Jerry Rudibaugh
Municipal Tax Hearing Officer

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: February 28, 2003
Decision: MTHO #75
Tax Collector: City of Phoenix
Hearing Date: None

DISCUSSION

Introduction

On September 25, 2002, ***Taxpayer*** filed a Protest of Assessment ("Protest") of the City of Phoenix ("City") tax assessment. After review, the City concluded on October 15, 2002, that the protest was timely but not in the proper form. On October 17, 2002, the Municipal Tax Hearing Officer ("Hearing Officer") granted the Taxpayer an extension until December 2, 2002 to correct the form of their protest. On October 18, 2002, the Taxpayer filed an Addendum to the Protest. On October 22, 2002, the Hearing Officer concluded the Protest was now in proper form and ordered the City to file any response on or before December 5, 2002. On October 25, 2002, the Taxpayer filed a request to have the Protest processed as a Redetermination. On October 28, 2002 the Hearing Officer granted the Taxpayer's request to process the Protest as a Redetermination. On November 22, 2002, the City requested an extension for their response because the auditor had other job commitments. On November 30, 2002, the Hearing Officer granted the City an extension until January 3, 2003. On December 20, 2002, the City filed its response. On January 6, 2003, the Hearing Officer ordered the Taxpayer to file a reply on or before January 23, 2003. On January 14, 2003, the Taxpayer filed its reply. On January 14, 2003, the Hearing Officer issued a letter indicating a written decision would be issued on or before March 3, 2003.

The Taxpayer is a limited partnership that operates a ***business***. The City performed an audit for the period January 1997 through June of 2000. The assessment included the following activities: retail, amusement, advertising, publishing, commercial rental, and restaurant. The audit concluded there was a total additional tax due of $220,014.72 plus interest of $89,299.10 up through July of 2002.

City Position

The City compared ticket sales reported by the Taxpayer during the sample months to Taxpayer's cash account of its general ledger for the same sample months to determine underreported ticket income. That error rate was then applied against the remaining monthly reported ticket sales. If the discrepancy between the ticket sales reported and the general ledger are due to timing disparities, the City asserted that a reconciliation of the two sources should be possible for any month. According to the City, such reconciliations were not provided by the Taxpayer for the City to review. As to the sample months, the City asserted they randomly selected sample months from the total months under audit. Further, the City indicated the random method was performed in accordance with generally accepted auditing standards.

The City asserted that the audit revealed that the Taxpayer was receiving telecommunication expense reimbursements from vendors, media groups and other persons operating ***at their***

facility. Initially, the city had assessed the taxpayer as a telecommunications provider. After the Taxpayer opposed an assessment as a telecommunications provider, the City changed the assessment to a tax on gross income from the amusement activity. The City argued that City Code Section 14-410 ("Section 410") states that gross income from the business activity of persons engaging in the business of operating or conducting sport events…are subject to the amusement tax. Further, business is defined in City code Section 14-100 ("Section 100") as all activities or acts, personal or corporate, engaged in and casual to be engaged in with the object of gain, benefit, or advantage, either direct or indirect, but not casual activities or sales. According to the City, the Taxpayer is in the amusement business and thus its receipts from recouping its telecommunications costs are taxable under the amusement classification. The City asserted that the prohibition under Arizona Revised Statute 42-6004 (2) ("Section 6004") does not apply because the City is not taxing interstate telecommunications.

The City concluded the reimbursement of the telecommunications charges are an integral part of the amusement income since all vendors, media groups, and other persons operating within the ***Taxpayer's facility*** are required to pay this charge.

As to the equipment rented from ***Lessor***, the City argued that the Taxpayer is not leasing a motor vehicle but is leasing the mobile production facility equipment that is in the trailer being pulled by the motor vehicle. The City does not dispute that the trailer is covered by the motor vehicle exemption. The City asserted that the State tax ruling cited by the Taxpayer give examples of items that become part of an exempt motor vehicle such as batteries, repair and replacement parts etc. It also gives examples of items that do not become part of an exempt motor vehicle such as safety flares, portable radios and telephones that merely plugged into the vehicle's electrical source. According to the City, the production facility equipment in the trailer may be plugged into the vehicle's electrical source and bolted in place to prevent damage during transportation between locations of use. However, the City argued that it does not become part of the motor vehicle and as a result is not exempt from taxation.

The City disputes the Taxpayer's argument that the signs, panels, etc. attached to the ***Taxpayer's facility*** is properly taxable as construction contracting and not subject to .the use tax. The City asserted that Regulation 14-415.2 ("Regulation 415") distinguishes between contracting and certain related activities. For example, the installation or removal of tangible personal property, which has, independent functional activity, such as artwork installed by bolts, is considered a retail activity. In this case, the installation of the ***Mural*** will be with bolts into the walls and a proposal for a two-sided opaque banner attached with swedge clamps to pipe in the top and bottom of the vinyl banner. Consistent with Regulation 415, the City argued these items qualify as taxable retail activity. Further, the City indicated that Arizona case law has held that billboards were tangible personal property and not part of the real property on which they were placed. The City argued that the attachment of the ***Murals*** and signs used by the Taxpayer to advertise their client's business is very similar to the billboards.

The City argued that the invoice from ***Vendor*** is not for professional services but a taxable retail sale. The City asserted that City Regulation 14-460.4 ("Regulation 460") defines "Professional Services" as services rendered by such persons as doctors, lawyers, accountants, architects, etc. for their customers or clients where the services meet particular needs of a specific client and only apply in the factual context of the client and the final product has no retail value in itself. Examples that are not in a form that would be subject to retail sales would be opinion letters and reports. Examples that are in a form that would be subject to retail sales would be artwork and manuals. Since the invoice from ***Vendor*** states the animations may not be released or duplicated without written permission, the City argued the animations are in a form that would be subject to retail sales.

Taxpayer Position

The Taxpayer argued that the City's comparison of the cash account of the general ledger to the ticket reports of the Taxpayer to calculate alleged underreported ticket sales is fundamentally in error. According to the Taxpayer, any discrepancy is the result of timing disparities. The Taxpayer asserted that the timing disparity is supported by the audit since in two of the sample months the Taxpayer's ticket reports exceeded its cash receipt ledger entries and in the other five sample months, the cash receipt entries exceeded the ticket reports. Because of the timing issue, the Taxpayer argued that the City's use of one to two consecutive month sample periods was improper. According to the Taxpayer, the City should have compared the cash account with the ticket reports over the entire audit period or used more numerous consecutive months as sample periods. According to the Taxpayer, ticket revenue reported for sales tax purposes sometimes includes cash receipts not yet reflected in the ticket reports. Conversely, ticket revenue reflected in the ticket reports may be reported for sales tax purposes prior to cash being received and reported in the general ledger. Additionally, the Taxpayer noted that ticket refunds reflected in the ticket reports do not flow through the cash receipts report. As a result, the Taxpayer concluded these two sources are not a valid means of comparison. Because these two accounts cannot be reconciled or validly compared, the Taxpayer objected to the sampling methodology of the City. According to the Taxpayer, the City should have compared the cash account with the ticket reports over the entire audit period or use more numerous consecutive months as sample periods.

The Taxpayer argued that the City's inclusion of taxpayer's reimbursement for telecommunications expenses should not be deemed as taxable amusement proceeds because Section 6004 forbids the taxation of interstate telecommunications. Further, the Taxpayer argued that if it is properly taxable under the telecommunications classification then the taxpayer is entitled to a retail exemption for its purchase of telecommunications equipment utilized within the facility pursuant to City Code Section 14-465 (g) ("Section 465") and 14-110 (a) (3) ("Section 110").

Secondly, the Taxpayer argued that the City improperly imposed the privilege tax under the amusement classification pursuant to Section 410, which includes the business of "operating or conducting ... sports events ... or any other business charging admission for exhibition, amusement, or entertainment". These are separately identifiable and unrelated telecommunications reimbursements charges. According to the Taxpayer, it receives expense reimbursements from vendors, media groups, and other persons operating within the ***Taxpayer's facility*** for access to a telecommunications system. The Taxpayer asserted these entities are not Taxpayer's paying customers and should not be deemed as business income under the amusements classification. The Taxpayer argued that the City is attempting to tax gross income that it is specifically forbidden to tax.

During the audit period, the Taxpayer rented equipment from ***LESSOR*** for use within the City. According to the Taxpayer, the rental of equipment from ***LESSOR*** entails the rental of a motor vehicle subject to the motor carrier tax. The Taxpayer asserted that Section 5860 provides that the payment of the motor carrier fee by a motor carrier exempts the motor carrier from transaction privilege tax. The Taxpayer argued that the equipment contained within the ***LESSOR*** vehicle is permanently affixed thereto and is properly deemed a part of the exempt vehicle. As a result, the equipment is not taxable.

TPR 95-8 states that radios, speakers, and cellular telephones, which are installed in an exempt vehicle, are exempt. It also indicates that radios and telephones that are merely plugged into the vehicle's electrical source are not exempt. In this case, the Taxpayer argued that the equipment is integrally tied into the vehicle and to other equipment within the vehicle to enable the vehicle to

function as a production facility. The Taxpayer asserted the ability to move with the traveling ***business*** is what is required to facilitate the ***business's*** television productions. According to the Taxpayer, the ***business*** is not just renting equipment but is renting a mobile vehicle that has a specific functional utility. Since the equipment has become attached to the motor vehicle, the Taxpayer argued the entire vehicle's rental is not subject to privilege tax.

The Taxpayer argued that installation of signs, panels, and etc. attached to the ***taxpayer's facility*** are properly taxed as a contracting activity and are not subject to the use tax. According to the Taxpayer, these items are intended to remain affixed thereto and are not intended to be reused at other locations. The Taxpayer indicated that the City has relied on case law that involved the ownership of billboards by an entity that did not own the property onto which the billboards were installed. In that case, the court determined that the billboards were personal property with independent functional utility. In this case, the Taxpayer asserted that the signage remains the property of the Taxpayer and was specifically designed for Taxpayer's facility. Further, the Taxpayer argued that there has been no evidence to demonstrate that these signs would ever have an independent functional utility at another location. Because the signage is intended to remain affixed to Taxpayer's facility and because the signage was not designed to be reused at other locations, such items are properly deemed part of the real property and not subject to use tax.

The Taxpayer argued that the creation of customized video animation productions were non-taxable professional services. According to the Taxpayer, custom animations are analogous to custom computer software because it is designed exclusively to the specifications of one customer's unique application. The Taxpayer asserted that Regulation 115. (1) (e) of the Model City Tax Code states that the sale of custom computer software is exempt from privilege/use tax even if it is prepared to the special order of a customer who will use the program to produce copies of the program for sale. It is the subsequent sale that is deemed taxable.

ANALYSIS

Issue No.1: Was City's Use of Comparison Between Ticket Reports and the Cash Account for Sample Months Proper?

Clearly use of randomly selected sample months is a proper auditing technique. While the Taxpayer has complained of a timing disparity between the cash account and the ticket reports, we are not convinced the City's comparison method was not proper. The City has indicated a willingness to review any reconciliation provided by the Taxpayer, however, no reconciliation was provided. For example, the Taxpayer has noted that ticket refunds are reflected in the ticket reports but do not flow through the cash receipts report. This would seem to be an item that the Taxpayer could provide reconciliation but none was provided. As to other timing differences, we would expect those differences to average out over the sample months. The Hearing Officer has not been convinced that the sample months selected by the City would somehow bias the overall result. Based on the above, the Hearing Officer denies Taxpayer's Issue No. 1.

Issue No.2: Are Gross Receipts from Reimbursement of Telecommunications Costs Taxable Proceeds Pursuant to Section 410?

According to the evidence presented, telecommunication services are provided to the Taxpayer. The Taxpayer permits vendors, media groups and other persons operating within the ***Taxpayer's facility*** to have access to the telecommunication services. The Taxpayer pays the total telecommunication bill and then collects the appropriate amount from the vendors, media groups etc. for their share of the bill. Based on the assessment, the Taxpayer has several business activities including amusements, advertising, restaurant, commercial rental, and retail. Just as the

other activities were not all lumped into the amusement activity, we do not find the reimbursement for telecommunication expenses from non-amusement customers would be an integral part of t he amusement activity. Accordingly, the Hearing Officer concludes the reimbursement of telecommunications costs from non-amusement customers is not taxable pursuant to Section 410.

Issue No. 3: Is Taxpayer Liable for Use Tax on its Rental Equipment from ***LESSOR***?

The parties were in agreement that the equipment was exempt if it became a part of the trailer. In the examples given by the parties, the differentiation is whether or not the equipment can be easily transferred from vehicle to vehicle such as a radio or telephone that is simply plugged into the electrical source or whether it is going to remain with one vehicle such as a radio, speaker, or cellular telephone installed in a vehicle. In this case, we find the equipment has been installed on the vehicle trailer such that it is integrally tied into the vehicle in order to function as a production facility. As a result, the Hearing Officer concludes the equipment has become a part of the trailer and is exempt from use tax.

Issue No. 4: Is the Installation of Signage into Taxpayer's Facility Properly Taxable as Construction Contracting or is it Considered as a Retail Activity Subject to the Use Tax?

In reviewing the examples given the signage in this case differs from the billboard examples since the signs are attached to the Taxpayer's facility and the signs do not appear to be useable at another location outside of the Taxpayer's facility. The signage is similar to artwork installed by bolts or similar fastenings. However, the Hearing Officer concludes that unlike artwork the signage would not be useable at another location. Further, the Hearing Officer concludes the ordinary reasonable person would assume the signage belongs to and is part of the facility on which it is located. As a result, the Hearing Officer concludes the signage does not have independent functional utility and the activity is properly classified as contracting and not retail activity. Therefore, the use tax assessment was improper.

Issue No. 5: Is the Taxpayer's Purchase of Customized Animations Subject to Use Tax?

