BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	DECISION OF HEARING OFFICER
[REDACTED]	Case No. 200800060-I
UTI # [REDACTED]	

A hearing was held on June 12, 2008 in the matter of the protest of [REDACTED] (Taxpayer) to an assessment of income tax and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2002. The record in this matter was left open until August 18, 2008 to allow for post-hearing memoranda. Taxpayer filed a pre-hearing memorandum. The Section timely filed its response post-hearing memorandum on July 14, 2008. Taxpayer timely filed his reply post-hearing memorandum by postmark dated August 14, 2008. Therefore, this matter is ready for ruling.

FINDINGS OF FACT

Based on information obtained from the Internal Revenue Service (IRS) through the Department's exchange of information agreement with the IRS (I.R.C. § 6103(d)(1)), the Section audited Taxpayer's 2002 Arizona income tax return and disallowed federal Schedule C losses claimed by Taxpayer. The Section also disallowed $[REDACTED] of Taxpayer's medical expense deduction and $[REDACTED] of the miscellaneous itemized deductions claimed on Taxpayer's 2002 Arizona income tax return. Accordingly, the Section issued a proposed assessment for 2002 that included tax and interest.

Taxpayer timely protested the assessment, disagreeing with the Section's adjustments and asserting that he should be allowed all of the deductions claimed. However, at the hearing, the Section stated, and Taxpayer did not argue, that the medical expenses and the miscellaneous deductions were no longer at issue. At issue is the propriety of the Section's proposed assessment of taxes for tax year 2002; more specifically the Schedule C losses.

In 2002, Taxpayer claimed an $83,187 loss on Schedule C of his federal tax return, stemming from expenses related to two yachts owned by Taxpayer. Taxpayer maintains that he was engaged in a "for profit" boat chartering business and that any losses are subject to deductions as a business loss. The Section argues that Taxpayer was not engaged in a "for profit" business, and therefore the losses claimed should not be allowed. The Section also questions the validity of some of the expenses claimed by Taxpayer. However, Taxpayer argues that the issue of substantiation was not mentioned in the assessment; therefore, the Section cannot raise the issue at the hearing.

The revenue, expenses, and losses for Taxpayer's activity from 1997 to 2002 were as follows:

Year	Gross Receipts	Expenses	Profit/Loss
1997	$ 36,177	$ 65,102	($28,925)
1998	$ 82,703	$106,978	($24,275)
1999	$ 50,282	$ 99,463	($49,181)
2000	$113,785	$206,411	($92,626)
2001	$138,641	$227,336	($88,695)
2002	$108,945	$192,132	($83,187)

At the hearing, Taxpayer testified as follows. In 2002 he was a [REDACTED] for [REDACTED]. He liked his job and had always enjoyed flying and believed that if a person did what they loved doing they would never have to "work" a day in their life. Taxpayer had been boating since 1983 but had never owned a large boat. While on a business trip, Taxpayer and his wife saw some larger boats and Taxpayer decided that when he retired he wanted to "do that" instead of fly airplanes. Taxpayer testified that his wife told him that if he could find a way to make money with a boat then he should "go right ahead." That began Taxpayer's quest to purchase a yacht.

Taxpayer looked at various charter management companies on the West coast, in the Virgin Islands, and in Florida and began corresponding with them regarding yachts. He stated that "the more specific [his] questions became about making a profit, the less response [he] got." However, he eventually came across a company called [CHARTER COMPANY], which appears to be a full-service yacht broker and charter company. Consequently, [CHARTER COMPANY] receives a commission or brokerage fee for the boats they sell. Taxpayer testified that he spoke with [MR. O], an owner of [CHARTER COMPANY], who shared documentation with Taxpayer showing previous years' revenues and expenses of some of the boats in their charter fleet. Taxpayer testified that after looking at the numbers, it seemed that there was an opportunity to make a profit if managed correctly. However, Taxpayer did not submit any formal business plan, budget, or calculation for a projected profit/loss for this venture.

Taxpayer provided a copy of a letter from [MR. O] dated November 20, 1996, shortly after Taxpayer visited [CHARTER COMPANY]. In that letter, [MR. O] stated in part as follows:

> 5. Cost vs. Revenue During 1st Year. Generally the 1st year start up costs and commissioning costs will not and cannot be covered by the chartering revenue. I stress the need to be totally realistic and practical in what it costs to properly equip and maintain a complex, 10 or 20 year old vessel. You must be able to afford the boat of your choice whether it is in charter or not. After the first year cost and expenses somewhat settle down, but there is always the unexpected spike, it is best to plan on it occurring. It has been my observation over the years that this is the most ignored part of the boat ownership dream, be realistic.

The language seems to be geared more toward explaining a way to subsidize an individual's "boat ownership dream" rather than a for-profit business venture. Taxpayer subsequently gave [CHARTER COMPANY] a down payment and asked [MR. O] to secure a boat for him.

In 1997, Taxpayer purchased his first boat, a 1980 [REDACTED] 42' yacht that was brokered by [MR. O] and/or [CHARTER COMPANY]. The purchase agreement provided by Taxpayer at the hearing was not signed by the sellers of the boat; therefore, it is unclear whether this was a proposal or the final agreement. Taxpayer named this yacht "[BOAT #1]." Taxpayer testified that the yacht was then placed into a yacht management agreement with [CHARTER COMPANY]. The terms of the agreement are not clear, as Taxpayer was unable to provide a copy of the management agreement. However, Taxpayer testified that the revenue received from [BOAT

#1]'s charters would be allocated 45% to [CHARTER COMPANY] and 55% to Taxpayer.

Although Taxpayer experienced significant losses in 1997 and 1998,[1] Taxpayer decided to purchase another boat. In July of 1999, Taxpayer purchased a second boat, "[BOAT #2]," a 1979 32' [REDACTED] yacht. This too was placed into a yacht management agreement with [CHARTER COMPANY] where the revenue was apparently split 50%-50% between Taxpayer and [CHARTER COMPANY].[2]

Taxpayer has testified in writing and at the hearing that from 1997 through 2005 he spent approximately 100 total hours of personal pleasure time captaining the yacht(s). However, he testified that he spent approximately 500 hours per year working on the boats. Taxpayer provided written and verbal testimony that he travelled to Florida approximately 2-3 times per year and performed such duties as: painting, preparing and varnishing teak railing, plumbing repair, replacing pumps, maintaining air conditioning systems, replacing windows and Plexiglas, and other various maintenance and upkeep of the boats. At the hearing, [Mr. M], a fleet manager at [CHARTER COMPANY] during 2002, testified that Taxpayer was frequently involved in the maintenance of the boats. When asked by Taxpayer's attorney whether the maintenance was enjoyable or just hard work, [Mr. M] stated that

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[1] Taxpayer referred to 1998 as a "banner year" despite having reported a $24,275 loss for the year.

[2] At the hearing, Taxpayer placed into the record a management agreement for [BOAT #2] between Taxpayer and [CHARTER COMPANY]. However, the management agreement was not signed by [CHARTER COMPANY].

although the maintenance was hard work, it was also enjoyable because it was rewarding. Specifically, he testified as follows:

> Is it fun to pull the top off of a waste collection tank in the bottom of the boat . . . and replace hoses and fittings and things that are leaking because the odors don't appeal to charterers? No, that's not fun. Is varnishing a handrail to where it shines in the sun and the dew sparkles off of it in the morning. Is that fun? Yeah, that's a lot of fun because you can see the rewards of your hard work.

The expenses listed on [CHARTER COMPANY]'s "Boat Activity Summary" for tax year 2002 showed that Taxpayer paid $134,929 in commissions, fees and expenses to [CHARTER COMPANY] for the two boats in 2002. However, the remaining $57,203 of the $192,132 expenses claimed by Taxpayer on Schedule C of his 2002 federal return was not accounted for at the hearing. Taxpayer's representative stated, in a letter dated June 28, 2007, that Taxpayer has a log book of travel, work performed, and time spent on the activity. However, none of that documentation was submitted at the hearing.

CONCLUSIONS OF LAW

At issue is whether the Section properly disallowed Taxpayer's federal Schedule C losses for tax year 2002. Because the issue in this matter pertains to expenses and deductions, it is important to note that "tax deductions, subtractions, exemptions, and credits are to be strictly construed" against the taxpayer. *Arizona Dep't of Revenue v. Raby*, 204 Ariz. 509, 511, 65 P.3d 458, 460 (App. 2003) (citing *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969)).

I.R.C. § 162(a) provides in pertinent part that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." However, in order for business expenses to be deductible in excess of gross income from an activity, a taxpayer must have conducted the activity with the intent to make a profit. *See* I.R.C. § 183(a); *see also Elliott v. Commissioner*, 90 T.C. 960, 970 (1988), *affd.* 899 F.2d 18 (9th Cir. 1990). Alternatively, a taxpayer may claim a deduction under I.R.C. § 183(b)(2), but only to the extent of the income derived from the activity.

Since Taxpayer is seeking to claim expenses that in the aggregate will exceed Taxpayer's gross income from the activity, it is necessary to determine whether the activity at issue was engaged in for profit. With respect to determining whether an activity is engaged in for profit, I.R.C. § 183(d) provides the following presumption:

> If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, . . . such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit.

If a taxpayer meets the criterion set forth in I.R.C. § 183(d), the activity is presumed to be engaged in for profit and the taxing entity has the burden of proof to rebut this

presumption. Nothing in the statute states that where a taxpayer does not meet the criterion set forth in I.R.C. § 183(d), there is a presumption that the activity was not engaged in for profit. However, an assessment of additional income tax is presumed correct. *Arizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948). Therefore, if the taxing authority has determined that the activity was not engaged in for profit, the taxpayer has the burden of proving that the taxing authority's determination is incorrect and that their activities were engaged in for profit.

Taxpayer purchased his first boat and placed it in charter service in 1997. He did not make a profit in any of the tax years from the inception of the activity up to and including the year at issue. Therefore, he is not entitled to the presumption under I.R.C. § 183(d). Rather, he has the burden of proving that the Section's determination is incorrect and that his activity was engaged in for profit.

Treas. Reg. § 1.183-2(a) states that "[t]he determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case." The regulation further states that "the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit." *Id.* The Supreme Court determined that "the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987) (emphasis added).

In determining whether an activity is engaged in for profit, Treas. Reg. § 1.183-2(b) states that among the factors that should normally be taken into account are: 1) the manner in which the taxpayer carries on the activity, 2) the expertise of the taxpayer or his advisors, 3) the time and effort expended by the taxpayer in carrying on the activity, 4) the expectation that assets used in the activity may appreciate in value, 5) the success of the taxpayer in carrying on other similar or dissimilar activities, 6) the taxpayer's history of income or losses with respect to the activity, 7) the amount of occasional profits, if any, which are earned, 8) the financial status of the taxpayer, and 9) the elements of personal pleasure or recreation involved in the activity.

No single factor is determinative. Rather, whether a taxpayer possesses the relevant profit objective is a question of fact to be determined in light of all the facts and circumstances. *See* Treas. Reg. § 1.183-2(b). However, "greater weight is given to objective facts than to the taxpayer's mere statement of his intent." Treas. Reg. § 1.183-2(a). With the above in mind, the Hearing Office considers the evidence presented pertaining to these factors.

Factor (1) *Manner in Which the Taxpayer Carried on the Activity*.

The regulations state that facts showing "the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books" may indicate the activity was engaged in for profit. Treas. Reg. § 1.183-2(b)(1). There was no

testimony or record that Taxpayer had developed any formal business plan, budget, or calculation for a projected profit/loss for this venture prior to purchasing his first yacht. Taxpayer's representative stated in the Hearing Memorandum that Taxpayer and [CHARTER COMPANY] "kept detailed and appropriate records," and had previously made reference to a log book of travel, work performed and time spent on maintenance. However, none of that documentation was presented or submitted at the hearing.

With respect to this first factor, the regulations also state that, "[a] change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive." Treas. Reg. § 1.183-2(b)(1). Taxpayer testified that in an effort to save on the cost of maintaining the boats, he personally performed some of the maintenance required. However, after reporting losses of $28,925 and $24,275 in 1997 and 1998 respectively, he decided to purchase a second boat in 1999. This does not seem reasonable if income or profit was his primary motivation.

Factor (2) *The Expertise of the Taxpayer or His Advisors.*

When Taxpayer purchased his first boat, he had no previous experience in owning or chartering a yacht.[3] Therefore, Taxpayer consulted with and utilized the services of [CHARTER COMPANY] to assist him with chartering out his boats. [CHARTER COMPANY] was in the business of charter boat management, and had the ability to

[3] Over the years Taxpayer did develop significant knowledge and experience in chartering and maintaining a yacht.

advertise the boats and provide captain services for charters when necessary, for which [CHARTER COMPANY] charged a fee or commission. However, according to its website,[4] [CHARTER COMPANY]'s fleet consists of privately-owned yachts rather than its own yachts. Thus, [CHARTER COMPANY] did not likely have experience as a boat owner trying to run a profitable charter business.

When deciding whether to purchase the first yacht, Taxpayer testified that he consulted with and relied on statements made by [Mr. O], an owner of [CHARTER COMPANY]. [MR. O], and/or [CHARTER COMPANY], had a pecuniary interest in Taxpayer's acquisition of a boat. [CHARTER COMPANY] would not only receive a commission from the sale of such a boat to Taxpayer, they would also receive commissions and fees from placing such a boat into their charter fleet. The U.S. Tax Court has noted that "a taxpayer's reliance on the advice of someone who the taxpayer knew, or should have known, had a conflict of interest may not be reasonable." *Magassy v. Commissioner*, T.C. Memo. 2004-4, 87 T.C.M (CCH) 791 (U.S. Tax Ct. 2004). Consequently, relying on [MR. O]'s advice may not have been reasonable under the circumstances. Taxpayer also testified that while he corresponded with other charter management companies, "the more specific [his] questions became about making a profit, the less response [he] got." This should have been another warning sign that making a profit would be unlikely.

Factor (3) *The Time and Effort Expended by the Taxpayer in Carrying on the Activity.*

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[4] Found at [REDACTED].

Taxpayer had a full time job in Arizona, and was not able to devote his full-time efforts to chartering the boat. Even so, Taxpayer testified that he travelled to Florida when able and spent approximately 500 hours per year in activities related to the boat chartering. Much of this, he testified, involved physically working on the boat. There is no doubt that Taxpayer spent "much of his personal time and effort to carrying on [the] activity." Treas. Reg. § 1.183-2(a)(3). However, as [Mr. M] testified, while this involved hard work, it was also somewhat enjoyable and rewarding.

Factor (4) *The Expectation That Assets Used in the Activity May Appreciate in Value.*

According to [Mr. M]'s testimony at the hearing, if properly maintained, yachts such as the ones purchased by Taxpayer tend to "hold their value." However, Taxpayer did not state that he intended to receive a large profit from the sale of the boats. Taxpayer states in his hearing memorandum that "at least the second boat showed a taxable gain." When depreciation is taken into account, this does not necessarily mean that the boat sold for a profit.

Factor (5) *The Success of the Taxpayer in Carrying On Similar or Dissimilar Activities.*

No evidence was presented at the hearing regarding Taxpayer's success in making other similar or dissimilar activities profitable. Therefore, this factor is not relevant.

Factors (6) and (7) *The Taxpayer's History of Income or Losses With Respect to the Activity and the Amount of Occasional Profits, If Any, Which Were Earned.*

Treas. Reg. § 1.183-2(b)(6) provides in part as follows:

> A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.

Taxpayer did not make a profit at any time up to and including the year at issue. In these first six years, Taxpayer had reported cumulative losses totaling $366,889. This seems well beyond a start-up stage. Taxpayer asserts that the events of September 11, 2001 caused a severe and unforeseeable downturn in his business and a loss in value. Clearly the events of September 11, 2001 had a negative affect on the revenue of many U.S. businesses, and it must have had a negative effect on Taxpayer's revenue. However, when comparing Taxpayer's losses in the year before and after, there is not a significant difference in the amount of losses reported. Taxpayer's pattern of losses seem to stem more from the continuously high expenses incurred each and every year rather than a single event.

