

## DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: January 5, 2006  
Decision: MTHO #252  
Tax Collector: City of Tempe  
Hearing Date: November 16, 2005

### DISCUSSION

#### Introduction

On July 13, 2005, *Taxpayer A* (“Taxpayer”) filed a protest of a tax assessment made by the City of Tempe (“City”). After review, the City concluded on July 21, 2005 that the protest was timely and in the proper form. On August 2, 2005, the Municipal Tax Hearing Officer (“Hearing Officer”) ordered the City to file any response on or before September 16, 2005. The City filed a response to the protest on September 16, 2005. On September 27, 2005, a Notice of Tax Hearing (“Notice”) scheduled the matter for hearing commencing on November 16, 2005. Both parties appeared and presented evidence at the November 16, 2005 hearing. On November 21, 2005, the Hearing Officer indicated the record was now closed and a written decision would be issued on or before January 5, 2006.

#### City Position

On July 8, 2005, the City issued an assessment against the Taxpayer for the period of August 2004 through June 2005 for taxes in the amount of \$1,243.69, license fees of \$120.00, and interest up through July 31, 2005, in the amount of \$1,425.87. The City indicated the Taxpayer was formed on August 6, 2002. Based on the records of the Arizona Corporation Commission (“ACC”), the initial members owning a twenty percent or greater interest in the capital or profits of the Taxpayer were *Members* (Collectively referred to as the “*Members*”). According to the City, *Taxpayer B* (“*Taxpayer B*”) is a corporation which was incorporated on December 5, 1995. Based on the records of the ACC, the *Members* were the only shareholders of the corporation holding more than twenty percent of the corporation’s stock. According to the City, *Taxpayer B* obtained a privilege tax license with the City in 1996 and operates a service station/convenience store located in the City.

The City indicated that the Taxpayer purchased the service station/convenience store from *XYZ Corporation* (“*XYZ*”). In connection therewith, the Taxpayer entered into an SBA guaranteed Business Loan Agreement (“*Agreement*”) with *Bank* (“*Bank*”) secured by a Deed of Trust and Assignment of Rents (“*Deed*”) on the real property guaranteed by *Taxpayer B*, the *Members*, and the *Trust* (“*Trust*”). The loan requires monthly payments of \$5,297.47 until its maturity on May 15, 2019. The City noted that at the same time, the Taxpayer and *Taxpayer B* entered into a twenty year commercial lease on the property which required *Taxpayer B* to make monthly rental payments to the Taxpayer in the amount of \$5,297.47. The City indicated that beginning in August 2004, *Taxpayer B*

commenced making monthly payments of \$5,297.47 to the Bank. In addition, the City determined that **Taxpayer B** also made property tax payments totaling \$12,410.64 through June of 2005. The City asserted that the Taxpayer and **Taxpayer B** are separate persons as defined in City Code Section 16-100 (“Section 100”) as follows:

“*Person* means an individual firm, partnership, joint venture, association, corporation, estate, trust, receiver, syndicate, broker, the Federal Government, this State, or any political subdivision or agency of this State. For the purposes of this Chapter, a personal shall be considered a distinct and separate person from any general or limited partnership or joint venture or other association with which such person is affiliated. A subsidiary corporation shall be considered a separate person from its parent corporation for purposes of taxation of transactions with its parent corporation.”

According to the City, a limited liability company (“LLC”) is a hybrid form of ownership for income tax purposes and is not specifically mentioned in the definition of person in Section 100. However, the City noted that for federal and state income tax purposes an LLC can elect to be treated as a corporation, a partnership, or as a disregarded entity. The City argued that regardless of the election, the Taxpayer is still a separate person from **Taxpayer B** pursuant to Section 100. The City noted that if the Taxpayer is treated as a corporation or a partnership, both such entities are defined as separate persons in Section 100. The City asserted that if the Taxpayer were treated as a disregarded entity the Taxpayer would meet the definition of “firm” in Section 100.

The City argued that the Taxpayer was engaged in the business of renting real property for privilege tax purposes. The City noted that Section 100 defines “business” as follows;

“*Business* means all activities or acts, personal or corporate, engaged in and caused to be engaged in with the object of gain, benefit or advantage, either direct or indirect, but not casual activities or sales.”

The City asserted that prior to the matters involved in the case, the Taxpayer engaged in the purchase, renovation, and subsequent sale of residential real estate for profit. According to the City, the Taxpayer was generally engaged for gain in the real estate business, and the purchase and lease of commercial property was a natural expansion of that business. The City indicated that the structure of the specific transaction in this case provides benefits to the organizers or members of the entities such as the following:

- The ability to generate monthly cash flow to the holder(s) of the real estate.
- The ability to transfer ownership of the service station/convenience store without affecting the real estate, and vice versa.
- The ability to shield the real estate from the general liabilities, including potential tax liens, arising from the operation of the service station/ convenience store.

The City asserted the leasing arrangement between the Taxpayer, as lessor, and **Taxpayer B**, as lessee, was in accordance with SBA rules. The City argued that the Bank and SBA would have relied on the validity of the lease and assignment in their decision to grant the loan and would continue to rely on the lease and assignment as collateral for the loan.

