BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of [REDACTED] TID # [REDACTED]	)	DECISION OF HEARING OFFICER Case No. 201400106-I

A hearing was held on June 12, 2014 in the matter of the protest of [REDACTED] and [REDACTED] (Taxpayers) to assessments of income tax and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax years 2009 and 2010. At the hearing it was determined to return the matter to informal status.

The Order returning the matter to informal status provided that the matter could be reset for formal hearing upon motion by either party. At the Section's request, a hearing was scheduled for and held on October 23, 2014. At the hearing it was agreed that the record remain open to allow the parties time to provide additional information.

Taxpayers and the Section timely submitted their respective Opening information and Response memorandum. Taxpayers did not submit a Reply. This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayers filed federal and Arizona income tax returns for 2009 and 2010.
2. Taxpayers showed Schedule C expenses of $[REDACTED] for 2009 and a loss of $[REDACTED] for 2010.
3. The Section reviewed Taxpayers' 2009 and 2010 returns and issued the following proposed assessments:
    a. Assessment dated April 3, 2013 for tax year 2009 disallowed Taxpayers' Schedule C expenses of $[REDACTED].

b. Assessment dated October 23, 2013 for tax year 2010 disallowed Taxpayers' Schedule C losses of $[REDACTED] and disallowed a portion of Taxpayers' miscellaneous itemized deductions subject to a 2% limitation.

4. The assessments calculated interest at the statutory rate. No penalties were imposed.

5. Taxpayers timely protested the assessments and submitted additional information for tax year 2009, including a copy of their 2009 Schedule C showing income of $[REDACTED] and a loss of $[REDACTED].

6. Based on the additional information, the Section issued a modified proposed assessment dated October 30, 2013 for tax year 2009 that disallowed Taxpayers' Schedule C loss (expenses in excess of the income) of $[REDACTED].

7. Taxpayers did not provide a log of activities showing time spent on the activity and the time spent racing.

8. Taxpayers have shown no profit for years 2005 through 2011 and have claimed losses in the total amount of $[REDACTED].

9. Taxpayers stated at the hearing that:

   a. The activity at issue was [REDACTED] racing by Taxpayers' [REDACTED] and [REDACTED] (children).

   b. Taxpayers' children began racing when they were minors. During tax years 2009 and 2010 the children were adults.

   c. During 2009 and 2010 the children were responsible for contacting sponsors to support the racing effort.

   d. The children entered into their own sponsor contracts during 2009 and 2010.

   e. Taxpayers hoped to create an opportunity for the children to take the business and create a profession.

   f. Taxpayers paid most of the expenses for the children's racing.

g. Taxpayer [REDACTED] served as the primary manager of the business and provided mechanic support at home and Taxpayer [REDACTED] maintained the books and records and handled the finances.

h. Neither Taxpayer participated in [REDACTED] racing as a contestant.

i. During 2009 and 2010 Taxpayers' children went to races on their own and decided where to race.

j. Taxpayers' [REDACTED] served as their [REDACTED]'s mechanic at the races.

k. The children tried to do everything to make the racing a successful business venture independently.

10. The Section stated at the hearing that:

a. Taxpayers had substantial other income and Taxpayers were not relying on the racing activity to support themselves during 2009 and 2010.

b. The activity involved elements of personal pleasure.

c. Taxpayers have not shown that they conducted the activity in a business-like manner.

d. Taxpayers did not show that the activity had a propensity for economic growth.

11. Taxpayers reported the following gross receipts, expenses and losses for tax years 2005 through 2011:

Year	Receipts	Expenses	(Loss)
2005	[REDACTED]	[REDACTED]	([REDACTED])
2006	[REDACTED]	[REDACTED]	([REDACTED])
2007	[REDACTED]	[REDACTED]	([REDACTED])
2008	[REDACTED]	[REDACTED]	([REDACTED])
2009	[REDACTED]	[REDACTED]	([REDACTED])
2010	[REDACTED]	[REDACTED]	([REDACTED])
2011	[REDACTED]	[REDACTED]	([REDACTED])
Totals	[REDACTED]	[REDACTED]	([REDACTED])

12. Taxpayers had other full-time employment during tax years 2009 and 2010 and reported wages and salaries of $[REDACTED] for 2009 and $[REDACTED] for 2010.

