DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: April 28, 2010
Decision: MTHO # 549
Taxpayer: ***Taxpayer***.
Tax Collector: City of Mesa
Hearing Date: April 6, 2010

DISCUSSION

Introduction

On August 10, 2009, a letter of protest was filed by ***Taxpayer*** of a tax assessment made by the City of Mesa ("City"). A hearing was commenced before the Municipal Tax Hearing Officer ("Hearing Officer") on April 6, 2010. Appearing for the City were ***Assistant City Attorney***, ***Tax Administrator***, ***Tax Audit Supervisor***, and ***Senior Tax Auditor***. Appearing for Taxpayer were ***Taxpayer Representatives***. At the conclusion of the April 6, 2010 hearing, the record was closed. On April 7, 2010, the Hearing Officer indicated a written decision would be issued on or before May 21, 2010.

DECISION

On June 25, 2009, the City issued an audit assessment of Taxpayer. The assessment was for the period of December 2004 through December 2008. The assessment was for additional taxes in the amount of $163,420.24, interest up through May 2009 in the amount of $19,232.13, penalties in the amount of $27,138.49, and a license fee of $50.00. The City issued a non-audit compliance assessment on July 16, 2009. The second assessment was for the period of February 2009. The second assessment was for additional taxes in the amount of $6,165.88, interest up through June 2009 in the amount of $61.65, penalties in the amount of $1,541.47, and a license fee of $20.00.

The City determined during the first audit that Taxpayer was acting at times as a construction contractor pursuant to City Code Section 5-10-415 ("Section 415"). The City also concluded that Taxpayer acted at times as a speculative builder pursuant to City Code Section 5-10-416 ("Section 416"). Taxpayer protested the portion of the assessment made pursuant to Section 415 but not the portion assessed pursuant to Section 416. The second assessment was made pursuant to Section 416. At the start of the hearing in this matter, Taxpayer acknowledged the City's second tax assessment was correct. However, Taxpayer asserted the tax had been paid. The City and Taxpayer reached agreement that Taxpayer would provide documentation for the City to review to substantiate whether or

not the taxes had already been paid. As a result, the parties requested the Hearing Officer to not make a ruling on the second assessment.

Taxpayer argued that instead of acting as a general contractor as alleged by the City, it was acting as a "construction manager". Taxpayer entered into a Management/Supervision Agreement(s) ("Agreement") with the owner(s) of properties in which Taxpayer was to build a custom home. City Exhibit No. 2 was an example of the Agreement. The Agreement provided that: Taxpayer was not the prime contractor on the project; Taxpayer would not perform any work items that were not approved in advance in writing by the owner(s); Taxpayer would not be responsible for the actual workmanship of the subcontractors, but for the supervision and inspection of the quality and accuracy of such work; Taxpayer would not be responsible for any taxes on the projects; the owners were responsible for all taxes; the owners were to pay all subcontractors directly; and, the owners were to contract directly with the subcontractors.

The City concluded that Taxpayer crossed the line of being a construction manager and instead acted in the capacity of a General Contractor. The City provided the following examples of how Taxpayer operated during the audit period: Taxpayer solicited proposals from subcontractors and material vendors; the proposals were issued in Taxpayer's name; purchase orders and purchase agreements were in the name of Taxpayer and signed by Taxpayer upon acceptance; subcontractors and material vendor invoices were billed to Taxpayer; invoices were paid by Taxpayer through checks from Taxpayer's bank account or through Taxpayer credit cards; job costs and payments were run through Taxpayer's accounting records; and, most invoices did not include any tax. The City noted that "construction contractor" is defined in City Code Section 5-10-100 ("Section 100") as follows: "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, …or improvement to real property,…."Construction contractor" includes subcontractors, …and any person receiving consideration for the general supervision and/or coordination of such a construction project….This definition shall govern without regard to whether or not the construction contractor is acting in fulfillment of a contract." Based on the above, the City concluded that Taxpayer was doing much more than just providing supervision services. The City concluded that Taxpayer was acting in the capacity of a General Contractor and subject to the tax pursuant to Section 415. As a result, the City further concluded that Taxpayer was considered to have constructive receipt of all amounts paid to the subcontractors and vendors.

