-four month period, the City will also lose the matching gross income from the sales after the twenty-four month period. The City authorized tax credits for City taxes pursuant to Section 416 (c). Section 416 (c) provides for a credit for taxes "charged separately to the speculative builder by a construction contractor. . .". As a result, the Taxpayer was authorized a credit for the total amount of City taxes separately charged to the Taxpayer by a construction contractor. Section 416 (c) further provides that the credits may not be claimed until the gross income against which such credits apply is reported. Accordingly, we find the City's method of allocating credits based on a sold square footage basis properly authorizes the

credits pursuant to Section 416 (c). While we recognize the Taxpayer may lose a portion of the tax credits if the timeshare unit is not totally sold within the twenty-four month period, we also recognize that the City will not be able to tax the gross income from those sales after the twenty-four month period.

As to the use tax on the furnishings, the Hearing Officer concurs with the City position. Based on the evidence, the furnishings are not sold to the buyers of the timeshare intervals. The buyers have the right of the use of the furnishings during their timeshare interval, however the Taxpayer maintains ownership and control over the furnishings. Based on the above, the furnishings are subject to the use tax.

Lastly, we find the City was authorized pursuant to City Code Section 540 (b) ("Section 540 (b)") to impose a penalty for late payment. It was also clear that the Taxpayer was not aware of the speculative builder tax until the City audit. As a result, we conclude that the Taxpayer has demonstrated reasonable cause to have the penalty waived.

FINDINGS OF FACT

1. On April 28, 2005, the Taxpayer filed a protest of a tax assessment made by the City.

2. After review, the City concluded on May 4, 2005 that the protest was timely and in the proper form.

3. On May 12, 2005, the Hearing Officer ordered the City to file a response to the protest on or before June 27, 2005.

4. The City filed a response to the protest on June 21, 2005.

5. On June 24, 2005, the Hearing Officer ordered the Taxpayer to file a reply on or before July 15, 2005.

6. The Taxpayer filed a reply on July 12, 2005.

7. On July 20, 2005, a Notice scheduled the matter for hearing commencing on August 24, 2005.

8. On July 21, 2005, the Taxpayer requested the hearing be rescheduled because of a time conflict with other matters.

9. On July 25, 2005, the Hearing Officer granted the request for the hearing to be rescheduled.

10. On July 26, 2005, a Notice rescheduled the hearing to commence on September 13, 2005.

11. Both parties appeared and presented evidence at the September 13, 2005 hearing.

12. On September 19, 2005, the Hearing Officer indicated the record was now closed and a written decision would be issued on or before October 28, 2005.

13. During the audit period, the Taxpayer was in the business of selling timeshare interval interests.

14. The City conducted an audit of the Taxpayer for the period of September 13, 2003 through February 2005.

15. As a result of the audit, the City concluded the Taxpayer owed speculative builder tax pursuant to Section 416 in the amount of $186,189.13.

16. The City also assessed the Taxpayer for use tax in the amount of $15,463.20, penalties for failing to timely pay taxes pursuant to Section 540 (b), and interest pursuant to Section 540 (a).

17. The buyer of a timeshare interval acquires an undivided 1/52nd fee ownership interest in a timeshare unit.

18. There was no breakdown in the sales agreements as to any portion of the sales price being for intangible benefits.

19. The interval owner may not make or authorize any alterations, additions or improvements to the unit without consent.

20. Timeshare units are used for recreational or vacation purposes and are not intended to be a person's permanent residence or dwelling.

21. The buyer of a timeshare interval has no right to store belongings at the timeshare for other than the one-week interval purchased.

22. The buyer of a timeshare interval has a right to use the furnishings in the timeshare during the interval purchased.

23. The buyer of a timeshare interval has no ownership or control over the furnishings.

24. The Taxpayer was unaware of the speculative builder tax until the City audit.

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 416 imposes a tax on being in business as a speculative builder within the City.

3. Section 100 (1) defines speculative builder as an owner-builder who sells improved real property consisting of "custom, model, or inventory homes…".

4. Section 100 (2) generally indicates the sale of improved property other than those specified in Section 100 (1) will be taxable speculative builder sales for up to twenty-four months after the improvements of the real property sold are substantially complete.

5. During the audit period, the Taxpayer was a speculative builder pursuant to Section 100 (2).

6. The speculative builder tax is imposed on the "selling price of the improved property".

7. It is reasonable to conclude that an individual purchaser would believe their total purchase amount was for improved property.

8. There was no documentation and/or records to demonstrate how much, if any, of the selling price is not attributable to improved real property.

9. Section 416 (c) provides for a credit for taxes "charged separately to the speculative builder by a construction contractor…".

10. The Taxpayer was authorized a credit for the total amount of City taxes separately charged to the Taxpayer by a construction contractor.

11. Section 416 (c) provides that the tax credits may not be claimed until the gross income against which such credits apply is reported.

12. The City's method of allocating credits based on a sold square footage basis properly authorizes the credits pursuant to Section 416 (c).

13. The Taxpayer may lose a portion of the tax credits if the timeshare unit is not totally sold within the twenty-four month period but the City would also not be able to tax the gross income on those sales after the twenty-four month period.

14. The City authorized a deduction for sales taxes paid to a construction contractor pursuant to Section 250.

15. The limitation placed on tax credits in Section 416 (c) does not apply to tax

deductions.

16. Since the Taxpayer was on the accrual basis, it was proper for the City to match the tax deductions with the gross income associated with those deductions.

17. The City's method of matching the timing of deductions with the recognition of the gross income based on square footage sold was proper.

18. The Taxpayer may lose a portion of the tax deductions if the timeshare unit is not totally sold within the twenty-four month period but the City would also not be able to tax the gross income on those sales after the twenty-four month period.

19. The furnishings to the timeshare units are subject to the use tax.

20. The City was authorized to impose a penalty for late payment of taxes.

21. The Taxpayer demonstrated reasonable cause to have the penalties waived.

22. The Taxpayer's protest should be partly granted and partly denied consistent with the Discussion, Findings, and Conclusions, herein.

ORDER

It is therefore ordered that the April 28, 2005 protest of ***Taxpayer***, LLC of a tax assessment made by the City of Peoria 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 Peoria shall revise its assessment to include any excess taxes paid by ***Taxpayer***, LLC to its construction contractor as part of the City's allocated tax deductions and credits.

It is further ordered that the City of Peoria shall revise its assessment to remove all late payment penalties assessed.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer