

## DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: April 8, 2009  
Decision: MTHO # 445  
Taxpayer: *Taxpayer*  
Tax Collector: City of Mesa  
Hearing Date: March 12, 2009

### DISCUSSION

#### Introduction

On May 26, 2008, a protest was filed by *Taxpayer* (“Taxpayer”) filed a protest of a tax assessment made by the City of Mesa (“City”). After review, the City concluded on June 12, 2008 that the protest was timely and in the proper form. On June 16, 2008, the Municipal Tax Hearing Officer (“Hearing Officer”) ordered the City to file any response on or before July 31, 2008. The City sent a July 28, 2008 email requesting an extension in order to allow time for Taxpayer to provide additional information. On July 29, 2008, the Hearing Officer granted the City an extension until September 26, 2008. The City sent a September 2, 2008 email requesting another extension as they were still waiting for documentation from Taxpayer. On September 3, 2008, the Hearing Officer granted the City an extension until October 31, 2008. The City sent an October 22, 2008 email requesting an extension as they were still waiting for documentation. On October 24, 2008, the Hearing Officer granted the City an extension until December 31. On December 26, 2008, the City filed a response to the protest. On December 29, 2008, the Hearing Officer ordered Taxpayer to file any reply on or before January 19, 2009. On January 6, 2009, a Notice of Tax Hearing (“Notice”) scheduled the matter for hearing commencing on February 12, 2009. On January 30, 2009, Taxpayer filed a request to reschedule the hearing. On February 2, 2009, a Notice rescheduled the hearing to commence on March 12, 2009. Both parties appeared and presented evidence at the March 12, 2009 hearing. On March 19, 2009, the Hearing Officer indicated that the record was closed and that a written decision would be issued on or before April 27, 2009.

#### City Position

The City conducted an audit of Taxpayer for the period February 2005 through December 2007. The City assessed Taxpayer for additional taxes due in the amount of \$8,308.23, and interest up through January 2008 in the amount of \$928.12. The City indicated the assessment was related to the rental of real and tangible personal property located at ***1234 South Baseline Road*** (“Baseline Property”). According to the City, the Baseline Property was occupied by an affiliated company, *Tenant* which operated a gas station and

convenience store.

The City noted that on February 18, 2005, Taxpayer borrowed \$1,600,000.00 from *Financial Institution* (“Bank”) in exchange for a deed of trust on the Baseline Property. Also on February 18, 2005, Taxpayer borrowed \$619,000.00 from the *Financing Corporation* in participation with the Small Business Administration (“SBA”) in exchange for a deed of trust on the Baseline Property and specified tangible personal property. The City asserted that Taxpayer, as owner, and *Tenant*, as tenant, entered into a February 18, 2005 lease for the Baseline Property and tangible personal property for \$14,000.00 per month. According to the City, Taxpayer purchased the Baseline Property from an unrelated party on February 25, 2005 for \$2,000,000.00.

The City disputed claims by Taxpayer that the lease agreement between Taxpayer and *Tenant* was dissolved on December 28, 2005. The City noted that Section 7 (f) of the Bank deed of trust contained a provision that the property could not be conveyed without the Bank’s consent. The City indicated that no documentation has been provided evidencing the Bank’s consent. The City noted that Section 1 of the *Financing Corporation* deed of trust contained a provision that the Taxpayer must remain in possession of the property. Further, Section 18 of the *Financing Corporation* deed of trust contained a provision that if the property were conveyed, all obligations secured by the deed of trust would be due and payable. According to the City, no documentation has been provided to show that *Financing Corporation* was aware of any conveyance of the property.

The City indicated that Taxpayer had entered into a February 18, 2005 Assignment of Leases and Rents (“Assignment No. 1”) in which Taxpayer assigned a security interest in the lease with *Tenant* to the Bank. Section 1 of the Assignment contained a provision that Taxpayer was unable to terminate the lease without the consent of the Bank. The City opined that no documentation was provided that showed that the Bank had consented to any termination of the lease. The City indicated Taxpayer had also entered into a February 18, 2005 Assignment of Rents and Leases (“Assignment No. 2”) with *Financing Corporation* in which Taxpayer assigned a security interest in the lease with *Tenant* to *Financing Corporation*. The City noted that Section 2 contained a provision that Taxpayer could not terminate the lease without the consent of *Financing Corporation*. The City asserted no documentation was provided to show that *Financing Corporation* had consented to the termination of the lease.