The City assessed Taxpayer for failure to file tax returns, failure to timely pay taxes, and negligence. The City indicated they had informed Taxpayer over the years regarding proper reporting and payment of taxes. As a result, the City requested the penalties be upheld.

Taxpayer did not dispute that its actions did not always follow the Agreement. Taxpayer acknowledged that some of the subcontractor invoices were billed and sent to Taxpayer. Taxpayer also acknowledged that the subcontractors were sometimes paid directly by

Taxpayer. Taxpayer did not dispute that some of the job proposals from the subcontractors were in Taxpayer's name. Taxpayer argued that the City did not take into account that some of the job proposals/ invoices from subcontractors and some of the payments to the subcontractors came directly from the owners and not Taxpayer. Taxpayer also argued that it was working as an agent of the owners when it entered into payments/ job proposals/ and purchase invoices. While there was no written agency agreement, Taxpayer asserted all third parties were verbally informed of the agency agreement between Taxpayer and the owners.

Based on the Agreement(s), Taxpayer and the owners intended for Taxpayer to act as a "construction manager" as opposed to a general contractor. If Taxpayer and the owners followed the Agreement(s), we would have concluded Taxpayer would only have been taxed on its fee. However, it is indisputable that the parties did not always follow the Agreement(s): Taxpayer did contract directly with the subcontractors; Taxpayer did pay subcontractors directly from Taxpayer's bank account or credit card; Invoices were made out directly to Taxpayer; Taxpayer did pay the invoices directly; and, most invoices did not include any tax charged. As a result of Taxpayer's actions, we agree with the City's conclusion that Taxpayer was acting as a general contractor. As a result, Taxpayer would be assessed taxes on the gross income from the business activity of construction contracting pursuant to Section 415. Accordingly, it was proper for the City to assess Taxpayer on the total gross receipts from each project. While Taxpayer argued that Taxpayer was acting as the agent for the owners, we note that City Code Section 5-10-400 ("Section 400") provides that all gross income is subject to tax until the contrary is established by the taxpayer. As a result, we conclude that the burden of proof is on Taxpayer to demonstrate that an agency relationship existed. That burden was not met by Taxpayer. The fact that the subcontractors did not include any taxes on their invoices would indicate they were not aware of any agency relationship. In addition, there was no reference in any of the documents provided that referred to any agency relationship.

We note that Taxpayer's request at the hearing for additional time to supply documentation was denied. Taxpayer had over nine months to supply additional documentation since the City issued the June 25, 2009 assessment to Taxpayer. The City had indicated that once a determination was made that Taxpayer was acting as a general contractor, even if Taxpayer was able to show that at times it acted as a construction manager that would not result in any change to the assessment. We want to make it clear that the determination of Taxpayer acting as a general contractor would have to be made on a project by project basis. For example, if Taxpayer could have demonstrated that on a particular project(s) it followed the Agreement we would have concluded that Taxpayer was not a general contractor for that project. We simply did not have such evidence.

Lastly, we have the matter of penalties. The City assessed Taxpayer for penalties pursuant to City Code Section 5-10-540 ("Section 540") for failure to file, failure to timely pay, and for negligence. The City noted that these penalties were assessed as the City had multiple contacts with Taxpayer over the years regarding proper reporting and payment of taxes. The penalties for failure to timely file and failure to timely pay may be waived for "reasonable cause". Reasonable cause is defined in Section 540 that a

taxpayer exercised ordinary business care and prudence, i.e., had a reasonable basis for believing that the tax did not apply to the business activity. We conclude that it would have been reasonable for Taxpayer to have contacted a tax expert for guidance when the City initially contacted Taxpayer regarding proper reporting and payment. It appears that Taxpayer simply ignored the City. We conclude Taxpayer did not exercise ordinary business care and prudence. Accordingly, we conclude Taxpayer has failed to demonstrate reasonable cause for waiving of the failure to file and failure to timely pay penalties. "Negligence" in Section 540 is defined as inadvertence, thoughtlessness, rather than an "honest mistake". We are convinced that Taxpayer believed it was acting as a construction manager and simply made an honest mistake. Accordingly, the negligence penalties are waived. Based on all the above, we conclude Taxpayer's protest should be denied with the exception of the negligence penalties.

