

7. Taxpayers presented no documentation showing that the amount reported on form 1099-INT was in error.
8. Taxpayers' annuity/pension income was increased by \$[REDACTED], from \$[REDACTED] to \$[REDACTED], based on the amounts reported on three 1099-R forms.
9. Taxpayers submitted a copy of a Cashier's Check dated March 19, 2003 in the amount of \$[REDACTED] made payable to [REDACTED].
10. Taxpayers presented no documentation showing that the amounts reported on the 1099-R forms were in error, that any amounts were repaid or the relationship between the \$[REDACTED] shown on form 1099-R and the \$[REDACTED] shown on the copy of the Cashier's Check.
11. Taxpayers' other income reported as negative \$[REDACTED] was changed to [REDACTED].
12. The other income of negative \$[REDACTED] was used to reduce Taxpayers' federal adjusted gross income (FAGI).
13. The \$[REDACTED] represented VA benefits that are not subject to income tax.
14. Taxpayers' VA benefits were not included in Taxpayers' FAGI.
15. Taxpayers' itemized deductions were reduced from \$[REDACTED] to \$[REDACTED] based on the federal limitation of high income taxpayers.
16. Taxpayers have not addressed or objected to the reduction of their itemized deductions.
17. Taxpayers' Schedule C deductions in the amount of \$[REDACTED] were disallowed.
18. Taxpayers' Schedule C showed gross income for tax year 2003 of \$[REDACTED].
19. Taxpayers deducted \$[REDACTED] on line 13 of their Schedule C as a section 179 deduction.

20. The section 179 deduction was comprised of office furniture in the amount of \$[REDACTED], a media system in the amount of \$[REDACTED] and a computer in the amount of \$[REDACTED].
21. Taxpayers provided receipts for the purchase of the computer, media system and \$[REDACTED] for the purchase of office furniture.
22. Taxpayers substantiated amounts deducted on line 13 of their Schedule C that were in excess of \$[REDACTED].
23. The media system was used in the waiting area of Taxpayers' home.
24. The office furniture consisted of shutters, drapes, cabinets and ceiling fans.
25. Taxpayers also deducted on their Schedule C car expenses in the amount of \$[REDACTED], interest in the amount of \$[REDACTED], meals and entertainment in the amount of \$[REDACTED] and utilities in the amount of \$[REDACTED].
26. Taxpayers presented no documentation supporting their deductions for car expenses, meals and entertainment and interest.
27. Taxpayer [REDACTED] counseled troubled students at her home.
28. Taxpayer [REDACTED] did not have a degree in counseling.
29. Taxpayer [REDACTED] testified she had enough hours in counseling to be hired by [REDACTED].
30. Taxpayers' post-hearing submission included copies of client hours log, 30 day reports and discharge summaries for the students Taxpayer [REDACTED] counseled.
31. The names and other identifying information of the students were redacted in Taxpayers' post-hearing submission.
32. Taxpayers provided no additional information or documentation supporting their claimed deductions.

CONCLUSIONS OF LAW

1. The presumption is that an assessment of additional income tax is correct. *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 191 P.2d 729 (1948).
2. Arizona Revised Statutes (A.R.S.) § 43-102(A)(1) provides that it is the intent of the Arizona legislature to adopt the provisions of the federal Internal Revenue Code relating to the measurement of adjusted gross income for individuals so that adjusted gross income reported to the IRS shall be the identical sum reported to Arizona, subject only to modifications set forth in Title 43 of the Arizona Revised Statutes.
3. The assessment by the Department for tax year 2003 resulted from the adjustments made by the IRS.
4. Arizona law requires that taxpayers *keep and preserve* “suitable records and other books and accounts necessary to determine the tax for which the person is liable for the period prescribed in § 42-1104.” A.R.S. § 42-1105(D).
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. Taxpayers have not presented evidence sufficient to overcome the presumption of correctness regarding increasing Taxpayers’ interest income and annuity/pension income, reducing Taxpayers’ Schedule A deductions and disallowing Taxpayers’ negative amount reported as other income on the federal return.
7. 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 factors that should normally 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.

