

Jerry Rudibaugh
Municipal Tax Hearing Officer

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: January 6, 2003
Decision: MTHO #43
Tax Collector: City of Mesa
Hearing Date: November 21, 2002

DISCUSSION

Introduction

On April 12, 2002, **ABC Constructors**, Inc. ("**ABC**" or "Taxpayer") filed a protest of a tax assessment made by the City of Mesa ("City"). On April 25, 2002, the City reviewed the protest and concluded it was timely and in the proper form. On May 1, 2002, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to respond on or before June 17, 2002. On June 14, 2002, the City filed a request for an extension in which to file its response. On June 18, 2002, the Hearing Officer granted the City an extension until June 24, 2002. On June 27, 2002 the City filed a request for an additional extension until August 16, 2002. On July 1, 2002, the Hearing Officer granted the City's extension request. On August 15, 2002, the City requested another extension until September 30, 2002, On August 15, 2002, the Hearing Officer granted the extension until September 30, 2002. The City filed its response on September 30, 2002. On October 8, 2002, the Hearing Officer ordered the Taxpayer to file any reply on or before October 22, 2002. On October 21, 2002, the Taxpayer filed a request for an extension until October 29, 2002. On October 24, 2002, the Hearing Officer granted the extension request until October 29, 2002. The Taxpayer filed its reply on October 29, 2002. The matter was scheduled for hearing commencing on November 21, 2002. Both the Taxpayer and City appeared and presented evidence at the November 21, 2002 hearing. On November 25, 2002, the Hearing Officer filed a letter indicating a decision would be issued on or before January 6, 2003.

The Taxpayer is an Arizona general contractor. On September 1, 1998, the Taxpayer entered into an agreement with **XYZ Health Systems** ("**XYZ**") to construct the **XYZ Zzz Hospital** ("**Zzz Hospital**") in the City. While **XYZ** was acquired by **RST Health Systems** in September 1999, we shall continue to refer to **XYZ** throughout this Decision both before and after the acquisition. The agreement provided that the Taxpayer was to provide pre-construction services such as architectural and engineering design work and would serve as the general contractor for the construction of the **Zzz Hospital**. The Taxpayer also entered into an agency agreement with **XYZ** to allow the Taxpayer to act as an agent on behalf of **XYZ** to procure materials incorporated into the construction of the hospital on a tax-free basis.

Prior to the opening of the **Zzz Hospital**, **XYZ** entered into an agreement to lease the hospital to **XYZ Zzz Hospital, L.L.C.** ("**XYZ LLC**"), a for profit organization. The hospital opened for business in November 2000. The lease agreement remained in effect from October 15, 2000 until July 31, 2001, after which **XYZ** purchased the entire ownership interest of the hospital.

The City conducted an audit of the Taxpayer for the period of September 1, 1997 through July 31, 2001 concerning the construction of the **Zzz Hospital**. As a result of that audit, the City assessed the Taxpayer for additional taxes pursuant to City Tax Code Section 5-10-415 ("Section 415") in the amount of \$110,236.01, plus applicable interest.

City Position

The City did not dispute that the Taxpayer had entered into a proper agency agreement and has purchased construction materials on behalf of *XYZ*. However, the City did dispute the Taxpayer's claim that *XYZ* was entitled to an exemption from taxation as a "qualifying hospital" pursuant to Sections 415 and City Code Section 5-10465 ("Section 465"). While the City agreed that *Area1 XYZ Medical Center* ("*Area1 XYZ*") and *Area2 XYZ Medical Center* ("*Area2 XYZ*") are "qualifying hospitals", the City did not agree that *XYZ* meets the definitional requirement. According to the City, *XYZ* is a corporate organization that owns and controls various entities, some of which happen to be licensed general hospitals. The City argued that a corporate entity, which owns licensed hospitals, but in and of itself is not a licensed hospital, is not entitled to claim an exemption under Section 465. In support of its argument, the City noted that the exemption letters from the Arizona Department of Revenue ("ADOR") specifically states, "Please note that only the hospital located at the above captioned address is entitled to the exemptions cited below." In reviewing the exemption letters provided by the Taxpayer, the City concluded that the exemptions available were for *Area2 XYZ*, located at 6644 E. _____ Avenue in the City, and *Area1 XYZ*, located at 525 West _____ Avenue in the City.

Based on the above, the City concluded that *XYZ* was at no time a "qualifying hospital" as defined in the City Tax Code, Arizona Revised Statutes or the rules promulgated by ADOR and the Arizona Department of Health Services ("ADHS"). Accordingly, the exemption for qualifying hospitals is not available. Therefore, the City requested that its assessment be upheld in the entirety.

Taxpayer Position

XYZ is a nonprofit organization that is exempt from federal and state income taxation pursuant to Section 501 (c) (3) ("Section 501") of the Internal Revenue Code ("IRC") of 1986, as amended and ARS Section 43-1201. *XYZ*'s primary exempt purpose is to provide healthcare to the public. *XYZ* owns, leases, and operates *Area1 XYZ*, and *Area2 XYZ*. According to the Taxpayer, *XYZ* holds general hospital licenses from ADHS for both *Area1 XYZ* and *Area2 XYZ*. The Taxpayer asserted that the *Zzz Hospital* is a 60-bed specialty hospital located on the campus of *Area2 XYZ*. The Taxpayer indicated that the *Zzz Hospital* was leased to the for-profit *XYZ L.L.C.* from October 15, 2000 until July 31, 2001. On August 1, 2001, *XYZ* bought out the interests of *XYZ LLC*. Prior to August 1, 2001, *XYZ* held a 60% voting interest and a 67.02 percent ownership interest in *XYZ LLC*. According to the Taxpayer, Section 415 provides an exemption from the construction contracting classification for proceeds attributable to the purchase of machinery, equipment or other tangible personal property that is exempt from or deductible from privilege or use tax pursuant to Section 465, subsections (g) and (p). The Taxpayer asserted that Section 465 provides an exemption for sales of tangible personal property to a "qualifying hospital", except when the property sold is for use in activities resulting in gross income from unrelated business income as that term is defined in IRC Section 512. The Taxpayer indicated that Code Section 5-10-100 ("Section 100") defines the term "qualifying hospital" to mean a licensed hospital which is organized and operated exclusively for charitable purposes, no part of the net earnings which inures to the benefit of any private shareholder or individual. According to the Taxpayer, the State uses the same definition pursuant to A.R.S. Section 42-500 (11). In order to meet the criteria of a "qualifying hospital", a hospital must establish that (1) it is licensed, (2) it is organized and operated exclusively for charitable purposes, and (3) no part of the net earnings of the hospital inure to the benefit of any private shareholder or individual.

The Taxpayer argued that it met the first criteria of a "qualifying hospital" regarding a license. According to the Taxpayer, it holds general hospital licenses issued by ADHS to the Taxpayer