The City asserted that the Taxpayer should not be allowed to claim, for loan compliance purposes, that rents are being paid while simultaneously claiming, for tax purposes, that no rents are paid. The City concluded that the lease payments were properly includable in the Taxpayer's gross income pursuant to City Code Section 16-445 ("Section 445"). In addition, the City noted that Section 445 (a) (1) provides that "Payments made by the lessee to, or on behalf of, the lessor for property taxes, repairs, or improvements are considered to be part of the taxable gross income." As a result, the City included the property tax payments made by *Taxpayer B* as part of the Taxpayer's taxable gross income.

In response to the Taxpayer's arguments, the City asserted that *Taxpayer B*, as a guarantor of the loan, is not directly liable on the loan or any of the individual payments. According to the City, *Taxpayer B* guarantee of the Bank loan to the Taxpayer is irrelevant to the case. Based on all the above, the City requested the assessment be upheld.

### **Taxpayer Position**

The Taxpayer indicated they have been a family owned and operated business since 1990. According to the Taxpayer, the property was originally leased from *XYZ* by *Taxpayer B*. The Taxpayer asserted they purchased the property from *XYZ* in July of 2004 for liability purposes. The Taxpayer indicated that no rental money is exchanged between the Taxpayer and *Taxpayer B*. The Taxpayer argued that since there was no exchange of monies, there can be no sales tax on rents received. Based on the above, the Taxpayer requested the assessment be reversed.

### **ANALYSIS**

We concur with the City that the Taxpayer and *Taxpayer B* are separate "persons" pursuant to Section 100. It is clear that the Taxpayer and *Taxpayer B* have entered into a long term lease which obligates *Taxpayer B* to pay the Taxpayer a monthly rental of \$5,297.47. It is also clear that the Taxpayer assigned the rights to the lease to the Bank in order to obtain a loan. As a result, *Taxpayer B* made the monthly payments directly to the Bank. However, the payments made by *Taxpayer B* were for the long term lease entered into with the Taxpayer and as such would have constituted rental income to the Taxpayer pursuant to Section 445. We must also agree with the City that the property taxes paid by *Taxpayer B* on behalf of the Taxpayer would also constitute taxable gross income pursuant to Section 445 (a) (1). While we understand the Taxpayer may have established separate legal entities for liability purposes, it also had the consequence of setting up separate legal entities for tax purposes. In this case, the one legal entity had a legal obligation, supported both by a commercial rental agreement and a Bank loan, to make payments to the other separate legal entity. Under the City Code, the payment obligations are taxable. Accordingly, the Taxpayer's protest should be denied.

## FINDINGS OF FACT

1. On July 13, 2005, the Taxpayer filed a protest of a tax assessment made by the City.
2. After review, the City concluded on July 21, 2005 that the protest was timely and in the proper form.
3. On August 2, 2005, the Hearing Officer ordered the City to file any response on or before September 16, 2005.
4. The City filed a response to the protest on September 16, 2005.
5. On September 27, 2005, a Notice scheduled the matter for hearing commencing on November 16, 2005.
6. Both parties appeared and presented evidence at the November 16, 2005, hearing.
7. On November 21, 2005, the Hearing Officer indicated the record was now closed and a written decision would be issued on or before January 5, 2006.
8. On July 8, 2005, the City issued an assessment against the Taxpayer for the period of August 2004 through June 2005 for taxes in the amount of \$1,243.69, license fees of \$120.00, and interest up through July 2005 in the amount of \$1,425.87.
9. The Taxpayer was formed on August 6, 2002.
10. The initial members owning a twenty percent or greater interest in the capital or profits of the Taxpayer were the *Members*.
11. *Taxpayer B* is a corporation which was incorporated on December 5, 1995.
12. The *Members* were the only shareholders of the corporation holding more than twenty percent of the corporation's stock.
13. *Taxpayer B* obtained a privilege tax license with the City in 1996 and operates a service station/convenience store located in the City.
14. The Taxpayer purchased the service station/convenience store from *XYZ*.
15. In connection with the store purchase, the Taxpayer entered into an SBA guaranteed Agreement with the Bank secured by a Deed on the real property guaranteed by *Taxpayer B*, the *Members*, and the Trust.
16. The loan requires monthly payments of \$5,297.47 until its maturity on May 15, 2019.

17. At the same time, the Taxpayer and *Taxpayer B* entered into a twenty year commercial lease on the property which required *Taxpayer B* to make monthly rental payments to the Taxpayer in the amount of \$5,297.47.
18. Beginning in August 2004, *Taxpayer B* commenced making monthly payments of \$5,297.47 to the Bank.
19. *Taxpayer B* also made property tax payments totaling \$12,410.64 through June of 2005.

### 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. The Taxpayer and *Taxpayer B* are separate “persons” pursuant to Section 100.
3. Pursuant to a long term lease agreement, *Taxpayer B* is obligated to pay the Taxpayer a monthly rental of \$5,297.47.
4. Pursuant to a loan agreement between the Taxpayer and the Bank, *Taxpayer B* made the \$5,297.47 payment directly to the Bank on behalf of the Taxpayer.
5. The property taxes on the service station/convenience store were the obligation of the Taxpayer and were paid by *Taxpayer B* on behalf of the Taxpayer.
6. The monthly rental amounts and property taxes paid by *Taxpayer B* on behalf of the Taxpayer constituted taxable rental income to the Taxpayer pursuant to Section 445.
7. The Taxpayer’s protest should be denied.

### ORDER

It is therefore ordered that the July 13, 2005 protest by *Taxpayer A* of a tax assessment made by the City of Tempe is hereby denied.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh  
Municipal Tax Hearing Officer