Jerry Rudibaugh

Municipal Tax Hearing Officer

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: October 11, 2002

Decision: MTHO #27

Tax Collector: City of Scottsdale

Hearing Date: May 29, 2002

DISCUSSION

Introduction

On December 26, 2001, "Taxpayer" filed a protest of the tax assessment of the City of Scottsdale ("City"). After review of the protest, the City concluded it was timely and in the proper form. On January 7, 2002, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to file a response to the protest on or before February 21, 2002. The City filed its response on February 15, 2002. On February 27, 2002, the City filed a revision to its assessment. On March 15, 2002, the matter was scheduled for hearing commencing on April 25, 2002. At the request of the Taxpayer, the hearing was rescheduled for May 29, 2002. On May 1, 2002, the Hearing Officer ordered the Taxpayer to file any reply to the City on or before May 21, 2002. The City and Taxpayer both appeared at the May 29,2002 hearing and presented evidence. The Taxpayer also submitted a hearing memorandum at that time. At the conclusion of the hearing, the parties agreed upon a briefing schedule whereby the Taxpayer would file additional information as well as any supplement to its hearing memorandum on or before June 12, 2002. The City would file its response brief on or before July 10, 2002 and the Taxpayer would file any reply brief on or before July 24, 2002. On June 4, 2002, the City filed a request for additional documents. As a result, the parties' request for a one-week extension to each of the briefing dates was granted. The Taxpayer filed additional information and a supplement to its hearing memorandum on June 19, 2002. The parties' request to extend the response deadline of the City until July 31, 2002 and the Taxpayer's reply deadline until August 21, 2002 was granted by the Hearing Officer on July 18, 2002.

The City filed its response on July 31, 2002. On August 21, 2002, the Hearing Officer approved the parties' stipulation to extend the Taxpayer's reply deadline until August 30, 2002. The Taxpayer filed their reply memorandum on August 30, 2002. On September 16, 2002, the Hearing Officer issued a letter indicating a written decision would be issued on or before October 14, 2002.

Taxpayer was the Construction Manager for the construction of the "Project" in the City. The Owner of the complex was "Owner". Taxpayer and Owner are wholly owned subsidiaries of "Parent". Owner and Taxpayer entered into a contract titled "Standard Form Agreement between Construction Manager and Owner" ("Agreement"). Taxpayer and Owner had the exact same address and suite number. In addition, the parties signing the Agreement held the same positions in all three entities: Taxpayer; Owner; and, the Parent. The City assessed the Taxpayer under the construction contracting definition of the City Code for the Project. Taxpayer did not report any gross income at the completion of the Project. The City concluded the Taxpayer's gross income was the same as the total cost of the project in the amount of $24,265,870.52.

The City assessed the Taxpayer for $268,853.33 in taxes and interest in the amount of $259,443.17. Subsequently, the City revised the assessment and reduced the taxes to $181,092.00 and the interest to $180,187.00.

City Position

The City asserted that a tax is assessed on the gross income of every construction contractor engaging in **construction contracting** within the City. Further, the City Code defines a **construction contractor** as "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 a...project, development or improvement to real property or to do any part thereof. Construction contractor includes subcontractors, specialty contractors, prime contractors, and any person receiving **consideration for the general supervision and/or coordination of such a construction project...."**

According to the City, the Taxpayer obtained a City business license and tax number in February 1995 and pulled several construction permits to begin the construction of the Project. The City argued that it is undisputed that the Taxpayer worked as a construction contractor and received consideration for the services performed for Owner as set forth in the Agreement. The Agreement provided that Owner would pay Taxpayer a two percent fee for the construction manager services during both the design phase and the construction phase.

The City argued that pursuant to the Agreement, Owner was to pay the Taxpayer for the cost of the work as defined in Article 8 of the Agreement. The City further argued that the Taxpayer independently contracted with and agreed to pay the subcontractors. As a result, the City concluded that the Taxpayer received gross income in the amount of total construction costs of $24,265,870.52 plus the two percent construction management fee.

The City asserts that the City Code does not exempt companies working for related companies from tax liability. Section 100 of the Code provides a definition of person that indicates "A subsidiary corporation shall be considered a separate person from its parent corporation for purposes of taxation of transactions with its parent corporation." For that reason, the City concluded the Taxpayer was a construction contractor for Owner even though they were subsidiaries of the Parent. Further the City asserts that pursuant to Section 210 of the City Code, when the gross income from the transaction is not indicative of the market value, the City shall determine the market value upon which the tax shall be levied. While the Taxpayer wants to explain what was the real agreement, the City argued the Agreement is the best evidence regarding the agreement in place and cannot be ignored. The City argued that the Agreement clarifies this by providing as follows:

"This Agreement represents the entire agreement between the Owner and Construction Manager and supercedes all prior negotiations, representations or agreements."

The City asserts that the Taxpayer was legally and contractually liable to pay the subcontractors and any-payments made to the subcontractors by affiliated companies were made on behalf of the Taxpayer. The City argued that any payments or forgiveness of the Taxpayer's debt is part of its gross income pursuant to Section 200 (a)(3) of the City Code.

While the Taxpayer has argued that it was the agent of Owner, the City argued that the Taxpayer has failed to meet its burden of proving it. The City asserted that the Taxpayer's testimony regarding its intent to create an agency relationship is not credible. The City argued that the Agreement could have easily stated it was an agreement between principal and agent if it was really meant to be an agency agreement. Even if the Taxpayer intended to form an agency relationship, the City argued that it is still necessary to scrutinize the "totality of facts and circumstances of each case" in order to determine if an actual agency relationship exists. Based on the various contracts, the Taxpayer maintained control over the construction site and bore the risk that the cost of the project would exceed the guaranteed maximum price. According to the City, the Taxpayer had a wide range of responsibility under the Agreement including the responsibility to "pay the contractors for work performed or direct the Owner to pay the contractors for work performed."

In order to form an agency relationship, the City argued that the Taxpayer must also prove that it held itself out as an agent to third parties. The City argued that neither the Agreement nor the contracts between the Taxpayer and subcontractors disclose the Taxpayer's intent to work as the agent of the Owner. The City acknowledged that there is some contractual language which states that subcontracts will be awarded by the Taxpayer as the agent of the owner. However, the City noted that the same contracts also had language that stated that the subcontracts would be awarded by the Taxpayer on its own behalf. The City argued that, at best, the contracts were ambiguous and contradictory. The City concluded that an ambiguous contract does not meet the Taxpayer's burden of proving that it held itself out as an agent of the Owner.

The City Code provides that a trade contractor is a taxable construction contractor and liable for payment of the tax on the project unless the trade contractor has been provided with a "written declaration from the [construction contractor] that the

[construction contractor] is liable for the tax and has provided the [trade contractor] his City Privilege License number." According to the City, Taxpayer did not give any written declarations for the Project. In response to the Taxpayer's argument that the subcontractors were the proper taxable entity, the City asserts that the Taxpayer cannot bind the City to its agreements with the subcontractors. 'While it is clear the Taxpayer intended the subcontractors to pay the tax on the construction activity, the City asserts it is still the Taxpayer who had the responsibility to insure the taxes were paid. The City indicated that the City cannot enforce the agreements since it was not a party to them. Further, the City asserted that most of the subcontractors could not be audited for the Project because only one out of a random sampling of ten had a City license.

Taxpayer Position

According to the Taxpayer, the City Code holds that a subcontractor is "a construction contractor performing work for ... a contractor who has provided the subcontractor with a written declaration that he is liable for the tax for the project and has provided the subcontractor his City Privilege License number." The Taxpayer argued that unless the trade contractor satisfies this exception, the trade contractor is a taxable construction contractor on the portion of the work that it undertook. The Taxpayer asserts that it did not provide either a written declaration to any of the trade contractors that it was liable for the tax on the project, nor a City Privilege License number. As a result, the Taxpayer argued that the trade contractors are taxable construction contractors. Further, the Taxpayer indicated that the trade contractors agreed to pay all sales taxes in connection with its work on the projects and the trade contractors invoiced sales tax during the project. As a result, the Taxpayer requested the City be ordered to collect the tax from the trade contractors as the proper taxable entities.

According to the Taxpayer, they entered into a principal-agent relationship with Owner and as a result the Taxpayer entered into trade contracts on behalf of the owner (Owner). The Taxpayer asserted the Agreement expressly stated that Taxpayer would enter into the "trade contracts ... acting in its capacity as the agent for the Owner." The Taxpayer relied on several decisions by the Arizona Board of Tax Appeals ("Tax Appeals Board") that held that a person acting as the "agent" of the owner in supervising and coordinating construction work is not a taxable contractor. According to the Taxpayer, the Agreement between the Taxpayer and Owner was incorporated into all subcontracts. The Taxpayer argued that it was contracting with a third party for a known principal and under the law the Taxpayer did not become a party to the contract. Thus, the Taxpayer concluded that as the agent of Owner, the exempt owner, Taxpayer is not taxable.

According to the Taxpayer, Section 415 of the City Code taxes the gross income from the business of construction contracting and the Taxpayer's income, at most must be limited to the amount transferred to it from Owner as an overhead cost transfer. The transfer account was two percent of the project cost. The Taxpayer asserted that all payments to trade contractors or vendors were made directly from Owner or the Parent. Based on all the above, the Taxpayer requested the Hearing Officer find that:

1) Taxpayer acted as the agent of the owner and is therefore not taxable; 2) that the trade contractors are taxable construction contractors under the City Code; and 3) At most, Taxpayer's taxable "gross receipts" are limited to the two percent overhead cost transfers.

