

DECISION OF MUNICIPAL TAX HEARING OFFICER

December 20, 2010

Taxpayer's Representative
Representative's Address

Taxpayer
MTHO #592

Dear Taxpayer's Representative:

We have reviewed the evidence submitted for redetermination by *Taxpayer* and the City of Mesa (Tax Collector or City). The review period covered was February 2006 through August 2009. Taxpayer's protest, Tax Collector's response, and our findings and ruling follow.

Taxpayer's Protest

Taxpayer purchased an apartment complex (the Property) and converted the complex into individual condominium parcels. Taxpayer was assessed City of Mesa privilege tax under the speculative builder classification for Taxpayer's reconstruction contracting activities. Taxpayer's activities do not rise to the level of reconstruction contracting. The total cost of all construction contracting activities performed on the Property during the 24 month period before part of the real property was first sold was less than 15% of the prior value of the Property.

Tax Collector's Response

Taxpayer did not provide sufficient records to establish the entire costs and actual timeline of the reconstruction contracting activities performed on the Property. The Tax Collector therefore used a combination of records provided by the Taxpayer to identify the reconstruction costs and reconstruct a timeline of activities during the project. The Tax Collector's review of these records showed that the total cost associated with the reconstruction contracting activities was 15.465% of the prior value of the Property. Taxpayer was therefore taxable as a speculative builder on its sale of the condominiums.

Discussion

Taxpayer purchased the Property on July 29, 2005 for \$9,250,000.00. The Property was an apartment complex at the time Taxpayer purchased it. Taxpayer subdivided the Property and converted the existing apartment complex into 152 individual condominium units. Taxpayer reconstructed improvements to the real property by remodeling and upgrading the individual condominium units and surrounding common areas of the complex.

The first condominium was sold February 6, 2006. All 152 condominiums were sold between February 2006 and August 2009. The Tax Collector conducted an audit assessment of Taxpayer for the period February 2006 through August 2009. During the audit the Tax Collector asked Taxpayer to provide records to determine the costs of the reconstruction contracting activity and to include a description of the cost, the date the cost was incurred, when paid, the condominium

unit that benefited from the cost and any taxes paid to the City and the State of Arizona by the vendors. Taxpayer did not provide the information requested by the Tax Collector.

Taxpayer had used an operating account and a development account. Taxpayer at times paid development costs from the operating account. Because Taxpayer had paid development costs from its operating account, the Tax Collector reviewed Taxpayer's operating account. Costs that were not identified in the operating account were assumed by the Tax Collector to be reconstruction costs.

The Tax Collector also reviewed Taxpayer's Construction Summary Report, a list of Taxpayer identified contractors and payments and other information. Through this process the Tax Collector identified total construction costs of \$1,430,773.38 paid before the first sale. The Tax Collector concluded that the total cost of construction before the first sale was 15.465% of the Property's prior value.¹

The Tax Collector issued a jeopardy assessment under the speculative builder classification for Taxpayer's reconstruction contracting activities. Taxpayer protested the assessment arguing that the total cost of all construction on the Property before the first sale was \$730,770.89, which is less than 15% of the prior value of the Property.²

Speculative builders are taxed under Mesa Tax Code (MTC) § 5-10-416 for their sale of improved real property. Improved real property means any real property which has been reconstructed as provided by Regulation.

Regulation § 5-10-416.2 defines the reconstruction of real property as the subdividing of real property and all construction contracting activities on the real property if:

- a structure existed on the real property before the reconstruction activity;
- the prior value of the structure exceeds fifteen percent (15%) of the prior value of the integrated property (land, improvements, and structure);
- the total cost of all construction contracting activities performed on said real property in the twenty-four (24) month period prior to the sale of any part of the real property exceeds fifteen percent (15%) of the prior value of the real property; and
- the structure which existed on the real property prior to the reconstruction activity still exists in some form upon the property, and is included, in whole or in part, in the property sold.

The only criteria in issue is whether the total cost of construction during the 24 month period before the sale of any part of the Property exceeded 15% of the prior value of the property.

The Tax Collector responded to Taxpayer's protest by submitting copies of its audit workpapers showing how it arrived at the additional \$700,002.49 of reconstruction costs. The Tax Collector also identified additional costs of \$339,367.25 the Tax Collector assumed were progress payments incurred before but not paid until after February 6, 2006. This additional amount raised the percentage of construction costs to 19.137% of the Property's prior value.

¹ Both parties considered the purchase price of the property of \$9,250,000.00 as its prior value.

² The assessment also included a small amount of unreported residential rental income related to Taxpayer's wind down of the apartment rentals. This portion of the assessment was not protested by Taxpayer and is not an issue here.