13. Taxpayers had no partnership or other agreement with their [REDACTED] or [REDACTED] or other written documentation indicating how the activity is to be run or how the expenses or profits would be divided.

14. Taxpayers have not provided evidence showing that they devoted significant time to their children's racing activity or to establishing a racing team.

CONCLUSIONS OF LAW

1. The presumption is that an assessment of additional income tax is correct. A*rizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948).

2. Once the presumption of correctness attaches, the taxpayer must present substantial credible and relevant evidence sufficient to establish that the assessment was erroneous. *U.S. v. McMullin,* 948 F.2d 1188 (10th Cir., 1991); *Anastasato v. C.I.R.*, 794 F.2d 884 (3rd Cir.,1986).

3. 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).

4. Arizona taxpayers may deduct on their Arizona income tax return itemized deductions calculated under the Internal Revenue Code (I.R.C.). Arizona Revised Statutes (A.R.S.) § 43-1042.

5. I.R.C. § 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

6. To be in a trade or business, a taxpayer must be regularly and actively involved in the activity. *See Stanton v. Commissioner,* 399 F.2d 326, 329-30 (5th Cir.1968); *McDowell v. Ribicoff,* 292 F.2d 174, 178 (3d Cir. 1961), *cert. denied,* 368 U.S. 919,

82 S.Ct. 240, 7 L.Ed.2d 135 (1961); *Daily Journal Co. v. Commissioner,* 135 F.2d 687, 688 (9th Cir.1943).

7. The activity must have been conducted with intent to make a profit. *See* I.R.C. § 183(a); *see also Elliott v. Commissioner*, 90 T.C. 960, 970 (1988), *aff'd,* 899 F.2d 18 (9th Cir. 1990).

8. Also, the taxpayer must undertake the activity with the expectation that he will make a profit. *Bessenyey v. Commissioner,* 379 F.2d 252, 255-56 (2d Cir.), *cert. denied,* 389 U.S. 931, 88 S.Ct. 293, 19 L.Ed.2d 283 (1967).

9. I.R.C. § 183(d) provides that if the gross income exceeds the deductions from such activity for three or more of the immediately preceding five years, the activity is presumed to be engaged in for profit and the taxing entity has the burden of proof to rebut this presumption.

10. If a taxpayer does not meet this qualification, the burden is on the taxpayer to prove that the activity was engaged in for profit.

11. Taxpayers' gross income did not exceed the deductions from their activity for three or more of the immediately preceding five years.

12. Taxpayers are not entitled to the presumption under I.R.C. § 183(d) that their activity was engaged in for profit.

13. Taxpayers bear the burden of proving that they possessed the necessary bona fide profit motive. *See Golanty v. Commissioner*, 72 T.C. 411, 426 (1979).

14. A taxpayer's motive must be determined by a careful analysis of all the surrounding objective facts, and greater weight is given to such facts than to a taxpayer's statement of intent. *See* Treas. Reg. § 1.183-2(a) and (b).

15. Treas. Reg. § 1.183-2(a) 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*.

16. In determining whether a taxpayer entered into or continued an activity for profit, Treas. Reg. § 1.183-2(b) sets forth the following nonexclusive list of objective factors that should be taken into account: 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.

17. No single factor is conclusive. Rather, determining 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).

18. The potential to profit in a given year is not enough. In a genuine business, one would expect losses to be recouped by eventual profits. *See Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967).

19. Considering all of the facts and circumstances here, the Hearing Officer finds that Taxpayers were not engaged in a business during tax years 2009 and 2010 with the objective of making a profit.

20. The Department has the authority to examine tax returns and make assessments if deficiencies are found. Income Tax Ruling (ITR) 93-6.

21. The department has the authority to audit, construe federal law, and determine Arizona gross income notwithstanding a failure by the Internal Revenue Service to make a similar determination. ITR 93-6.

22. A.R.S. § 42-1123(C) provides that if the tax, whether determined by the department or the taxpayer, or any portion of the tax is not paid on or before the date prescribed

for its payment the department shall collect, as a part of the tax, interest on the unpaid amount from the date prescribed for its payment until it is paid.

23. A.R.S. § 42-1123(C) recognizes the time value of money, and thus requires a taxpayer that is holding or using money that rightfully belongs to the State to pay interest for the use of that money. *Valencia Energy Co. v. Arizona Dep't of Revenue,* 191 Ariz. 565, 959 P.2d 1256, (1998).

24. Taxpayers are liable for the interest that was included in the proposed assessments.

25. The Section's proposed assessments disallowing Taxpayers' Schedule C losses for tax years 2009 and 2010 are affirmed.

DISCUSSION

Taxpayers timely filed their tax year 2009 and 2010 personal income tax returns and claimed Schedule C business losses of $[REDACTED] for 2009 and $[REDACTED] for 2010. The Section reviewed Taxpayers' returns and issued assessments disallowing Taxpayers' deduction of their Schedule C business losses. The Section maintains that Taxpayers' activity during tax year 2009 and tax year 2010 was not a business engaged in for a profit.

If a taxpayer's gross income exceeds his deductions from an activity for three or more of the immediately preceding five years, the activity is presumed to be engaged in for profit and the taxing entity has the burden of proof to rebut this presumption. Otherwise the taxpayer has the burden to show that the activity was engaged in for profit. Here, Taxpayers' gross income has not exceeded their deductions from their activities for three of the last five years. Taxpayers therefore bear the burden of proving that they had the required profit motive.

Whether a taxpayer is engaged in business for a profit depends on the facts and circumstances of each case. Treas. Reg. § 1.183-2(b) considers the following nonexclusive list of factors: 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 conclusive. Rather, determining whether a taxpayer possesses the relevant profit objective is a question of fact to be determined in light of all the facts and circumstances. A taxpayer's declaration of his motive to engage in business to make a profit is not controlling. The motive must be determined from the surrounding objective facts.

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

To operate a business in a business like manner requires the taxpayer to analyze items such as the amount of startup costs required, the time it should take to recover those costs and the market for their activity. *Smith v. Commissioner,* T.C. Memo 2007-154. Taxpayers here did not present evidence that the activity was carried on in a businesslike manner. Taxpayers submitted a summary business plan. However, Taxpayers did not provide actual books and records, a business plan showing projections for recouping their expenses and earning a profit. Taxpayers had no partnership or other agreement with their [REDACTED] or [REDACTED] or other written documentation regarding the activity. The documents that were provided related to the children's racing activity and not to the operation of a race team. Taxpayers have not shown they carried on the activity in a businesslike manner.

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

Taxpayers have not demonstrated an expertise in operating a race team or in the business aspects of racing [REDACTED]. While Taxpayers testified that Taxpayer [REDACTED] performed repairs and maintenance on the [REDACTED] and Taxpayer

[REDACTED] kept the books, those activities do not demonstrate an expertise in the economic and business aspects of an activity. *See, e.g*., *Anthony J. McCarthy v. Commissioner*, TC Memo 2000-135 (2000); *Burger v. Commissioner*, 809 F.2d 355 (7th Cir. 1987).

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

The fact that a taxpayer spends much time and effort in conducting an activity may indicate that he or she has a profit objective, particularly if the activity does not have substantial personal or recreational aspects. Taxpayers testified that they did not attend the races or participate in racing. Taxpayers did not establish how much time they devoted to the activity in providing mechanic support at home, maintaining the books and records and handling the finances. Taxpayers were employed full-time limiting the time they could devote to the activity. Taxpayers have not shown that they (as opposed to their children) expended significant time and effort in carrying on the activity.

