

7. The Section issued a modified proposed assessment dated June 8, 2011 that allowed Taxpayers' medical expenses but continued to disallow Taxpayers' Schedule C expenses.
8. Taxpayers continued to protest the modified proposed assessment.
9. Taxpayers' Schedule C deducted car and truck expenses of \$[REDACTED], depreciation of \$[REDACTED] and deductible meals and entertainment of \$[REDACTED].
10. The depreciation amount of \$[REDACTED] included depreciation of \$[REDACTED] for a truck.
11. Taxpayers also submitted additional information regarding miles driven, car rental and lodging and meal expenses resulting from Taxpayers' investment activities.
12. Taxpayers' information substantiated [REDACTED] miles driven.
13. For tax year 2006 the standard mileage rate for calculating car and truck expenses was 44.5¢ per mile.
14. The allowable deduction for car and truck expenses based on Taxpayers' mileage of [REDACTED] was \$[REDACTED].
15. Based on the additional information submitted by Taxpayers, the Section issued a second modified proposed assessment dated November 17, 2011 that disallowed Taxpayers' Schedule C expenses and allowed a deduction in the amount of \$[REDACTED] for a portion of Taxpayers' investment related expenses as a miscellaneous itemized deduction on Schedule A.
16. Taxpayers' federal adjusted gross income for 2006 was \$[REDACTED].
17. Taxpayers were investors in real property.
18. Taxpayers' investment activities included visiting properties they owned as well as properties they were interested in buying.

19. In 2006 Taxpayers sold one of their investment properties for \$[REDACTED] and reported a capital gain of \$[REDACTED] on their federal Schedule D.
20. Taxpayers stated at the hearing that they claimed car and truck expenses based on mileage and also claimed depreciation because some of the depreciation was for equipment other than vehicles.
21. Taxpayers have not provided documentation relating to the other equipment for which they claimed depreciation.
22. Taxpayers have not provided documentation to show that the claimed car and truck expenses of \$[REDACTED] were based on other than mileage.
23. Taxpayers' car and truck expenses of \$[REDACTED] claimed on their Schedule C were based on mileage.

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. 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.
6. Investment property is a capital asset and any gain or loss from its sale is generally a capital gain or loss. Internal Revenue Service (IRS) Publication 17, p. 103.
7. Taxpayers were investors in real property.
8. Expenses incurred in managing one's investments are not expenses incurred in a "trade or business" as those words are used in this I.R.C. § 1221. *Forte Inv. Fund v. State Tax Commission*, 369 Mass. 786, 343 N.E.2d 420 (1976).
9. Investment expenses for managing investments that produce taxable income may be deducted as a miscellaneous itemized deduction. I.R.C. § 212; IRS Publication 529, pp. 2 and 10.
10. The deduction is limited to amounts in excess of 2% of the taxpayer's adjusted gross income. I.R.C. § 67; IRS Publication 529, pp. 2 and 10.
11. Investment expenses are not deductible as ordinary and necessary expenses paid or incurred in carrying on any trade or business. *Wilson v. U.S.*, 179 Ct.Cl. 725, 376 F.2d 280 (1967).
12. A deduction for car and truck expenses may be based on standard mileage rates or on actual car expenses, but not both. IRS Pub. 463, pg. 15.

13. Taxpayers have not produced documentation to substantiate a deduction for car and truck expenses based on actual expenses greater than the amount based on mileage.
14. The Section properly disallowed Taxpayers' Schedule C business expenses and properly allowed Taxpayers a miscellaneous itemized deduction for their substantiated investment expenses, subject to the 2% federal limitation.
15. 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.
16. The Section's second modified proposed assessment dated November 17, 2011 for tax year 2006 was proper.

DISCUSSION

Taxpayers timely filed their 2006 Arizona income tax return. Taxpayers' federal tax return had showed Schedule C expenses of \$[REDACTED]. No income was reported on Schedule C. Taxpayers' Schedule C expenses were generated by Taxpayers' investment activities in real property. Gains from the sales of Taxpayers' investment real property were reported as capital gains on their Schedule D.

The Section audited Taxpayers and disallowed their Schedule C investment expenses and instead allowed Taxpayers a Schedule A miscellaneous itemized deduction for those expenses. The allowed Schedule A expenses were lower than the Schedule C expenses because of a federal limitation on the amount of miscellaneous itemized deductions a taxpayer may take and the Section disallowed Taxpayers' claimed depreciation deduction.

Taxpayers disagree with the Section's adjustments. Taxpayers contend they properly deducted their investment expenses on Schedule C. Two questions are thus presented:

- how Taxpayers may deduct their investment expenses on their tax return, and
- were Taxpayers entitled to deduct both car and truck expenses and the depreciation claimed on their Schedule C.

Deducting Investment Expenses.

A taxpayer may generally deduct his ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. But expenses incurred for the production or collection of income not from a business may only be deducted as a miscellaneous itemized deduction subject to a limitation.

Here Taxpayers did not incur expenses in carrying on a trade or business. Taxpayers purchased real property for investment and incurred expenses in managing their investments. Taxpayers treated the real property as a capital asset and reported the gain from the sale of the property as a capital gain on Schedule D. Taxpayers were 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 however is a miscellaneous itemized deduction on the investor's Schedule A. Investment expenses are not deductible as ordinary and necessary business expenses on Schedule C.

The deduction is limited to amounts in excess of two percent of the taxpayer's adjusted gross income. The Section properly disallowed Taxpayers' Schedule C expenses and properly allowed Taxpayers a Schedule A miscellaneous itemized deduction for substantiated amounts in excess of the limit.

Car and Truck Expenses and Depreciation.

Taxpayers had claimed a deduction for car and truck expenses of \$[REDACTED], depreciation of \$[REDACTED] and deductible meals and entertainment of \$[REDACTED]. The Section allowed a miscellaneous itemized deduction, subject to the 2% limitation, for the car and truck expenses of \$[REDACTED] and meals and

entertainment of \$[REDACTED]. The Section disallowed the depreciation deduction because a taxpayer cannot take a deduction for actual car expenses and also at the standard mileage rate.

Taxpayers questioned at the hearing whether the car and truck expenses of \$[REDACTED] was based on mileage or on actual expenses. The Section stated at the hearing that the \$[REDACTED] appeared to have been arrived at by multiplying the mileage driven of [REDACTED] by the standard mileage rate of 44.5¢ per mile. The burden is on the taxpayer to show he is entitled to a deduction or exemption from tax. Taxpayers have not shown that they incurred actual car and truck expenses of \$[REDACTED] in addition to their claimed depreciation. The Section properly allowed Taxpayers a miscellaneous itemized deduction for car and truck expenses based on mileage and properly disallowed an additional deduction for depreciation.

Taxpayers' claimed depreciation amount of \$[REDACTED] included depreciation of \$[REDACTED] for a truck. Taxpayers' Form 4562 indicated that the other \$[REDACTED] for depreciation was a MACRS deduction for assets placed in service in tax years beginning before 2006. Taxpayers have provided no documentation relating to the \$[REDACTED] of depreciation. Taxpayers have not met their burden to show they were entitled to any deduction for depreciation.

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 second modified proposed assessment dated November 17, 2011 is upheld.

DATED this 25th day of September, 2012.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[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