DECISION OF MUNICIPAL TAX HEARING OFFICER

March 27, 2015

Taxpayers
Taxpayer's Address

Taxpayers
MTHO #852

Dear Taxpayers:

We have reviewed the evidence presented by ***Taxpayers*** and the City of Sedona (Tax Collector or City) at the hearing on February 20, 2015. The review period covered was May 2011 through June 2013. Taxpayers' protest, Tax Collector's response, and our findings and ruling follow.

Taxpayers' Protest

Taxpayers are individuals and own a limited liability company (LLC) that operates a restaurant. Taxpayers own the real property used by the restaurant. Taxpayers were previously assessed City of Sedona privilege tax under the commercial lease classification for the lease of real property owned by Taxpayers to the LLC. Taxpayers continue to contend that because they are the sole owners of the LLC, they are not leasing the property to another person. The state legislature passed an exemption from city tax of leases between related entities showing that the legislature did not intend these transactions to be taxed. The City never informed Taxpayers that there would be another assessment after the last audit. Finally, the City's estimates of the rental value and the square footage of the property continue to be overstated.

Tax Collector's Response

Taxpayers own the property used by their LLC. Under the City tax code the LLC is a separate taxable entity. Taxpayers are therefore taxable on that lease. The assessment was based on the estimated market value of the rent. Taxpayers have not submitted evidence that the Tax Collector's estimate was not reasonable and correct. The new state statute was not effective until July 1, 2013. The current audit period ended June 30, 2013. The assessment should be upheld.

Discussion

Taxpayers owned the real property at issue. The property was used by their wholly owned LLC to operate a restaurant. The LLC paid the mortgage and other related expenses on behalf of Taxpayers. The Tax Collector had previously conducted an audit of Taxpayers for the period January 2005 through April 2011 and issued an assessment under the commercial lease classification. Taxpayers protested and we upheld that assessment. (*See,* MTHO # 775).

Effective July 1, 2013 state law precluded cities from taxing rentals of real property between related entities. Therefore starting July 1, 2013 Taxpayers' lease of the property to their LLC is not subject to the city privilege taxes. The issue presented here is whether Taxpayers are taxable for the period between the end of the last audit period (April 2011) and the effective date of the state law. For the reasons stated below we uphold the City's assessment.

Taxpayers and the LLC are separate persons under the tax code.

Taxpayers continue to argue that they were 100% owners of the lessee LLC and therefore no tax should be due. Our prior decision held that Taxpayers established the LLC on the advice of their accountant to provide a level of protection. Taxpayers are free to use whatever form of business they choose, but in choosing a form they must accept its advantages and disadvantages. *Higgins* v. *Smith***,** 308 U.S. 473 (1940). While Taxpayers may have owned the LLC, the LLC was a separate legal entity.

In 2013 the Arizona state legislature passed H.B. 2324 which precluded cities from taxing commercial leases between affiliated companies, businesses, persons or reciprocal insurers. *See,* A.R.S. § 42-6004.A.11. The amendment to A.R.S. § 42-6004.A. became effective July 1, 2013. H.B. 2324 was not retroactive and does not apply to the review period at issue here. Prior to July 1, 2013 Taxpayers' lease continued to be subject to the City privilege tax.

The Assessment was not barred.

Taxpayers argue that the City did not inform them that an assessment would be issued for taxes due from the end of the prior audit period to the effective date of A.R.S. § 42-6004.A.11. Generally, it is taxpayers' responsibility to be familiar with the code of the jurisdiction where they operate. Every person is presumed to know the law and its requirements, and a mistake as to such requirements is no excuse for failure to meet them. *Newman v. Fidelity Savings and Loan Association,* 14 Ariz. 354, 128 P. 53 (1912).

The taxation of commercial leases is governed by Sedona Tax Code (STC) § 8-445. Neither that section nor the Model City Tax Code has a legal requirement for the City to give personal notice to taxpayers that their activity is taxable or that the City will issue an assessment before the tax may be imposed. No authority has been cited that would allow us to invalidate the assessment because Taxpayer was not aware that the City would impose the tax for periods after the first audit.

The Tax Collector's Estimate was based on a reasonable basis.

We previously upheld the Tax Collector's estimate as being reasonable. Taxpayers continue to question the estimate. 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 required by the Code or satisfactory to the Tax Collector. Taxpayers have not presented any evidence showing that the Tax Collector's estimate was not reasonable and correct. Based on the record here, we find no basis to conclude that the Tax Collector's estimate was not reasonable and correct.

Taxpayers' Other Arguments do not Address the City's Privilege Tax Assessment.

Taxpayers also raised certain issues involving their attempts to obtain a City Business License (not privilege tax license), overpayment of sewer fees and stress related to their dealings with the City Attorney. The purpose of the administrative hearing process under STC § 8-570 is to contest the applicability or amount of tax, penalty, or interest imposed upon the Taxpayer under the City's privilege tax. Arguments addressing other fees, business licenses and dealings with the City Attorney do not bear on the amount of privilege tax, penalty or interest owed by Taxpayers.

Based on all the above, we conclude Taxpayers' protest should be denied and the Tax Collector's assessment upheld.

Findings of Fact

1. Taxpayers are individuals and own real property in the City.
2. Taxpayers are 100% owners of an LLC that operates a restaurant on Taxpayers' property.
3. The LLC was established on an accountant's advice to limit liability.
4. Neither Taxpayers nor the LLC are corporations.
5. The LLC pays the mortgage on the property and other expenses on behalf of Taxpayers.
6. It is the City's position that Taxpayers are leasing the property to the LLC.
7. Taxpayers did not file returns or pay City privilege tax on the lease of the property to the LLC.
8. The Tax Collector previously conducted an audit assessment of Taxpayers for the period January 2005 through April 2011 and issued an assessment on June 3, 2011. That assessment was upheld by the Municipal Tax Hearing Officer on June 12, 2013 in MTHO # 775.
9. The Tax Collector conducted a subsequent audit assessment of Taxpayers for the period May 2011 through June 2013.
10. The Tax Collector continues to considered Taxpayers taxable under the commercial lease classification.
11. The assessment was based on the Tax Collector's estimate of the value of the lease from Taxpayers to the LLC.
12. Taxpayers timely protested the assessment.
13. Taxpayers believed the City should have told Taxpayers that it was going to audit Taxpayers for periods after the prior audit.

Conclusions of Law

1. STC § 8-445 imposes the City privilege tax on the business activity of renting, leasing or licensing for use real property located in the City.
2. Taxpayers were held to be subject to the City privilege tax under the commercial lease classification for a prior audit period.
3. Neither the facts nor the relevant statutory provisions changed during the current audit period.
4. Effective July 1, 2013 A.R.S. § 42-6004.A.11. precludes the City from Taxing Taxpayers on their lease of real property to their LLC.
5. For the reasons stated in our prior decision dated June 12, 2013 in MTHO # 775, Taxpayers continued to be taxable under the commercial lease classification for periods before July 1, 2013.

6. Taxpayers are presumed to know the law and its requirements, and a mistake as to such requirements is no excuse for failure to meet them. *Newman v. Fidelity Savings and Loan Association,* 14 Ariz. 354, 128 P. 53 (1912).

7. The fact a taxpayer was not informed by the City that taxes are due for periods after the end of the prior audit period is not a basis for abating an otherwise valid assessment.

8. The City's assessment for the review period May 2011 through June 2013 is upheld.

Ruling

The protest by Taxpayers of an assessment made by the City of Sedona for the period May 2011 through June 2013 is denied.

The Tax Collector's Notice of Assessment is upheld.

The parties have 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: ***City Auditor for Sedona***
Municipal Tax Hearing Office