FINDINGS OF FACT

1. On August 10, 2009, Taxpayer filed a protest of a tax assessment made by the City.

2. On June 25, 2009, the City issued an audit assessment of Taxpayer.

3. The first assessment was for the period of December 2004 through December 2008.

4. The first assessment was for additional taxes in the amount of $163,420.24, interest up through May 2009 in the amount of $19,232.13, penalties totaling $27,138.49, and a license fee of $50.00.

5. The City issued a second assessment on July 16, 2009.

6. The second assessment was for additional taxes in the amount of $6,165.88, interest up through June 2009 in the amount of $61.65, penalties in the amount of $1,541.47, and a license fee of $20.00.

7. At the start of the hearing, Taxpayer acknowledged that the City's second tax assessment was correct.

8. Taxpayer agreed to provide documentation for the City to review in order to substantiate whether or not the taxes had already been paid for the second assessment.

9. The parties requested the Hearing Officer to not make a ruling on the second assessment.

10. During the audit period, Taxpayer had entered into Agreement(s) with the owner(s) of properties in which Taxpayer was to build a custom home.

11. The Agreement provided that: Taxpayer was not the prime contractor on the project; Taxpayer would not perform any work items that were not approved in advance in writing by the owner(s); Taxpayer would not be responsible for the supervision and inspection of the quality and accuracy of such work; Taxpayer would not be responsible for any taxes on the projects; the owners were to pay all taxes; the owners were to pay all subcontractors directly; and, the owners were to contract directly with the subcontractors.

12. The City provided the following examples of how Taxpayer operated during the audit period; Taxpayer solicited proposals from subcontractors and material vendors; the proposals were issued in Taxpayer's name; purchase orders and purchase agreements were in the name of Taxpayer and signed by Taxpayer upon acceptance; subcontractors and material vendor invoices were billed to Taxpayer; invoices were paid by Taxpayer through checks from Taxpayer's bank account or through Taxpayer credit cards; job costs and payments were run through Taxpayer's accounting records; and, most invoices did not include any tax.

13. Taxpayer failed to file tax returns or pay taxes during the audit period.

14. Taxpayer did not dispute that during the audit period some of the subcontractor invoices were billed and sent to Taxpayer.

15. Taxpayer did not dispute during the audit period that sometimes the subcontractors were paid directly by Taxpayer.

16. Taxpayer did not dispute during the audit period that some of the job proposals from the subcontractors were in Taxpayer's name.

17. Prior to the April 6, 2010 hearing, Taxpayer had over nine months in which to supply additional documentation.

18. Most invoices did not charge City tax.

19. There was no reference in any of the documents provided that referred to any agency relationship.

20. The City had multiple contacts with Taxpayer over the years regarding the proper reporting and payment of taxes.

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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 415 imposes a tax on the gross income from the business activity of construction contracting.

3. Taxpayer's actions during the audit period went beyond being a construction manager as Taxpayer acted as a construction contractor pursuant to Section 100.

4. It was proper for the City to assess taxes on Taxpayer on the gross income from construction contracting for each project during the audit period.

5. Section 400 provides that all gross income is subject to tax until the contrary is established by the taxpayer.

6. Taxpayer has failed to demonstrate that a known agency relationship existed between Taxpayer and the owners.

7. The City was authorized pursuant to Section 540 to assess penalties.

8. Taxpayer failed to demonstrate reasonable cause to have the penalties waived for failing to timely file or timely pay taxes.

9. Taxpayer believed it was acting as a construction manager and made an honest mistake.

10. The negligence penalties should be waived.

11. Taxpayer's August 10, 2009 protest should be denied with the exception of the negligence penalties.

ORDER

It is therefore ordered that the August 10, 2009 protest by ***Taxpayer*** of a tax assessment made by the City of Mesa should be denied with the exception of the negligence penalties, consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Mesa shall remove all negligence penalties from the assessment.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer