

7. The Section disallowed Taxpayers' Schedule C expenses because it considered Taxpayer an investor rather than a trader in securities and an investor can only deduct investment expenses as a miscellaneous itemized deduction on form Schedule A.
8. A taxpayer's miscellaneous itemized deduction for investment expenses is limited to amounts in excess of the taxpayer's FAGI.
9. The proposed assessment included interest but no penalties.
10. Taxpayers protested the assessment stating that Taxpayer traded options on the stock market as full-time work and Taxpayer was therefore a trader and could deduct her investment expenses on Schedule C.
11. Taxpayers paid the assessment under protest.
12. Taxpayers' 2007 federal income tax return showed wages and salaries of \$[REDACTED] earned by [REDACTED].
13. Taxpayers testified at the hearing that [REDACTED] worked on her trading activity every day when the market was open. Time not spent on trading options was spent on following the market and researching and analyzing options.
14. Taxpayers provided a log of option trades showing that:
 - a. Taxpayer executed 38 trades during 2007.
 - b. Taxpayer traded on 35 days during 2007.
 - c. Taxpayer did not execute any trades during the months of February and August 2007.
 - d. Taxpayer executed between 2 and 7 trades during the other months of 2007.
 - e. Taxpayers purchased options of \$[REDACTED] and sold options of \$[REDACTED] during 2007.
15. Taxpayers' post-hearing submission included trading logs for tax years 2008 through 2012 listing the number of trades for those years as follows:

Year	Trades
2008	41
2009	27
2010	36
2011	55
2012	62

16. The Section stated in its post-hearing memorandum that it was able to verify investment expenses of \$[REDACTED] of Taxpayer's claimed expenses of \$[REDACTED].
17. Two percent of Taxpayers' FAGI, after the disallowance of a deduction of the Schedule C expenses, was \$[REDACTED].
18. Taxpayers did not submit substantiation for the investment expenses not verified by the Section.

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. 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).

5. A person who purchases and sells securities such as stocks or commodities falls into one of three distinct categories: dealer, trader, or investor. See *King v. Commissioner*, 89 T.C. 445 (1987).
6. A dealer sells securities to customers in the ordinary course of his business. *Frank Chen v. Commissioner*, TC Memo 2004-132 (2004).
7. Taxpayers did not hold securities for sale to customers in the ordinary course of their business. Taxpayers were not dealers of securities.
8. A trader is engaged in the trade or business of buying and selling securities for his own account. *Frank Chen v. Commissioner*, *supra*.
9. I.R.C. § 162(a) allows a deduction for a taxpayer's ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.
10. A trader may deduct his allowable investment expenses on Schedule C as business expenses under I.R.C. § 162(a).
11. Investment expenses incurred by an investor for the production or collection of income are not ordinary and necessary business expenses.
12. Investment expenses of an investor may only be deducted as a miscellaneous itemized deduction on the investor's Schedule A. I.R.C. § 212.
13. The deduction allowed by I.R.C. § 212 is limited to the extent the aggregate of such deductions exceeds two percent of the Taxpayers' adjusted gross income. I.R.C. § 67(a).
14. In order to qualify as a trader (as opposed to an investor), Taxpayers' purchases and sales of securities during the tax year must have constituted a trade or business.
15. In determining whether a taxpayer who manages his own investments is a trader, and thus engaged in a trade or business, relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the

- activity, and the frequency, extent, and regularity of the taxpayer's securities transactions." *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983).
16. For a taxpayer to be considered a trader, the taxpayer's trading activity must be substantial, frequent, regular, and continuous. *Boatner v. Commissioner*, T.C. Memo. 1997-379 (1997), affd. 164 F.3d 629 (9th Cir. 1998).
 17. Also, investors generally purchase and hold securities for capital appreciation and income whereas traders buy and sell with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. *Liang v. Commissioner*, 23 T.C. 1040 (1955).
 18. Taxpayers' trading activity during 2007 was not substantial, frequent, regular, and continuous.
 19. Taxpayers were investors in securities in tax year 2007.
 20. Taxpayers have not produced documentation to substantiate the claimed investment expenses not verified by the Section.
 21. The Section properly disallowed Taxpayers' Schedule C business expenses.
 22. Taxpayers' verified investment expenses qualifying as miscellaneous itemized deductions on Schedule A totaled less than Taxpayers' standard deduction.
 23. The standard deduction is in lieu of all itemized deductions allowed by A.R.S. § 43-1042. A.R.S. § 43-1041(B). A taxpayer therefore cannot claim both itemized deductions and the standard deduction.
 24. 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.
 25. Because Taxpayers paid the tax and interest protested, this matter is treated as a protest of a denial of a claim for refund. A.R.S. § 42-1118(I).
 26. The Section's proposed assessment dated February 29, 2012 for tax year 2007 is upheld and Taxpayers are not entitled to a refund of the taxes or interest paid.

DISCUSSION

Taxpayers timely filed their 2007 Arizona income tax return. Taxpayers' federal tax return showed Schedule C expenses of \$[REDACTED]. Taxpayers' Schedule C expenses were related to Taxpayer's investment activities of purchasing and selling securities (options). The Section audited Taxpayers and disallowed their Schedule C investment expenses because the Section considered Taxpayers investors rather than traders in securities. A trader can deduct his investment expenses as business expenses on Schedule C. An investor can only deduct investment expenses as a miscellaneous itemized deduction on Schedule A subject to a limitation.¹

Taxpayers protested arguing that Taxpayer traded options on the stock market as full-time work and Taxpayer was therefore a trader who could deduct investment expenses on Schedule C. The burden is on Taxpayer to show she was a trader. For the reasons that follow, we find that Taxpayer was an investor and not a trader in securities.

There is no bright-line test to determine whether a person is a trader or investor in securities. To qualify as a trader, a taxpayer's trading activities must be substantial, frequent, regular, and continuous. 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, supra*.

In cases where taxpayers were held to be traders, the number of transactions indicated that they were engaged in market transactions on an almost daily basis for a substantial and continuous period, generally exceeding a single year. In addition, those activities constituted the taxpayer's sole or primary income producing activity. (See discussion in *Moller v. United States, supra* and *Frank Chen v. Commissioner supra*).

¹ Also, an investor can either itemize deductions, including investment expenses, or take a standard deduction, whichever is greater, but not both. Here, Taxpayers' standard deduction was larger than their itemized deductions. A trader on the other hand can claim his investment expenses on Schedule C and also claim either an itemized deduction for other deductible expenses or the standard deduction.

Here, Taxpayer's trading activity during 35 days of the year consisting of 38 trades is not substantial, frequent, regular or continuous. The level of Taxpayer's trading activity was more in line with or even less than the activity in cases holding taxpayers to be investors. For example, in *Thomas A. Endicott v. Commissioner*, TC Memo 2013-199 (2013) the court did not consider the taxpayer's trading activity during 75, 99, and 112 days over a three year period to be substantial enough to qualify as a trader. See also *William G. Holsinger v. Commissioner*, TC Memo 2008-191 (2008) where the court found doubtful that taxpayers who executed 289 trades in Year 1 and 372 trades in Year 2, but traded on only 63 days in Year 1 (representing less than 40% of the trading days for that year) and on only 110 days in Year 2 (representing less than 45% of the trading days for that year) were conducting the activity with the frequency, continuity, and regularity indicative of a business.

In *Stephen A. Paoli v. Commissioner*, TC Memo 1991-351 (1991), while taxpayer reported 326 sales of stock or options worth more than \$9 million during the tax year, forty percent of the sales were made during a one-month period and taxpayer made only one sale and didn't buy any stock during a three-month period. The court found the taxpayer to be an investor because his pattern of buying and selling stocks wasn't sufficiently regular and continuous throughout the year.

Taxpayers testified that every day they would research and follow the market to determine which securities to trade. However, the substantial, frequent, regular, and continuous activity considered is not the activity of researching and investigating opportunities. The substantial, frequent, regular, and continuous activity refers to actual purchase/sale transactions. In *Rudolph W. Steffler v. Commissioner*, TC Memo 1995-271 (1995), the court held that the taxpayer's activity wasn't frequent, regular, or continuous enough to amount to a trade or business even though the taxpayer spent 40-60 hours per week on his commodities activities but traded on only 5 to 12 days

each year, bought only 16 to 44 commodities contracts each year, and bought only five different commodities.

Similarly, in *ACAR v. U.S.*, 98 AFTR 2d 2006-6296 (2006) taxpayer devoted 6 to 8 hours a day nearly every day to his trading activities and his average number of trades for the year amounted to approximately twice a day for the twelve month period. The court however held that those facts did not necessarily make taxpayer a trader because taxpayer's trades occurred on less than half the days of each month, and did not take place at all during the months of June, July and August. The taxpayer's trading activity was not regular and continuous throughout the year.

Finally, Taxpayers' investment activity was not their sole or primary income producing activity. While Taxpayers reported a \$[REDACTED] capital loss for the year, they reported wages of \$[REDACTED] earned by [REDACTED]. Taxpayers have thus not established that Taxpayer [REDACTED] was a trader in options for tax year 2007.

Because Taxpayer was not a trader, the Section properly considered Taxpayers investors. An investor incurs his expenses for the production or collection of income which are deductible under I.R.C. § 212. The deduction allowed by I.R.C. § 212 is a miscellaneous itemized deduction on Taxpayers' Schedule A limited to amounts in excess of two percent of the Taxpayers' adjusted gross income. The Section thus properly disallowed Taxpayers' Schedule C expenses and properly calculated a Schedule A miscellaneous itemized deduction amount subject to the limit.

Taxpayers' verified Schedule A expenses in excess of the federal limit was less than Taxpayers' standard deduction. The proposed assessment therefore continued to allow the standard deduction.

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 interest included in the proposed assessment was proper.

Based on the foregoing, the Section's proposed assessment dated February 29, 2012 is upheld and Taxpayers' protest is denied.

DATED this 5th day of November, 2013.

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