dba *Area2 XYZ* and dba for *Area1 XYZ*. Secondly, the Taxpayer asserted it is organized and operated exclusively for charitable purposes. In support of its argument, the Taxpayer provided copies of determination letters from the Internal Revenue Service (“IRS”) recognizing *XYZ* as a charitable organization described in LRC Section 501 (c)(3). According to the Taxpayer, it also meets the third criteria that “no part of the net earnings of the organization inures to the benefit of any private shareholder or individual.” The Taxpayer asserts that the IRS determination letter recognizing *XYZ*’s exempt status pursuant to IRC Section 501 (c) (3) also evidences this requirement. The Taxpayer further argued that the fact the *Zzz Hospital* was operated briefly for a for-profit entity in which *XYZ* owned a controlling interest does not affect this conclusion. The Taxpayer relied upon IRS Revenue Ruling 98-15 in reaching this conclusion. Revenue Ruling 98-15 set forth a two-part standard whereby an IRC Section 501 (c)(3) organization may form and participate in a partnership and still be operated exclusively for exempt purposes if (1) the partnership furthers a charitable purpose and (2) the partnership agreement permits the exempt organization to act in furtherance of its exempt purposes and only incidentally for the benefit of the for-profit partners. The Taxpayer argued that the structure of *XYZ* LLC falls square within the parameters described by the IRS. The organizational documents of *XYZ* LLC require that the LLC be operated in a manner that furthers charitable purposes within the meaning of IRC Section 501 (c)(3) by promoting health for a broad cross section of its community, and that such purposes are primary. Also, *XYZ*, as the exempt hospital, holds a two-thirds voting and ownership interest in the LLC and therefore retains ultimate authority over the assets and activities being managed. As a result, the Taxpayer concludes that *XYZ* meets the third part of the “qualifying hospital” definition.

The Taxpayer argued that the property it purchased on *XYZ*’s behalf was used to construct the *Zzz Hospital*, which is solely owned by *XYZ* and operated in furtherance of *XYZ*’s exempt purposes. Therefore, the Taxpayer concluded that the property purchased for *XYZ* was not used in an unrelated business, and the exemption must be allowed. According to the Taxpayer, the entire assessment in this matter relates to nontaxable sales of construction materials purchased by *ABC* on behalf of *XYZ* pursuant to an agency agreement. Based on the above, the Taxpayer requests the entire assessment be denied.

ANALYSIS

The parties were in agreement on most of the facts and legal issues. There was no dispute that the Taxpayer had an agency agreement to purchase construction materials on behalf of *XYZ*. The only issue between the parties was whether or not *XYZ* was a “qualifying hospital” pursuant to Section 100 and thus its purchases would be exempt pursuant to Section 465. To meet the definition of a “qualifying hospital”, a hospital must establish that it meets three criteria. There was no dispute that *XYZ* met the criteria of being organized and operated exclusively for charitable purposes and that no part of the net earnings of the hospital inure to the benefit of any private shareholder or individual. That leaves us with the third criteria of being licensed in which the parties disagreed.

The Taxpayer has argued that *XYZ* had a license and therefore it met the third criteria. The City has argued that *XYZ* is the corporate organization that owns *Area1 XYZ* and *Area2 XYZ*, which are licensed as general hospitals by the State. According to the City *XYZ* is not a licensed general hospital.

Based on the evidence presented, the Hearing Officer concludes that *XYZ* holds a license for both *Area1 XYZ* and *Area2 XYZ*. Further, the *Zzz Hospital* had a license prior to providing services. While the *Zzz Hospital* and *Area2 XYZ* had different addresses, the Hearing Officer

concludes they were at the same location since they were at the same “campus” location and were physically connected. It is unclear to the Hearing Officer what else **XYZ** could have done in order to qualify as a “qualifying hospital” to obtain exempt status for the purchases for the construction of the **Zzz Hospital**. Based on all the above, the Hearing Officer concludes that **XYZ** was a “qualifying hospital” pursuant to Section 100 and the construction materials purchased by the Taxpayer on behalf of **XYZ** were exempt pursuant to Section 465. Therefore, the Taxpayer’s protest petition should be granted.

FINDINGS OF FACT

1. On April 12, 2002, the Taxpayer filed a protest of a tax assessment made by the City.
2. On April 25, 2002, the City reviewed the protest and concluded it was timely and in the proper form.
3. On May 1, 2002, the Hearing Officer ordered the City to respond on or before June 17, 2002.
4. On June 14, 2002, the City filed a request for an extension on which to file its response.
5. On June 18, 2002, the Hearing Officer granted the City an extension until June 24, 2002.
6. On June 27, 2002, the City filed a request for an additional extension until August 16, 2002.
7. On July 1, 2002, the Hearing Officer granted the City’s extension request.
8. On August 15, 2002, the City requested another extension until September 30, 2002.
9. On August 15, 2002, the Hearing Officer granted the extension until September 30, 2002.
10. The City filed its response on September 30, 2002.
11. On October 8, 2002, the Hearing Officer ordered the Taxpayer to file any reply on or before October 22, 2002.
12. On October 21, 2002, the Taxpayer filed a request for an extension until October 29, 2002.

13. The Taxpayer filed its response on October 29, 2002.
14. The matter was scheduled for hearing commencing on November 21, 2002.
15. Both the Taxpayer and City appeared and presented evidence at the November 21, 2002 hearing.
16. On November 25, 2002, the Hearing Officer filed a letter indicating a decision would be issued on or before January 6, 2003.
17. The Taxpayer is an Arizona general contractor.
18. On September 1, 1998, the Taxpayer entered into an agreement with *XYZ* (now *RST Health Systems*) to construct the *Zzz Hospital* in the City.
19. The agreement provided that the Taxpayer was to provide pre-construction services such as architectural and engineering design work and would serve as the general contractor for the construction of the hospital.
20. The Taxpayer also entered into an agency agreement with *XYZ* to allow the Taxpayer to act as an agent on behalf of *XYZ* to procure materials incorporated into the construction of the hospital on a tax-free basis.
21. Prior to the opening of the *Zzz Hospital*, *XYZ* entered into an agreement to lease the hospital to *XYZ* LLC, a for-profit organization.
22. The *Zzz Hospital* opened for business in November 2000.
23. The lease agreement remained in effect from October 15, 2000 until July 31, 2001, after which *XYZ* purchased the entire ownership interest of the hospital.
24. The City conducted an audit of the Taxpayer for the period of September 1, 1997 through July 31, 2001 concerning the construction of the *Zzz Hospital*.
25. The City assessed the Taxpayer for additional taxes pursuant to Section 415 in the

amount of \$110,236.01, plus applicable interest.

26. The Taxpayer entered into an agency agreement and had purchased construction materials on behalf of *XYZ*.
27. *XYZ* holds a license to operate a general hospital dba *Area1 XYZ* at 525 West ____ Road in the City.
28. *XYZ* holds a license to operate a general hospital dba *Area2 XYZ* at 6644 East __ Avenue in the City.
29. The *Zzz Hospital* was constructed adjacent to and physically connected to *Area2 XYZ*, but the *Zzz Hospital* and *Area2 XYZ* had different addresses.
30. The *Zzz Hospital* was granted a license to operate by ADHS.
31. *XYZ* is organized and operated exclusively for charitable purposes.
32. No part of the net earnings of *XYZ* inure to the benefit of any private shareholder or individual.

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 415 taxes the income from construction contracting.
3. Section 415(b) provides for an exemption from taxation under the construction contracting classification for the gross proceeds of sales or gross income attributable to the purchase of machinery, equipment or other tangible personal property that is exempt from privilege tax pursuant to Section 465.
4. Section 465 provides an exemption for sales of tangible personal property to a qualifying hospital, except when the property sold is for use in activities resulting in gross income from unrelated business income.

5. Section 100 defines a “qualifying hospital” as a licensed hospital, which is organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.
6. Based on the facts presented and consistent with the analysis herein, **XYZ** is a qualifying hospital and thus its purchase of machinery, equipment or other tangible personal property is exempt pursuant to Sections 415(b) and 465.
7. The Taxpayer’s Protest Petition should be granted.

ORDER

It is therefore ordered that the April 12, 2002 protest of **ABC Constructors**, Inc. of the City of Mesa tax assessment is hereby granted.

It is further ordered that the City of Mesa shall revise the tax assessment of **ABC Constructors**, Inc. by allowing the qualifying hospital exemption for property that **ABC Constructors**, Inc. purchased on behalf of **XYZ**.

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

Jerry Rudibaugh

Municipal Tax Hearing Officer