

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: August 31, 2010

Decision: MTHO # 574

Taxpayers:

Tax Collector: City of Mesa

Hearing Date: August 3, 2010

DISCUSSION

Introduction

On October 19, 2009, a letter of protest was filed by *Taxpayers* of a tax assessment made by the City of Mesa (“City”). A hearing was commenced before the Municipal Tax Hearing Officer (“Hearing Officer”) on August 3, 2010. Appearing for the City were the *Assistant City Attorney*, a *Tax Audit Supervisor* and the *Tax Auditor*, and a *Law Clerk*. Appearing for Taxpayers were their *representatives*. At the conclusion of the August 3, 2010 hearing, the record was closed. On August 4, 2010, the Hearing Officer indicated a written decision would be issued on or before September 17, 2010.

DECISION

On September 14, 2009, the City issued a non-audit compliance assessment of Taxpayers. The assessment was for the period of March 2003 through June 2009 (“Compliance Period”). The assessment was for additional taxes in the amount of \$24,447.92, interest up through August 2009 in the amount of \$5,178.39, penalties in the amount of \$6,052.78, and a license fee of \$70.00.

Taxpayers owned the property at *12345 Baseline Road* (“Baseline Property”) in the City. Taxpayers leased the Baseline Property to an affiliated company, *The New Rentors*. *The New Rentors* operated a western show and dinner at the Baseline Property. The City issued an estimated assessment due to the failure of Taxpayers to respond to City requests for self-assessment of taxes due. While Taxpayers did not dispute the taxability of the rental transactions, Taxpayers did dispute the amount of the City’s estimates including the square footage used. The City had used a square footage of 15,676 based on County Assessor Records (“County Records”). The City then used “Fair Market Values for Commercial Rentals” by Cushman & Wakefield, a leasing company that tracks rental values in the area. As those values varied during the Compliance Period, the estimated monthly rental utilized by the City ranged from \$15,205.72 per month to \$23,043.72 per month. The City assessed Taxpayers for rental income pursuant to City Code Section 5-

10-445 (“Section 445”). The City noted that City Code Section 5-10-210 (“Section 210”) provides that when a transaction between affiliated companies is not indicative of the market value of the transaction, the City shall determine the “market value” upon which the City tax shall be levied. City Code Section 5-10-545 (“Section 545”) provides that when a taxpayer fails to file a return, the City may make a reasonable estimate of the amount of tax that is due.

Taxpayers argued the subject property was neither an average rent amount nor a typical commercial rental and as a result the Cushman & Wakefield values could not be relied on. Taxpayers asserted that the business was only open one or two days a week and the summer heat make use of the outdoor space impractical. Subsequent to the assessment period, Taxpayers entered into a commercial lease agreement (“Lease”) with an unrelated *third party* for the lease of the Baseline Property. The Lease itemized the real and personal property associated with the lease arrangement. The terms of the Lease were to run from November 1st to April 30th in each year. The base rent during the six month period was \$12,000.00 per month. In addition, the *third party* would pay Taxpayers a percentage of the monthly gross revenues. Taxpayers provided testimony that the Baseline Property was leased with the *third party* for a six month period as the entertainment group was unable to use the property during the summer months. As a result, Taxpayers indicated the rental rate was negotiated on what they would expect for a full twelve month period and then compressed into the usable six month period.

Taxpayers argued the City’s assessment was an unreasonable determination of the fair rental value. Taxpayer provided evidence that of the 15,676 square feet utilized by the City, 3,500 square feet was for the personal residence of Taxpayers and not part of the business. In addition, 400 square feet was for personal storage space of Taxpayers. If the personal areas are removed, the square footage for commercial rent would be reduced to 11,776 square feet (15,676-3900).

There was no dispute that the transaction between the *New Rentors* and Taxpayers resulted in taxable rental income to Taxpayers pursuant to Section 445. It also clear that because the parties to the transaction were related, it was proper for the City to utilize an estimate pursuant to Sections 210 and 545. We further conclude that the City’s usage of Cushman & Wakefield values for commercial rentals was a reasonable estimation methodology pursuant to Section 545. The remaining issue is whether or not Taxpayers were able to provide sufficient documentation to demonstrate pursuant to Section 545 that the City’s estimates were not reasonable. In this case, we conclude that Taxpayers did provide sufficient documentation to support a revision to the City’s estimate. First, Taxpayers provided sufficient evidence to demonstrate that the square footage utilized by the City should be reduced for property utilized solely by Taxpayers and not the *New Rentors*. We shall require the City to revise their estimates by utilizing a square footage of 11,776. Secondly, we are convinced based on the lease agreement with the *third party* that the City’s revised estimate (based on 11,776 square feet) should be reduced by fifty percent to reflect the fact that the western show and dinner was primarily a six month “season”. Based on the evidence presented, we are unable to place any value on intangibles or any value attributable to the *New Rentors*. Accordingly, there are no

further adjustments to be made to the City's estimate. Based on all the above, Taxpayer's protest should be partly granted and partly denied.

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, and failure to timely pay. 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 simply have not been provided with any basis for Taxpayers failure to file tax returns or pay taxes in a timely manner. As a result, we conclude that Taxpayers have not provided reasonable cause to have the penalties waived.

FINDINGS OF FACT

1. On October 19, 2009, Taxpayers filed a protest of a tax assessment made by the City.
2. On September 14, 2009, the City issued an audit assessment of Taxpayers.
3. The assessment was for the period of March 2003 through June 2009 ("Compliance Period").
4. The assessment was for additional taxes in the amount of \$24,447.92, interest up through August 2009 in the amount of \$5,178.39, penalties totaling \$6,052.78, and a license fee of \$70.00.
5. Taxpayers owned the Baseline Property in the City.
6. Taxpayers leased the Baseline Property to an affiliated company, the *New Rentors*.
7. The *New Rentors* operated a western show and dinner facility at the Baseline Property.
8. The City issued an estimated assessment due to the failure of Taxpayers to respond to City requests for self-assessment of taxes due.
9. Taxpayers did not dispute the taxability of the rental transactions, but did dispute the amount of the City's estimates including the square footage used.
10. The City used a square footage of 15,676 based on County Records.

11. The City used “Fair Market Values for Commercial Rentals” by Cushman & Wakefield.
12. The estimated monthly rentals utilized by the City varied during the Compliance Period and ranged from \$15,205.72 to \$23,043.72 per month.
13. Taxpayers failed to file tax returns or pay taxes during the Compliance Period.
14. Subsequent to the assessment period, Taxpayers entered into a Lease with an unrelated *third party*, for the lease of the Baseline Property.
15. The Lease itemized the real and personal property associated with the Lease arrangement.
16. The terms of the Lease were to run from November 1st to April 30th in each year.
17. The base rent during the six month period was \$12,000.00 per month.
18. In addition, *the third party* would pay Taxpayers a percentage of the monthly gross revenues.
19. The Baseline Property was leased with the *third party* for a six month period because the entertainment group was unable to use the property during the summer months.
20. The rental rate for the *third party* was negotiated on what Taxpayers expected for a full twelve month period and then compressed into a usable six month period.
21. Of the 15,676 square feet utilized by the City, 3,500 square feet was for the personal residence of Taxpayers.
22. In addition. 400 square feet was for personal storage space of Taxpayers.

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 445 imposes a tax on the gross income from the business activity of commercial rental.

3. Taxpayer's actions during the Compliance Period were taxable pursuant to Section 445.
4. Section 210 provides that when a transaction between affiliated companies is not indicative of the market value of the transaction, the City shall determine the market value upon which the City tax shall be levied. .
5. Section 545 provides that when a taxpayer fails to file a return, the City may make a reasonable estimate of the amount of tax that is due.
6. Because the *New Rentors* and Taxpayers were related, it was proper for the City to utilize an estimate pursuant to Sections 210 and 545.
7. The City's usage of Wakefield and Cushman values for commercial rentals was a reasonable estimation methodology pursuant to Section 545.
8. Taxpayers provided sufficient documentation to demonstrate that the square footage used by the City should be reduced to 11,776 square feet.
9. Taxpayers provided sufficient documentation to demonstrate that the City's revised estimate (based on 11,776 square feet) should be reduced by fifty percent.
10. The City was authorized pursuant to Section 540 to assess penalties.
11. Taxpayer failed to demonstrate reasonable cause to have the penalties waived for failing to timely file or timely pay taxes.
12. Taxpayer's October 19, 2009 protest should be partly granted and partly denied, consistent with the Discussion, Findings, and Conclusions, herein.

ORDER

It is therefore ordered that the October 19, 2009 protest by *Taxpayers* of a tax assessment made by the City of Mesa should be partly granted and partly denied consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Mesa shall reduce the square footage for the assessment to 11,776 square feet.

It is further ordered that the City of Mesa shall reduce the revised assessment (based on the 11,776 square feet) by fifty percent.

It is further ordered that this Decision is effective immediately.

Municipal Tax Hearing Officer