8. Applying the above factors, Taxpayer [REDACTED] was engaged in business during tax year 2003.
9. Taxpayers did not substantiate their deductions for car expenses, meals and entertainment and interest.
10. Taxpayers' utility expenses, to the extent such expenses were substantiated, were deductible as home office expenses.
11. Expenses, such as depreciation, home insurance, and utility charges that are deductible only because the home is used for business, are limited to the gross income derived from the business use of the home after other business expenses are deducted. I.R.C. § 280A(c)(5).
12. If there is a loss, home office expenses must be carried forward to a year in which there was a gain. I.R.C. § 280A(c)(5).
13. Internal Revenue Code (I.R.C.) Section 179 deductions cannot exceed the aggregate amount of taxable income derived from the trade or business during the taxable year. I.R.C. § 179(b)(3)(A).
14. Taxpayers' substantiated Section 179 expenses in excess of the income derived from [REDACTED] counseling business.
15. Taxpayers' deduction of Section 179 expenses was limited to the aggregate amount of taxable income derived from the trade or business during the taxable year.

16. Taxpayers' deduction for home office expenses and Section 179 expenses could not exceed, in the aggregate, \$[REDACTED].
17. The Section's disallowance of Taxpayers' Schedule C deductions in the amount of \$[REDACTED] must be changed to a disallowance of \$[REDACTED].
18. Taxpayers did not provide documents in support of their protest for the other adjustments.
19. 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.

DISCUSSION

Taxpayers timely filed their 2003 tax year personal income tax return. Based on information received from the IRS, the Section issued a proposed assessment to Taxpayers increasing interest income taxable to Arizona and annuity/pension income, reducing Taxpayers' Schedule A deductions, and disallowing Taxpayers' Schedule C deductions and a negative amount reported as other income on their federal return.

The presumption is that an assessment of additional income tax is correct. Taxpayers have not presented evidence sufficient to overcome the presumption of correctness regarding increasing Taxpayers' interest income and annuity/pension income, reducing Taxpayers' Schedule A deductions and disallowing Taxpayers' negative amount reported as other income on the federal return. Therefore those adjustments are upheld.

Taxpayers claimed deductions for car expenses, Section 179 depreciation expenses, interest, meals and entertainment and utility expenses on their Schedule C. In the assessment the Section disallowed all deductions on the Schedule C because Taxpayer [REDACTED] was not engaged in business for a profit.

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.

Taxpayer [REDACTED] counseling activity was carried on in a business-like manner. Taxpayer kept client hour logs and prepared 30 day reports and discharge summaries for the students. While [REDACTED] did not have a degree in counseling, she testified she had sufficient hours to be hired by [REDACTED]. The time records indicated she spent from two to eight hours a day on the counseling activity on the days reflected in the time logs. The assets in the activity were not likely to appreciate in value. The activity of counseling students would not have personal pleasure or recreational value. Taxpayers had other sources of income and did not appear to be dependent on income from the counseling activity for their livelihood. There was no evidence presented on Taxpayer's success in carrying on other similar activities, history of income or losses.

In weighing the facts and circumstances of this case, the Hearing Officer finds that Taxpayer [REDACTED] was engaged in a business with the objective of making a profit. Therefore Taxpayers were entitled to deduct their business expenses to the extent allowed by law.

Taxpayers are required to *keep* and *preserve* "suitable records and other books and accounts necessary to determine the tax for which the person is liable. Taxpayers

must show their entitlement to a deduction. Taxpayers did not substantiate their deductions for car expenses, meals and entertainment and interest. Taxpayers have not overcome the presumption of correctness regarding the disallowance of the deductions for car expenses, meals and entertainment and interest. The Section's disallowance of those amounts is upheld.

Taxpayers also deducted utility expenses and Section 179 deductions on their Schedule C. Those deductions are limited to the amount of income realized from the business activity. Taxpayers' income from the business in 2003 was \$[REDACTED]. That is the maximum deduction that may be taken in this case for home office expenses and/or Section 179 deductions for the 2003 tax year. Taxpayers were entitled to a deduction of \$[REDACTED] on their Schedule C for tax year 2003. The Section's disallowance of Taxpayers' Schedule C deductions in the amount of \$[REDACTED] must be changed to a disallowance of \$[REDACTED].

The proposed 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. For Arizona purposes, 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.

Based on the foregoing, the Section's proposed assessment dated August 6, 2008 is affirmed except the Section's disallowance of Taxpayers' Schedule C deductions in the amount of \$[REDACTED] must be changed to a disallowance of \$[REDACTED].

DATED this 8th day of April, 2010.

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