ANALYSIS

Pursuant to Section 100, the Taxpayer was a person receiving consideration for the general supervision and/or coordination of a construction project. While the Taxpayer argued that it was acting as the agent for the Owner of the project, the Hearing Officer agrees with the City that the burden of proof is on the Taxpayer. To meet that burden, the Taxpayer must demonstrate an actual agency relationship exists and that the Taxpayer held itself out as an agent to third parties. Based on the overall evidence, the Hearing Officer concludes the Taxpayer has failed to demonstrate an agency relationship existed or that it held itself out as an agent to third parties. The strongest points for the Taxpayer regarding the agency issue were: 1) Article 4.1 of the Agreement which provided as follows: "Trade contracts shall be awarded by the Construction Manager acting in its capacity as the agent for the Owner." and 2) The fact that all the checks to the subcontractors were issued by the Owner. The strongest points against the Taxpayer were: 1) The broad responsibilities and authority granted to the Taxpayer under the Agreement; 2) The lack of any clear disclosure to the subcontractors that the Taxpayer was acting as an agent of the Owner, and 3) Article 3.8 of the contract between the Taxpayer and subcontractors which provided as follows: "Subcontractor agrees to accept the risk of nonpayment if Construction Manager is not paid progress payments or the final payment from Owner for any reason..."

Based on the overall evidence, it appears that the Taxpayer may have wanted a principal agent relationship with the Owner. However, we must conclude the Taxpayer has failed to meet its burden of proof primarily because of the overall control and

authority granted the Taxpayer and the lack of any clear disclosure to third parties.

While the Taxpayer never received any payments from the Owner, there was a two percent cost transfer on the books to the Taxpayer. As a result, the Hearing Officer concludes the two percent cost transfer was gross income to the Taxpayer. As to the total construction costs, it is clear that those monies were not paid directly to the Taxpayer. However, we agree with the City that Section 210 authorizes the City to determine the market value upon which to assess taxes when the transaction between affiliated companies is not indicative of the market value. We also agree with the City that pursuant to Section 210, gross income includes the reduction of or forgiveness of indebtedness. While the Owner directly paid the subcontractors, we find this to be consistent with Section 8.1 of the Agreement, which provides the Owner, can directly pay the subcontractors upon the Construction Manager's approval and directions. It is also clear from Section 3.8 of the contract between the Taxpayer and the subcontractors that the subcontractors were informed they would not be paid if and until the Owner paid the Taxpayer. Further, it was the obligation of the Taxpayer to pay the subcontractors. In order to meet that obligation, the Owner directly paid the subcontractors and thus eliminated the indebtedness of the Taxpayer to the subcontractors. Based on the above, the Hearing Officer concludes the total costs of construction were taxable gross income to the Taxpayer pursuant to the City Code.

Lastly, the Taxpayer intended for the subcontractors to be liable for payment of the tax on the Project. That intent is clearly set forth in Section 5.3 of the contract between the Taxpayer and the subcontractors. Section 5.3 provides that the subcontractors shall pay all sales or use taxes. The primary issue is whether such language is sufficient to transfer the tax liability from the Taxpayer to the subcontractors and thus force the City to audit the various subcontractors in order to determine if sales and use taxes were actually paid to the City for the Project. We think not. The Taxpayer is still the responsible entity for ensuring the appropriate taxes were paid to the City. With that said, we want to make it clear that the City can only collect the sales tax once and the City must give the Taxpayer credit for taxes on the Project which the Taxpayer can demonstrate were paid to the City by other subcontractors. While it is clear that the Taxpayer did pay some taxes to the subcontractors, it is not clear that those taxes were then paid to the City. We will leave it up to the parties to agree upon a reasonable approach for the Taxpayer to demonstrate to the City that other entities paid the taxes to the City. The Hearing Officer would suggest a reasonable approach would be for the Taxpayer to provide an affidavit from the various subcontractors attesting what amount of taxes were paid to the City for the Project and under what account number the taxes were paid.

FINDINGS OF FACT

1. On December 26, 2001 the Taxpayer filed a protest of the tax assessment of the City.

2. After review of the protest, the City concluded the protest was timely and in the proper form.

3. On January 7, 2002, the Hearing Officer ordered the City to file a response to the protest on or before February 21, 2002.

4. The City filed its response on February 15, 2002.

5. On February 27, 2002, the City filed a revision to its assessment.

6. On March 15, 2002, the matter was scheduled for hearing commencing on April 25, 2002.

7. At the request of the Taxpayer, the hearing was rescheduled for May 29, 2002.

8. On May 1, 2002, the Hearing Officer ordered the Taxpayer to file any reply on or before May 21, 2002.

9. The City and Taxpayer both appeared at the May 29, 2002 hearing and presented evidence.

10. The Taxpayer submitted a hearing memorandum at the May 29, 2002.

11. At the conclusion of the hearing, the parties reached agreement whereby the Taxpayer would file additional information as well as any supplement to its hearing memorandum on or before June 12, 2002.

12. The City would file any response on or before July 10, 2002 and the Taxpayer would file any reply on or before July 24, 2002.

13. On June 4, 2002, the City filed a request for additional documents.

14. The parties' request for a one-week extension to each of the briefing dates was granted.

15. The Taxpayer filed additional information and a supplement to its hearing memorandum on June 19, 2002.

16. The parties' request to extend the response deadline of the City until July 31, 2002 and the Taxpayer's reply deadline until August 21, 2002 was granted by the Hearing Officer.

17. The City filed its response on July 31, 2002.

18. On August 21, 2002, the Hearing Officer approved the parties' stipulation to extend the Taxpayer's reply deadline until August 30, 2002.

19. The Taxpayer filed their reply memorandum on August 30, 2002.

20. On September 16, 2002, the Hearing Officer issued a letter indicating a written decision would be issued on or before October 14, 2002.

21. The Taxpayer was the Construction Manager for the construction of the Project in the City.

22. The Owner of the Project was Owner.

23. Owner and the Taxpayer entered into an Agreement.

24. The parties signing the Agreement held the same position in Owner, Taxpayer, and the Parent.

25. The City assessed the Taxpayer under the construction contracting definition of the City Code for the Project.

26. The City concluded the Taxpayer's gross income was the same as the total cost of the Project in the amount of $24,265,870.52.

27. The Taxpayer did not report any gross income at the completion of the Project.

28. The City assessed the Taxpayer for $268,853.33 in taxes and interest in the amount of $259,443.17.

29. Subsequently, the City revised the assessment and reduced the taxes to $181,092.00 and the interest to $180,187.00.

30. The Taxpayer obtained a City business license and tax number in February 1995 and pulled several construction permits to begin construction of the Project.

31. The Agreement provided that Owner would pay the Taxpayer a two percent fee for the construction manager services during both the design phase and the construction phase.

32. Pursuant to t he Agreement, Owner was to pay the Taxpayer for the cost of the work as defined in Article 8.

33. Based on the various contracts, the Taxpayer maintained control over the construction site and bore the risk that the cost of the project would exceed the guaranteed maximum price.

34. The Taxpayer intended for the subcontractors to pay the tax on the construction activity.

35. Pursuant to Section 8.1 of the Agreement, the Owner could directly pay the subcontractors upon the approval of the Taxpayer.

36. Pursuant to Section 3.8 of the contract between the Taxpayer and the subcontractors, the subcontractors were informed they would not be paid if and until the Owner paid the Taxpayer.

37. The Owner directly paid the subcontractors on behalf of the Taxpayer.

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. A tax is assessed on the gross income of every construction contractor engaged in construction contracting within the City.

3. Pursuant to Section 100 of the City Code, Owner and the Taxpayer were separate entities for taxation purposes.

4. Pursuant to the Agreement and the City Code, the Taxpayer was a construction contractor for Owner.

5. Pursuant to the Agreement, the Taxpayer was legally and contractually liable to pay the subcontractors and any payments made to the subcontractors by affiliated companies were made on behalf of the Taxpayer.

6. Pursuant to Section 210 of the City Code, when the gross income from a transaction between related entities is not indicative of the market value, the City shall determine the market value upon which the tax shall be levied.

7. Pursuant to Section 200 of the City Code, any payments or forgiveness of the Taxpayer's debt is part of the gross income.

8. The Taxpayer had the burden of proof to show an agency relationship existed.

9. The Taxpayer had the responsibility to insure the taxes were paid on the Project.

10. It is the duty of the agent to disclose to all third parties that they are working as an agent on behalf of their principal.

11. The Taxpayer failed to properly disclose to third parties that the Taxpayer was working as an agent on behalf of the Owner.

12. The Taxpayer is entitled to credit for those taxes paid to the subcontractors for the Project if the Taxpayer can provide evidence that those taxes were subsequently paid to the City.

13. Consistent with the discussion contained herein, the protest of the Taxpayer should be denied.

ORDER

It is therefore ordered that consistent with the discussion contained herein, the December 26, 2001 protest of Camden

Development, Inc. of the tax assessment of the City of Scottsdale is hereby denied.

It is further ordered that the City of Scottsdale shall give Camden Development, Inc. credit for taxes paid to subcontractors for the Project if the Taxpayer can provide evidence that those taxes were subsequently paid to the City of Scottsdale.

It is further ordered that this decision is effective immediately.

Jerry Rudibaugh

Municipal Tax Hearing Officer