The City concluded based on the invoice from ***Vendor*** that the animations were a taxable retail sale. The language relied upon by the City was: "Neither party may duplicate nor release the animations specified above to any source without written permission for the other party". We concur with the Taxpayer that we cannot conclude from such language that the animations are going to be subject to retail sale. We also concur with the Taxpayer that the custom animations are analogous to custom computer software since it is designed exclusively to the specifications of one customer's unique application. Based on all the above, the Hearing Officer concludes the customized animations are a professional service and not subject to the use tax.

FINDINGS OF FACT

1. On September 25, 2002, the Taxpayer filed a Protest of the City tax assessment.

2. The City concluded on October 15, 2002 that the Protest was timely but not in the proper form.

3. On October 17, 2002, the Hearing Officer granted the Taxpayer an extension until December 2, 2002 to correct the form of their Protest.

4. On October 18, 2002, the Taxpayer filed an Addendum to the Protest.

5. On October 22, 2002, the Hearing Officer concluded the Protest was now in proper form and ordered the City to file any response on or before December 5, 2002.

6. On October 25, 2002, the Taxpayer filed a request to have the Protest processed as a Redetermination.

7. On October 28, 2002, the Hearing Officer granted the Taxpayer's request to process the Protest as a Redetermination.

8. On November 22, 2002, the City requested an extension for their response because the auditor had other job commitments.

9. On November 30, 2002, the Hearing Officer granted the City an extension until January 3, 2003.

10. On December 20, 2002, the City filed its response.

11. On January 6, 2003, the Hearing Officer ordered the Taxpayer to file a reply on or before January 23, 2003.

12. On January 14, 2003, the Taxpayer filed its reply.

13. On January 21, 2003, the Hearing Officer issued a letter indicating a written decision would be issued on or before March 3, 2003.

14. The Taxpayer is a limited partnership that operates a ***business***.

15. The City performed an audit for the period January 1997 through June of 2000.

16. The assessment included the following activities: retail, amusement, advertising, publishing, commercial rental, and restaurant.

17. The audit concluded there was a total additional tax due of $220,014.72 plus interest of $89,299.19 up through July of 2002.

18. The City randomly selected seven months from the total months under audit to review.

19. The City compared ticket sales reported by the Taxpayer during the sample months to Taxpayer's cash account of its general ledger for the same sample months to determine underreported ticket income.

20. That same error rate was then applied against the remaining monthly reported tickets

sales.

21. A reconciliation of the two sources should be possible for any months.

22. No reconciliations were provided by the Taxpayer.

23. The Taxpayer receives expense reimbursements from vendors, media groups, and other persons operating within the ***Taxpayer's facility*** for access to a telecommunications system.

24. During the audit period, the Taxpayer rented equipment from ***LESSOR*** for use within the City.

25. The equipment from ***LESSOR*** is permanently affixed to a. trailer being pulled by a motor vehicle.

26. The signage installed in Taxpayer's facility is affixed thereto and are not intended to be reused at other locations.

27. The animations purchased by the Taxpayer are designed exclusively to the specifications 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. Use of randomly selected sample months is a proper auditing technique.

3. There was not sufficient evidence to demonstrate that the sample months selected by the City resulted in a bias to the overall result.

4. The Taxpayer's protest of the City's use of sample months to compare ticket reports and the cash account should be denied.

5. Section 410 authorizes a tax on the gross income from the business activity of persons engaging in the amusement business.

6. The reimbursement for telecommunications expenses from non-amusement customers is not an integral part of the amusement business.

7. Tangible personal property that becomes part of the motor vehicle is exempt from use tax pursuant to ARS 42-1310.01.

8. The ***LESSOR*** equipment has been installed on the vehicle trailer such that it is integrally tied into the vehicle in order to function as a production facility.

9. The ***LESSOR*** equipment has become part of the vehicle trailer and is exempt from use tax.

10. The ordinary reasonable person would assume the signage belongs to and is a part of the facility on which it is located.

11. The signage at the Taxpayer's facility does not have independent functional utility and the activity is properly classified as contracting and not retail activity.

12. We cannot conclude that the animations are going to be subject to retail sales.

13. The customized animations are a professional service and not subject to the use tax.

ORDER

It is therefore ordered that the September 25, 2002 protest filed by ***Taxpayer*** of the City of Phoenix tax assessment is hereby partly granted and partly denied consistent with the Discussion herein.

It is further ordered that the City of Phoenix shall revise its assessment consistent with the conclusion that the reimbursement of telecommunications costs is not taxable pursuant to Section 410.

It is further ordered that the City of Phoenix shall revise its tax assessment consistent with the conclusion that the rental equipment from ***Lessor*** is not subject to the use tax.

It is further ordered that the City of Phoenix shall revise its assessment consistent with the conclusion that installation of signage into the facility of ***Taxpayer*** is properly classified as construction contracting.

It is further ordered that the City of Phoenix shall revise its assessment consistent with the conclusion that the customized animations are a professional service and are not subject to the use tax.

It is further ordered that this decision shall be effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer