



9. The Section agreed that Taxpayer was a day-trader engaged in the business of buying and selling securities for his own account.
10. Taxpayer did not sell securities to customers.
11. The Section contends that even a day-trader engaged in the business of buying and selling securities has to report his investment gains and losses as capital gains and losses and his capital loss deduction is limited to a maximum of \$3,000 in excess of his capital gains.
12. Taxpayer disagreed with the modified proposed assessment to the extent it disallowed Taxpayer's Schedule C loss and Schedule C expense of \$[REDACTED] paid for computer repair. Taxpayer agreed to the other adjustments in the Section's modified proposed assessment.
13. The Section did not consider the computer repair expense reasonable because Taxpayer could have purchased a new computer for the same amount or less.
14. The Section did not question that Taxpayer used the computer in his investing business.
15. Taxpayer testified he paid to have his computer repaired because Taxpayer's accounting program would not operate on a new computer with a Windows operating system. It was therefore necessary to repair the old computer.
16. Taxpayer testified that he did not make a mark-to-market election for tax year 2006.

#### CONCLUSIONS OF LAW

1. Arizona Revised Statutes (A.R.S.) § 43-1001(2) defines Arizona gross income of a resident individual as the individual's federal adjusted gross income for the taxable year, computed pursuant to the Internal Revenue Code (I.R.C.).
2. The intent of the Arizona legislature was to adopt the provisions of the federal Internal Revenue Code relating to the measurement of adjusted gross income for

individuals so that federal adjusted gross income reported to the Internal Revenue Service shall be the identical sum reported to Arizona, subject only to modifications set forth in Title 43 of the Arizona Revised Statutes. A.R.S. § 43-102(A)(1).

3. Arizona taxpayers may deduct on their Arizona income tax return itemized deductions calculated under the Internal Revenue Code. A.R.S. § 43-1042.
4. 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.”
5. The burden is on the taxpayer to show he is entitled to a deduction or exemption from tax. See *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969).
6. Taxpayer demonstrated that the computer repair expense in the amount of \$1,465 was an ordinary and necessary expense entitled to be deducted.
7. I.R.C. § 1211(b) provides that in the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus, if the losses exceed the gains, the lower of \$3,000 or the excess of the losses over the gains.
8. I.R.C. § 1221 provides that a capital asset is property held by the taxpayer (whether or not connected with his trade or business), but excludes from capital assets: (1) property of a kind which would properly be included in the inventory of the taxpayer; (2) real property or other depreciable property used in the taxpayer's trade or business; (3) a copyright, a literary, musical, or artistic composition, or similar property; (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of inventory; and (5) publications of the Federal Government.

9. A person who purchases and sells securities falls into one of three distinct categories: dealer, trader, or investor. See *King v. Commissioner*, 89 T.C. 445, (1987).
10. A dealer's business involves sales to customers in the ordinary course of that business. *Frank Chen v. Commissioner*, TC Memo 2004-132 (2004).
11. Only the dealer's securities fall within the exception to capital asset status that is provided for "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business". *Frank Chen v. Commissioner, supra*.
12. Securities such as stocks and commodities, unless held by a dealer of the securities, fall within the definition of "capital asset" in I.R.C. § 1221, and are outside the statutory exclusions. See, *Arkansas Best Corp. v. C.I.R.* 485 U.S. 212, 108 S.Ct. 971 (1988); *Frank Chen v. Commissioner, supra*.
13. Taxpayer did not hold securities for sale to his customers in the ordinary course of his business. Taxpayer was not a dealer of securities.
14. Taxpayer was a trader engaged in the trade or business of buying and selling securities for his own account.
15. The income or loss from sales of exchanges of securities by a trader or by an investor produces capital gains or losses rather than ordinary income or loss. *Frank Chen v. Commissioner, supra*.
16. Even though Taxpayer was a trader, his losses from his commodities transactions were capital losses limited to a maximum of \$3,000 in excess of his capital gains for tax year 2006.
17. Because Taxpayer already reported a capital loss of \$3,000 from his other investments, Taxpayer is not entitled to any additional capital loss for tax year 2006 due to his investment losses at issue. Those losses may be carried forward to future years as provided by the Internal Revenue Code.

18. Traders in securities and commodities may make a mark-to-market election that allows them to treat their gains and losses as ordinary and not capital. See, I.R.C. § 475(f).
19. A timely election must first be made and appropriate records kept.
20. Taxpayer did not make a mark-to-market election for tax year 2006 and is therefore not entitled to a mark-to-market treatment.
21. 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.
22. The proposed assessment issued by the Section for tax year 2006 was proper except the Section shall allow Taxpayer an additional Schedule C expense deduction in the amount of \$[REDACTED] for computer repair.

#### DISCUSSION

Taxpayer timely filed his 2006 Arizona income tax return. Taxpayer's federal tax return showed a Schedule C loss of \$[REDACTED] and Schedule C expenses of \$[REDACTED] and \$[REDACTED]. Taxpayer's Schedule C loss and expenses were generated by Taxpayer's investment activities in securities (commodities). The Section audited Taxpayer and disallowed his Schedule C loss and Schedule C investment expenses.

Taxpayer protested and submitted additional information. The Section thereafter issued a modified proposed assessment allowing Taxpayer a portion of his Schedule C expenses, but continued to disallow all of Taxpayer's Schedule C losses. Taxpayer disagreed and requested a hearing. Two questions were presented for decision at the hearing in this matter:

- Can Taxpayer deduct the cost of repairing an old computer?
- Can Taxpayer deduct the full amount of his investment losses?

### **Deduction of Computer Expenses.**

Taxpayer paid \$[REDACTED] for repairs to an older computer. The Section did not dispute the amount or that Taxpayer did have a computer repaired, but disallowed the deduction because it believed Taxpayer could have purchased a new computer for that amount. The Section did not cite any authority for its position.

Taxpayer testified he paid to have his computer repaired because Taxpayer's accounting program would not operate on a new computer with a Windows operating system. It was therefore necessary for Taxpayer to repair his old computer. Based on these facts, Taxpayer was entitled to deduct the cost of the repair as an ordinary and necessary business expense.

### **Deduction of Investment Losses.**

The parties agree that Taxpayer was a trader, engaged in the business of trading commodities. Taxpayer contends he properly deducted all of his investment losses on his Schedule C. This case thus presents the issue of how a trader may deduct his investment losses on his income tax return.

Income and losses may be categorized as ordinary income and losses or capital gains and losses. Generally, a taxpayer's losses from engaging in a business may be taken as a deduction. However, capital losses in excess of capital gains are limited to a maximum of \$3,000 per year. Any excess loss may be carried forward to future tax years.

As the court stated in *King v. Commissioner, supra*, a person who purchases and sells securities falls into one of three distinct categories: dealer, trader, or investor. How a taxpayer reports his investment income and losses depends into which category the taxpayer falls.

### **Security Dealers.**

A dealer in securities is engaged in the business of selling securities to customers in the ordinary course of that business. A dealer's securities fall within the

exception to capital asset status because it is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Because a dealer is selling inventory and not a capital asset, his income or loss from the sales of securities constitutes ordinary income or loss. There is no contention that Taxpayer here was a dealer in securities.

### **Security Traders and Investors.**

Both a trader and an investor are engaged in the activity of buying and selling securities for their own account. A trader buys and sells securities with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit from such movements on a short-term basis.” *Liang v. Commissioner*, 23 T.C. 1040 (1955). A trader’s activities are substantial, frequent, regular, and continuous and thus constitute a business.

Since a securities trader is engaged in business, his investment expenses are ordinary and necessary business expenses. He may deduct those expenses on his Schedule C. However, because the trader is buying and selling securities for his own account and not selling inventory to his customers, the trader is selling a capital asset. As such, any gain or loss from the trader’s transactions in securities is a capital gain or loss. Therefore, even though a trader is engaged in business, his investment losses are capital losses and not ordinary losses. Capital losses are limited each year to a maximum of \$3,000 in excess of capital gains. Even though Taxpayer was a trader in securities, the Section properly disallowed his Schedule C loss.

### **Mark-to-Market Election.**

Traders in securities and commodities may make a mark-to-market election that allows them to treat their gains and losses as ordinary and not capital. See, I.R.C. § 475(f). But a timely election must first be made and appropriate records kept. Without the election, the gains and losses of traders are treated as capital and not

ordinary. Taxpayer did not make a mark-to-market election for tax year 2006 and is therefore not entitled to a mark-to-market treatment.

The assessment included interest. 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. The accruing interest included in the proposed assessment was proper.

Based on the foregoing, the Section's proposed assessment dated November 2, 2011 is upheld in part. The Section shall allow Taxpayer an additional Schedule C expense deduction in the amount of \$[REDACTED] for computer repair.

DATED this 24th day of May, 2012.

ARIZONA DEPARTMENT OF REVENUE  
HEARING OFFICE

[REDACTED]  
Hearing Officer

Original of the foregoing sent by  
certified mail to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue  
Individual Income Tax Audit Section