In its Reply, Taxpayer provided a listing of construction costs totaling \$759,824.46 prepared by *Best CPA Consulting Firm*. That amount is still below 15% of the Property's prior value. However, Taxpayer's Reply did not respond to the Tax Collector's calculations of the additional reconstruction costs for work done before February 6, 2006.

The Tax Collector had considered the records made available by Taxpayer to be insufficient to correctly determine the amount of tax owed by Taxpayer. A comparison between Taxpayer's listing submitted with its Reply and the Tax Collector's workpapers E-9 and E-10 confirms that Taxpayer had paid some development costs from its operating account,³ that Taxpayer had not included in its spreadsheet certain costs from its development account,⁴ and that Taxpayer's list included certain payments from the operating account and one from the development account that were not on the Tax Collector's workpapers.⁵

Regulation § 5-10-350.2(e)(1) requires taxpayers to maintain records that will permit the Tax Collector to ascertain all construction expenditures relating to owner-builders and speculative builders. In light of the record in this case and the discrepancies listed above, Taxpayer did not maintain necessary records to permit the Tax Collector to ascertain all construction costs relating to Taxpayer's speculative builder activities.

If a taxpayer does not maintain or provide books and records the Tax Collector considers necessary to determine the taxpayer's tax liability, the Tax Collector is authorized to use estimates, projections, or samplings, to determine the correct tax. MTC § 5-10-555(e). Because Taxpayer did not have the required records, the Tax Collector was authorized to use estimates to determine the correct tax.

MTC § 5-10-545(b) requires that any estimate made by the Tax Collector be made on a reasonable basis. Here, Taxpayer's books and records made available to the Tax Collector did not satisfactorily identify and segregate costs relating to the reconstruction of the apartments to condominiums. Under the circumstances, the Tax Collector's method of estimating construction costs was reasonable.

It is the responsibility of the taxpayer to prove that the Tax Collector's estimate is not reasonable and correct by providing sufficient documentation of the type and form satisfactory to the Tax Collector. Taxpayer has failed to prove that the Tax Collector's estimate was not reasonable and correct. While Taxpayer provided a list it contends are construction costs incurred by Taxpayer, Taxpayer provided no records to dispute the Tax Collector's calculation of the additional \$700,002.49 of construction costs.

Findings of Fact

1. Taxpayer purchased an apartment complex (the Property) on July 29, 2005 for \$9,250,000.00.
2. Taxpayer subdivided the Property and converted the existing apartment complex into 152 individual condominium units.

³ See for example Taxpayer's operating account check nos. 1018, 1029, 1042, 1061, 1064, 1076, 1093, 1094, 1097, 1101, 1102, 1122, 1147, 1149, 1173, 1185, 1195, 1198 and 1212.

⁴ See for example check nos. 2011, 2032, 2035, 2048, 2058, 2064, 2065, 2089, 2096 and 2105.

⁵ See for example check nos. 999, 1002, 1022, 1026, 1039, 1080, 1099, 1142, 1172 and 2112.

3. Taxpayer remodeled and upgraded the individual condominium units and surrounding common areas of the complex.
4. The first condominium was sold on February 6, 2006.
5. All 152 condominiums were sold during the period February 2006 through August 2009.
6. Prior to the sale of the units Taxpayer leased the apartments.
7. Taxpayer paid Mesa privilege tax on the residential lease of the apartment units but did not report or pay tax on the sale of the condominium units.
8. The Tax Collector conducted an audit assessment of Taxpayer for the period February 2006 through August 2009 and issued a jeopardy assessment under the speculative builder classification for Taxpayer's reconstruction contracting activities.
9. During the audit process the Tax Collector asked Taxpayer to provide records to determine the costs of the reconstruction contracting activity and to include a description of the cost, the date the cost was incurred, when paid, the condominium unit that benefited from the cost and any taxes paid to the City and the State of Arizona by the vendors.
10. Taxpayer did not provide sufficient information to establish the costs and timeline of its reconstruction activities.
11. Taxpayer used an operating account and a development account. Taxpayer at times paid development costs from the operating account. Costs that were not identified in the operating account were considered costs of the reconstruction activity.
12. Costs were included in Taxpayer's Construction Summary that were not included in the development account checkbook pages. Those amounts were considered costs of the reconstruction activity.
13. The Tax Collector calculated that the total costs of reconstruction contracting was \$1,430,773.38, an amount that is more than 15% of the prior value of the Property.
14. The purchase price of \$9,250,000.00 is the prior value of the Property.
15. Taxpayer protested the assessment arguing that the total cost of all construction on the Property before February 6, 2006 was \$730,770.89, less than 15% of the prior value of the Property.
16. The assessment included a small amount of unreported residential rental income. This portion of the assessment was not protested by Taxpayer and is not an issue here.
17. The Tax Collector responded to Taxpayer's protest by submitting copies of its audit workpapers showing how it arrived at an additional \$700,002.49 of reconstruction costs.
18. The Tax Collector also identified additional costs of \$339,367.25 that were paid after February 6, 2006 for construction the Tax Collector assumed was done before February 6, 2006.
19. This additional amount raised the percentage of construction costs to 19.137% of the Property's prior value.

20. In its reply, Taxpayer provided a listing of construction costs prepared by *Best CPA Consulting Firm*. that totaled \$759,824.46, an amount still below 15% of the Property's prior value.
21. Taxpayer's Reply did not respond to the Tax Collector's calculations of the additional reconstruction costs of \$700,002.49 for work done before February 6, 2006 or to the Tax Collector's calculation of the additional costs of \$339,367.25 that were paid after February 6, 2006 for construction the Tax Collector assumed was done before February 6, 2006.
22. The Tax Collector stated in its Audit Comments that Taxpayer was provided a copy of the Tax Collector's analysis of costs in excess of 15% of the prior value of the Property but Taxpayer chose not to respond and requested that the assessment be issued for Taxpayer's consideration.
23. Taxpayer did not respond to the Tax Collector's analysis of costs either in its Protest to the assessment or in its Reply to the Tax Collector's Response to the Protest.
24. Taxpayer has not submitted additional documents addressing the Tax Collector's estimate of Taxpayer's construction costs for the audit period.
25. Taxpayer's total cost of reconstruction was at least \$1,430,773.38.

Conclusions of Law

1. The City imposes a privilege tax on speculative builders for their sale of improved real property. MTC § 5-10-416.
2. Improved real property means any real property which has been reconstructed as provided by Regulation. MTC § 5-10-416(2)(C).
3. Regulation § 5-10-416.2 defines the reconstruction of real property as the subdividing of real property and all construction contracting activities on the real property if:
 - a. a structure existed on the real property before the reconstruction activity;
 - b. the "prior value" of the structure exceeds fifteen percent (15%) of the "prior value" of the integrated property (land, improvements, and structure);
 - c. the total cost of all construction contracting activities performed on said real property in the twenty-four (24) month period prior to the sale of any part of the real property exceeds fifteen percent (15%) of the "prior value" of the real property; and
 - d. the structure which existed on the real property prior to the reconstruction activity still exists in some form upon the property, and is included, in whole or in part, in the property sold.
4. Taxpayer's records made available to the Tax Collector were insufficient for the Tax Collector to correctly determine the amount of tax owed by Taxpayer.
5. Taxpayers are required to maintain records that will permit the Tax Collector to ascertain all construction expenditures relating to owner-builders and speculative builders. Regulation § 5-10-350.2(e)(1).

6. Taxpayer did not maintain necessary records to permit the Tax Collector to ascertain all construction expenditures relating to Taxpayer's speculative builder activities.
7. If a taxpayer does not maintain or provide books and records the Tax Collector considers necessary to determine the taxpayer's tax liability, the Tax Collector is authorized to use estimates, projections, or samplings, to determine the correct tax. MTC § 5-10-555(e).
8. The Tax Collector was authorized here to use estimates to determine the correct tax owed by Taxpayer.
9. The Tax Collector's estimate is required to be made on a reasonable basis. MTC § 5-10-545(b).
10. The Tax Collector's method of estimating construction costs was reasonable. MTC § 5-10-545(b).
11. It is the responsibility of the taxpayer to prove that the Tax Collector's estimate is not reasonable and correct by providing sufficient documentation of the type and form satisfactory to the Tax Collector. MTC § 5-10-545(b).
12. Taxpayer failed to proven that the Tax Collector's estimate was not reasonable and correct.
13. The Tax Collector's privilege tax assessment against Taxpayer for the period February 2006 through August 2009 was proper.

Ruling

Taxpayer's protest of an assessment made by the City of Mesa for the period February 2006 through August 2009 is denied.

The Tax Collector's Notice of Assessment to Taxpayer dated April 19, 2010 for the period February 2006 through August 2009 is upheld.

The Taxpayer has timely rights of appeal to the Arizona Tax Court pursuant to Model City Tax Code Section -575.

Sincerely,

Hearing Officer

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c: ***Tax Audit Supervisor***
Municipal Tax Hearing Office