BEFORE THE STATE BOARD OF TAX APPEALS
STATE OF ARIZONA
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HALL'S CUSTOM CONSTRUCTION, INC., COLLEGE PARK DEV., LLC CIBOLA HEIGHTS DEV., LLC PIONEER PARK DEV., LLC SIERRA SUNSET DEV., LLC LOS JARDINES DEV., LLC, Appellants, vs. ARIZONA DEPARTMENT OF REVENUE, Appellee.	)	Docket No. 1967-08-S(6) NOTICE OF DECISION FINDINGS OF FACT AND CONCLUSIONS OF LAW

The State Board of Tax Appeals, having considered all evidence and arguments presented, and having taken the matter under advisement, finds and concludes as follow:

FINDINGS OF FACT

Hall's Custom Construction, Inc., College Park Dev., LLC, Cibola Heights Dev., LLC, Pioneer Park Dev., LLC, Sierra Sunset Dev., LLC and Los Jardines Dev., LLC (collectively, "Appellants") engage in the business of real estate development in and near Yuma, Arizona. Appellants operate as production home residential development businesses through a multi-arm structure of affiliated entities. For each subdivision developed by Appellants there were three "arms" utilized in the multi-arm structure: a development arm responsible for the development of a particular subdivision (including roads, utilities, common areas and other infrastructure), a construction arm that actually builds the homes for the development arm on lots owned by the development arm, and a marketing arm that purchases the completed homes and underlying lots from the development arm and sells them to the homebuyers.

For the period May 1999 through June 2000, Hall's Custom Construction, Inc. was the development arm for all of the subdivisions (except for Cibola Heights the construction of which did not begin until 2001) and reported transaction privilege tax to the Arizona Department of Revenue ("Department") under the prime contracting classification on the proceeds of sales of completed homes/lots to an affiliated marketing arm. Beginning in 2000, there were three LLCs established for each subdivision – a Development LLC, a Construction LLC, and a Sales LLC, each named after the subdivision (e.g., College Park Construction, LLC, College Park Development, LLC, and College Park Sales, LLC). From that time on, each of the Development LLCs developed the land, hired the affiliated Construction LLC to build the houses pursuant to a construction agreement, sold the completed home and the underlying lot to the affiliated Sales LLC pursuant to a Rolling Option Agreement, and reported transaction privilege tax to the Department under the prime contracting classification based on the proceeds of the sale to the Sales LLC.[1] The Sales LLCs then sold the homes to the final homebuyers. The Department audited the Construction LLC and Sales LLC for each subdivision and accepted without change their filing position as having no taxable revenue for transaction privilege tax purposes. The Department also audited Appellants (i.e., the Development LLCs) and treated them as the taxable contractors for the subdivisions. Appellants do not contest their status as "contractors" under the transaction privilege tax classification.[2]

When Appellants paid transaction privilege tax, they took a land deduction allowed prime contractors under A.R.S. § 42-5075(B)(1). On audit, the Department did not question or assess any additional tax based on these land deductions.

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[1] The inter-company sales of a final affiliated entity, Ponderosa Valley, are all reported under the name of Hall's Custom Construction, Inc. Ponderosa Valley did not file refund claims.

[2] While the Department and Appellants have stipulated to the fact that the Development LLCs are the contractors in this case, there was testimony offered at the hearing before the Board indicating that perhaps the Construction LLCs, and not the Development LLCs, should have been taxed as the prime contractors.

In May 2003, following the audit, Appellants claimed that the estimated fair market values they used for the land deduction on their transaction privilege tax returns understated the actual fair market value of the land. They submitted refund claims for high land deductions based on appraisals obtained from a certified real estate appraiser.

In July 2003, the Department denied the refund claims. Appellants protested the Department's denial of the refund claims. The denial was ultimately upheld by an administrative hearing officer. Appellants now timely appeal to this Board.

DISCUSSION

The issue before the Board is whether the Department properly denied Appellants' refund claims.

Arizona imposes a transaction privilege tax on the business of engaging in prime contracting. A.R.S. § 42-5075. A "prime contractor" is defined as a "contractor who supervises, performs or coordinates the construction . . . and who is responsible for the completion of the contract." A.R.S. § 42-5070(G)(6). A.R.S. § 42-5075(G)(2) defines a "contractor" to include "a person, firm, or other organization . . . that undertakes to . . . or does personally or by or through others, construct, alter, repair, add to, subtract from . . . any project, development or improvement, or to do any part of such a project . . . ."

The transaction privilege tax is imposed on the gross proceeds of sales or gross income from a business. Under the prime contracting classification, a deduction is allowed for gross receipts attributable to the "sales price of land, which shall not exceed the fair market value" of the land. A.R.S. § 42-5075(B)(1).

Appellants contend that they originally underestimated their land deductions and, relying largely on a prior Board decision,[3] argue that, absent a contract separately stating the sales price of the land,

[3] *Acacia/Autumn & Masters Limited Partnership and Acacia/Country Limited Partnership v. Arizona Dep't of Rev.*, No. 1042-93-S(3), 1994 WL 662628 (Ariz. Bd. Tax App. 1994). In *Acacia/Autumn*, the taxpayer "assigned values, for internal allocation purposes only, that were somewhat greater than or less than the appraisal value to individual lots." 1994 WL 662628 at *2. In that case, the Board did not look to these "internal allocations" as being the same as the sales price, but instead noted that "where a land deduction does not exceed the fair market value the requirement of

they are entitled to use the higher fair market value appraisals subsequently obtained from a certified real estate appraiser for their land deductions. The Board disagrees.

The contract by which a Sales LLCs purchased the completed homes (the lots and improvements) from a Development LLC was the Rolling Option Agreement. Under the Rolling Option Agreement, the Purchase Price paid by the Sales LLCs to Appellants for each transaction was calculated by a specific formula: Purchase Price equaled the sum of the costs (dwelling construction costs, lot costs, and averaged off-site/on-site costs) plus a profit (a profit percentage figure multiplied by the sum of the lot costs and averaged off-site/on-site costs). Appellants listed these Purchase Price amounts in their General Ledger Detail Reports and reported the amounts as their gross proceeds on their transaction privilege tax returns to the Department.

While the Purchase Price Formula in the Rolling Option Agreement contains no stated numerical values, it includes the components that comprise the "inside sale" (i.e., a sale between related entities). Appellants use these components to allocate income from the sales to each affiliated entity. In short, it is possible to calculate the *actual* sales price of land. Nevertheless, Appellant did not use these figures for their land deductions but instead used higher estimated fair market values. Appellants now want to use the even higher fair market value appraisals subsequently obtained from a certified real estate appraiser for their land deductions. The appraiser used three appraisal methods based on determining the fair market value for a *retail sale* (e.g., the sale from a Sales LLC to an individual homebuyer).

By dividing their business operations into separate legal entities and selling developed lots through multiple sales transactions, Appellants have reduced their overall tax liability on the sale of

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[the land deduction statute] is met and the deduction is appropriate." *Id* (*citing Estes Homes v. Arizona Dep't of Rev.*, No. 934-92-S/U(3), 1993 WL 389145 (Ariz. Bd. Tax App. 1993 at *2).

residential homes because the house and lot are sold at a "wholesale" or "inside price" (i.e., the price charged to a related entity) to the Sales LLCs. Accordingly, Appellants avoid paying transaction privilege tax based on the final retail price of the property when it is sold to a consumer. The "inside price" will be lower than the retail price but higher than the construction cost. However, any sale between related entities must be at a price that reflects a reasonable value and falls within the parameters of A.R.S. § 42-5012. This statute addresses sales between affiliated entities and provides that:

> In determining value as applied to sales from one to another of affiliated corporations, or persons, or other circumstances where the relation between the buyer and seller is such that the gross proceeds from the sale are not indicative of the true value of the subject matter of the sale, the department shall prescribe uniform and equitable rules for determining the value upon which the tax shall be levied, corresponding as nearly as possible to the gross proceeds from the sale of similar products of like quality or character by other taxpayers where no common interest exists between the buyer and seller, but otherwise under similar circumstances and conditions.

In this case, Appellants sell to the Sales LLCs at a lower inside price than the retail price to the final purchaser. Appellants reported and paid tax on their proceeds from these inside sales. In order to maintain the fact and appearance of independent entities, the land deduction should also be based on the inside sales. The Board reaches this conclusion following a full and thorough presentation by the parties at the hearing before the Board. To the extent that *Acacia/Autumn* is inconsistent with this finding, the current Board will not follow that decision in this case. [4]

CONCLUSIONS OF LAW

The Department properly denied Appellants' refund claims. *See* A.R.S. § 42-5075(B)(1); A.R.S. § 42-5012.

. . .

[4] The Board does not address the decision of the Director of the Department in a case (Case No. 200100166-S) cited by Appellants. The case is distinguishable on the facts in that it does not involve a multi-arm business structure. Further, and the Board is not bound by the determination under A.R.S. § 42-1004(C).

ORDER

THEREFORE, IT IS HEREBY ORDERED that the appeal is denied and the final order of the Department is affirmed.

This decision becomes final upon the expiration of thirty (30) days from receipt by the taxpayer, unless either the State or taxpayer brings an action in superior court as provided in A.R.S. § 42-1254.

DATED this 29th day of April, 2009.

STATE BOARD OF TAX APPEALS

Amy W. Fellner, Chairperson

AWF:ALW

CERTIFIED

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