Despite Taxpayer's efforts to save on the cost of maintaining the boats, [CHARTER COMPANY] still charged him $70,906 for repairs and maintenance on the two boats during 2002. When combined with the $64,023 of commissions and fees charged by [CHARTER COMPANY], the amounts paid to [CHARTER COMPANY] alone, exceeded Taxpayer's 2002 revenue by $25,984. This loss was before any depreciation or

other expenses were taken into account. At such a ratio, the likelihood of Taxpayer ever making a profit was minimal.

Factors (8) and (9) *The Financial Status of the Taxpayer and the Elements of Personal Pleasure or Recreation.*

"Substantial income from sources other than the activity, (particularly if the activity's losses generate substantial tax benefits) may indicate that the activity is not engaged in for profit." Treas. Reg. § 1.183-2(b)(8). This is especially true where "there are personal or recreational elements involved." *Id.*

Taxpayer had wage income of $[REDACTED] during 2002. It appears that he was not relying on the boat chartering activities for his economic sustenance, and that the losses could generate substantial tax benefits. Indeed, Taxpayer used his $83,187 loss from his charter boat activities to offset a large portion of his wage income. Although not discussed at length in the hearing, there are tax benefits to chartering a yacht. On its website, [CHARTER COMPANY] even refers to some of these tax benefits.[5]

Taxpayer testified that between 1997 and 2005 he only spent approximately 100 hours of personal pleasure time sailing his boats. While this may be less use that someone with significantly more free time, yachting, by its nature, is a recreational activity, and Taxpayer did enjoy it. Additionally, as [Mr. M] testified, even performing difficult work on the boat was often rewarding and could be enjoyable.

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[5] In noting the benefits of charter ownership, [CHARTER COMPANY] states that there are "tax advantages associated with charter yacht ownership, including deferral of state sales tax on purchase, and deductions for operating expenses, depreciation, and interest against your charter revenues." Website [REDACTED].

Having considered all of the objective factors above, it is evident that Taxpayer would have liked to make a profit. However, "[c]hartering a yacht to others in order to afford to keep it through tax savings for one's personal enjoyment is not the same as having a profit objective." *Antonides v. Commissioner*, 91 T.C. 686, 697 (1988), *affd.* 893 F.2d 656 (4th Cir. 1990). Given the Taxpayer's significant continued losses over a sustained period of time and the recreational nature of yachting, the evidence seems to indicate that Taxpayer did not engage in this activity with the primary objective of making a profit. Rather, the Hearing Office concludes that it is more likely that Taxpayer's motivation for purchasing a boat was due to his love of boats, his desire to engage in boating after retirement, and the potential tax benefits available. Taxpayer stated that while on a business trip in Florida, he looked at yachts and decided he wanted to purchase one. Taxpayer testified that it was his wife that brought up the issue of profit, not him. A profit motive on the part of the Taxpayer seemed to be secondary to his desire to own and use a boat after retirement.

Based on the above, the Hearing Office upholds the Section's disallowance of Taxpayer's Schedule C losses. Because the disallowance of Schedule C losses is upheld in full, it is not necessary to address Taxpayer's argument regarding the issue of substantiation.

As to the interest portion of the assessment, A.R.S. § 42-1123.C provides that if the tax "or any portion of the tax is not paid" when due "the department shall collect, as a part of the

tax, interest on the unpaid amount" until the tax has been paid. Therefore, interest is a part of the tax and generally may not be abated unless the tax to which it relates is found not to be due for whatever reason. The tax was due in this case and the associated interest cannot be abated.

Regarding Taxpayer's request for reimbursement of fees and other costs, the Hearing Office cannot address or render a ruling on this request. A.A.C. R15-10-401 provides specific instructions for such requests and requires a taxpayer seeking the reimbursement of such fees and costs to "file a written application with the Department's problem resolution officer" rather than the Hearing Office.

Based on the foregoing, the Section's proposed assessment is affirmed.

DATED this 15th day of September, 2008.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by
certified mail to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Individual Income Tax Audit Section