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

No evidence was submitted whether the motorcycles would appreciate in value.

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

Taxpayers did not demonstrate a significant ability to succeed in similar small business endeavors. Taxpayers testified that Taxpayer [REDACTED] was successful in other small businesses such as auto repair. No other evidence was presented.

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 Are Earned*.

Taxpayers have a history of losses dating back to 2005. From 2005 through 2011 Taxpayers reported losses of $[REDACTED]. A history of continuing losses may be indicative that Taxpayers did not have a profit motive.

Factor (8) *Taxpayer's Financial Status.*

Substantial income from sources other than the activity, in particular if the losses result in substantial tax benefits, may indicate that the taxpayer is not conducting the

activity for profit, especially if there are personal or recreational elements involved. Taxpayers earned wages in excess of $[REDACTED] in both 2009 and 2010. The losses reported by Taxpayers for those years offset over one-third of their wage income, a substantial tax benefit.

Factor (9) *The Elements of Personal Pleasure or Recreation*.

The presence of personal motives in carrying on an activity, especially where there are recreational or personal elements involved, may indicate that the activity is not engaged in for profit. *See*, § 1.183-2(b)(9), Income Tax Regs. The record does not establish that the activity involved personal pleasure to Taxpayers. While it may be assumed that racing a [REDACTED] involves an element of personal pleasure, Taxpayers here did not actively race. The record does however establish a personal motive for Taxpayers in seeing their children succeed in their racing efforts and independently establishing successful racing venture.

While Taxpayers may have subjectively hoped to establish a successful racing team, their objective actions did not reflect that they took appropriate actions to operate a business for profit. The activity was [REDACTED] racing by Taxpayers' adult children. Most of the documentation presented by Taxpayers related to their children's racing activity and the children's attempts to secure sponsors in their own names. During the tax years at issue the children determined what races to attend and attended the races by themselves. Taxpayers' [REDACTED] was the race mechanic at the races. Taxpayers did not attend the races or participate in racing. The children tried to do everything independently to make the activity a successful business venture. No documentation or evidence was presented regarding Taxpayers' involvement in the racing activity.

Taxpayers testified that their intent was to establish a successful racing team. However, once the children became adults, Taxpayers did not participate in the activity as a family. Taxpayers had no partnership or other agreement with their [REDACTED] or [REDACTED] or other written documentation establishing a race team or indicating how

the activity was to be run or how the expenses or profits would be divided. There was no objective evidence that a race team involving Taxpayers was established or how Taxpayers would reap any financial benefit from their [REDACTED]'s or [REDACTED]'s racing success. In weighing the facts and circumstances of this case, the Hearing Officer finds that Taxpayers did not operate a business during tax years 2009 and 2010 with the objective of making a profit.

The proposed assessment included interest. A.R.S. § 42-1123(C) provides that if the tax, whether determined by the department [as here] or the taxpayer, or any portion of the tax is not paid on or before the date prescribed for its payment the Department shall collect, as a part of the tax, interest on the unpaid amount from the date prescribed for its payment until it is paid.

Interest is not a penalty, but is simply compensation to the state for the lost time-value of money received after the due date. *Valencia Energy Co. v. Arizona Dep't of Revenue, supra*. (Non-punitive interest is, after all, nothing more than compensation for the use of money. The taxpayer had the benefit of using the funds before paying the tax claim and, in the legal sense, suffers no loss by reason of paying interest on the money it retained in its possession.)

Based on the foregoing, the Section's modified proposed assessment for tax year 2009 dated October 30, 2013 and proposed assessment for tax year 2010 dated October 23, 2013 are affirmed.

DATED this 24th day of March, 2015.

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