The City indicated that federal tax return Forms 1065 filed by Taxpayer for 2006 and 2007 show ownership by Taxpayer of all real and tangible personal property at the Baseline Property. The City also noted that the lease between Taxpayer and *Tenant* called for \$14,000.00 monthly payments. According to the City, *Tenant* continues to make monthly payments to Taxpayer from *Tenant*’s bank account to Taxpayer’s bank account. The City asserted that *Tenant* continues to operate the gas station/convenience store as evidenced by the fact that store receipts are deposited with a *Tenant* bank account; *Tenant* holds the liquor license; and, *Tenant* holds the tax license.

In response to letters submitted by Taxpayer from *Financing Corporation* and the Bank, the City argued the letters make it clear that no consent was ever obtained to allow Taxpayer to convey property to *Tenant* and to dissolve the lease during the audit period. The City noted that the letters were almost identical and one was dated September 18, 2008 and the City presumed the other undated letter was also sent in September 2008. Lastly, the City argued that Taxpayer has failed to provide any evidence to substantiate its argument that the lease amount of \$14,000.00 per month was in excess of fair market value. Based on all the above, the City requested that that assessment be upheld.

### **Taxpayer Position**

Taxpayer argued that there was no business purpose for the existence of a lease between Taxpayer and *Tenant*. Taxpayer indicated that *Individual* is the 100 percent owner of each entity. Taxpayer opined that paperwork existed to support lease payments between the two entities for 2005. According to Taxpayer no paperwork existed to support lease payments in 2006. Taxpayer asserted that effective on January 1, 2006, *Tenant* and Taxpayer became one entity and the lease agreement was dissolved. Taxpayer provided a copy of the minutes of a December 28, 2005 meeting in which *Individual* attended and voted to tender the ownership of *Tenant* to Taxpayer.

Taxpayer argued that the Bank deed of trust simply granted the Bank certain rights should Taxpayer not abide by declarations contained in paragraph 7. According to Taxpayer, paragraphs 4, 9, 10, 11, and 12 provide remedies for the Bank but none grant them the power to prevent a conveyance of property. Taxpayer indicated that in order to take advantage of tax depreciation rules, all depreciable assets were transferred from Taxpayer to *Tenant* in 2005. In support of its assertion, Taxpayer provided a copy of a February 18, 2005 Bill of Sale in which *Tenant* agreed to pay Taxpayer \$1,080,000.00 for goods. *Tenant* was to pay Taxpayer monthly payments of \$14,000.00 for the transferred goods.

Taxpayer argued that the *Financing Corporation* deed of trust granted *Financing Corporation* with remedies should Taxpayer breach the agreements. According to Taxpayer, *Financing Corporation* was not granted any power to prevent conveyance from Taxpayer to *Tenant*.

Taxpayer argued that the 2006 Federal Form 1065 shows all assets under Taxpayer because *Tenant* was a “disregarded entity” for tax reporting purposes. Taxpayer noted the 2006 Federal Form 1065 for *Tenant* indicated it was the “final return” and there was no balance sheet or income events for the period reported.

According to Taxpayer, the \$14,000.00 per month payments from *Tenant* was in consideration of the assets transferred to *Tenant* in February 2005. Taxpayer also noted that the cash transfers were expected by Taxpayer’s lenders.

Taxpayer argued that if the City should prevail in its assertion that rents exist between Taxpayer and *Tenant*, the City’s stated value of \$14,000.00 must be turned down under a

generally accepted definition of fair market value (“FMV”). Taxpayer noted that City Code Section 5-10-210 (“Section 210”) provides that FMV shall correspond as nearly as possible from similar transactions of like quality or character under similar circumstances and conditions.

### ANALYSIS

There was no dispute that a lease agreement was entered into on February 18, 2005 between Taxpayer and *Tenant* for the Baseline Property and tangible personal property. The lease was for a period of twenty years. While *Individual* was the owner of both Taxpayer and *Tenant*, the two entities were separate legal entities and separate “persons” pursuant to City Code Section 5-10-100 (“Section 100”). There was no dispute that Taxpayer and *Tenant* entered into a February 18, 2005 agreement whereby *Tenant* agreed to pay Taxpayer \$14,000.00 per month for the lease of the Baseline Property and tangible personal property. There was also no dispute that Taxpayer on February 18, 2005, entered into assignment of leases and rents whereby the Bank and *Financing Corporation* were assigned a security interest in the lease between Taxpayer and *Tenant*. The assignments of leases and rents were required by the Bank and *Financing Corporation* as additional security for loaning money to Taxpayer. It is also clear from the deeds of trust that Taxpayer entered into with the Bank and *Financing Corporation* that Taxpayer could not modify or terminate the lease without prior written approval by the Bank and *Financing Corporation*. However, Taxpayer provided a bill of sale on the same day, February 18, 2005, whereby the personal property was sold by Taxpayer to *Tenant* for \$1,080,000.00. Also on the same day, February 18, 2005, *Tenant* signed a promissory note to pay Taxpayer \$14,000.00 per month (the exact amount that was to be paid pursuant to their lease agreement). According to Taxpayer, the lease agreement was cancelled effective January 1, 2006. As a result, there should have been two payments of \$14,000.00 per month by *Tenant* during the period of March 18, 2005 through January 1, 2006 for the lease agreement and for the promissory note. The evidence shows that there has always been one \$14,000.00 per month payment from *Tenant* to Taxpayer. The fact that the monthly payment for the promissory note was the same as the lease agreement would not provide either the Bank or *Financing Corporation* any clue that Taxpayer was attempting to modify/terminate the lease agreement. Taxpayer indicated it wanted to transfer the personal property to *Tenant* in order to take advantage of Federal tax rules on depreciation. While we understand Taxpayer made a business decision to maximize use of depreciation, it cannot have it one way for the Bank and *Financing Corporation* and another way for federal tax purposes on the exact same day. There was no evidence that the Bank and *Financing Corporation* stopped relying on the lease agreement being in place to help secure the loans made to Taxpayer. Based on all the above, we must agree with the City that Taxpayer received lease payments for the Baseline Property from *Tenant* in the amount of \$14,000.00 per month throughout the audit period.

Taxpayer argued that the monthly rental amounts used by the City did not reflect the market value as required by Section 210. Taxpayer had established the monthly rental amounts based on cash flow presentations made by the entity that sold the property to Taxpayer. Taxpayer argued the monthly rental amounts were not accurate because of

misrepresentations by the seller. Taxpayer has filed a lawsuit against the sellers and others claiming the cash flows were misrepresented. Unfortunately for Taxpayer, we have no way of knowing the outcome of its lawsuit against the seller and others. The evidence we have is that *Tenant* paid Taxpayer \$14,000.00 per month and that amount was relied on by independent third parties in making loans to Taxpayer. As a result, we conclude that the \$14,000.00 monthly amount was the market value and the City's determination of gross receipts for the audit period was proper. Based on all the above, Taxpayer's protest should be denied.

### FINDINGS OF FACT

1. On May 26, 2008, a protest was filed by Taxpayer of a tax assessment by the City.
2. After review, the City concluded on June 12, 2008 that the protest was timely but not in the proper form.
3. On June 16, 2008, the Hearing Officer ordered the City to file any response on or before July 31, 2008.
4. The City sent a July 28, 2008 email requesting an extension in order to allow Taxpayer time to provide additional information.
5. On July 29, 2008, the Hearing Officer granted the City an extension until September 26, 2008.
6. The City sent a September 2, 2008 email requesting another extension as they were still waiting for documentation from Taxpayer.
7. On September 3, 2008 the Hearing Officer granted the City an extension until October 31, 2008.
8. The City sent an October 22, 2008 email requesting an extension as they were still waiting for documentation.
9. On October 24, 2008, the Hearing Officer granted the City an extension until November 30, 2008.
10. On November 20, 2008, the City sent an email requesting additional time to review documentation from Taxpayer.
11. On November 29, 2008, the Hearing Officer granted the City an extension until December 31, 2008.
12. On December 26, 2008, the City filed a response to the protest.
13. On December 29, 2008, the Hearing Officer ordered Taxpayer to file any reply on or

before January 19, 2009.

14. On January 6, 2009, a Notice scheduled the matter for hearing commencing on February 12, 2009.
15. On January 30, 2009, Taxpayer filed a request to reschedule the hearing.
16. On February 2, 2009, a Notice rescheduled the hearing to commence on March 12, 2009.
17. Both parties appeared and presented evidence at the March 12, 2009 hearing.
18. On March 19, 2009, the Hearing Officer indicated the record was closed and a written decision would be issued on or before April 27, 2009.
19. The City conducted an audit of Taxpayer for the period February 2005 through December 2007.
20. The City assessed Taxpayer for additional taxes due in the amount of \$8,308.23, and interest up through January 2008 in the amount of \$928.12.
21. The assessment was related to the rental of real and tangible personal property located at Baseline Property.
22. The Baseline Property was occupied by an affiliated company, *Tenant*, which operated a gas station and convenience store.
23. On February 18, 2005, Taxpayer borrowed \$1,600,000.00 from the Bank in exchange for a deed of trust on the Baseline Property.
24. On February 18, 2005, Taxpayer borrowed \$619,000.00 from *Financing Corporation* in participation with the SBA in exchange for a deed of trust on the Baseline Property and specified tangible personal property.
25. On February 18, 2005, Taxpayer as owner, and *Tenant*, as tenant, entered into a lease for the Baseline Property and tangible personal property for \$14,000.00 per month.
26. On February 18, 2005, Taxpayer entered into Assignment No. 1 whereby Taxpayer assigned a security interest in its lease with *Tenant* to the Bank.
27. On February 18, 2005, Taxpayer entered into Assignment No. 2 with *Financing Corporation* in which Taxpayer assigned a security interest in its lease with *Tenant* to *Financing Corporation*.
28. Federal Tax Return Forms 1065 filed by Taxpayer for 2006 and 2007 show ownership by Taxpayer of all real and tangible personal property at the Baseline



Property.

29. **Tenant** still operates the gas station/convenience store and the store receipts are deposited into a **Tenant** bank account; **Tenant** holds the liquor license; and, **Tenant** holds the tax license.
30. **Individual** is the 100 percent owner of both Taxpayer and **Tenant**.
31. On February 18, 2005, Taxpayer sold the tangible personal property, which was part of the lease agreement, to **Tenant** for \$1,080,000.00.
32. On February 18, 2005, **Tenant** signed a promissory note to pay Taxpayer \$14,000.00 per month.
33. Taxpayer has filed a lawsuit against the entity that sold Taxpayer the Baseline Property.
34. Taxpayer claims the seller of the Baseline Property misrepresented the cash flows.

#### 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. Pursuant to Section 100, **Tenant** and Taxpayer were separate persons.
3. During the audit period, **Tenant** paid Taxpayer \$14,000.00 per month for the rental of the Baseline Property and tangible personal property.
4. The Bank and **Financing Corporation** relied on Assignment No. 1 and Assignment No. 2, respectively in making loans to Taxpayer.
5. The Bank and **Financing Corporation** deed of trusts required Taxpayer to notify them prior to conveying any property.
6. There was no evidence that either the Bank or **Financing Corporation** were notified of the February 18, 2005 sale of personal property from Taxpayer to **Tenant**.
7. **Tenant** continued to pay Taxpayer \$14,000.00 per month throughout the audit period.
8. There was no evidence that the Bank and **Financing Corporation** stopped relying on the lease agreement remaining in place between Taxpayer and **Tenant**.

9. The monthly rental amount of \$14,000.00 was based on the cash flow presentation that the seller of the Baseline Property made to Taxpayer.
10. The Bank and *Financing Corporation* relied on the \$14,000.00 monthly payments when they made loans to Taxpayer.
11. Taxpayer has failed to prove the \$14,000.00 monthly amount was not market based.
12. Taxpayer's protest should be denied.

**ORDER**

It is therefore ordered that the May 26, 2008 protest by *Taxpayer* of a tax assessment by the City of Mesa is hereby denied.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh  
Municipal Tax Hearing Officer