

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)

[REDACTED])

UTI # [REDACTED])

DECISION OF
HEARING OFFICER

Case No. 201100249-I

A hearing was held on January 24, 2012 in the matter of the protest of [REDACTED] (Taxpayer) to an assessment of income tax and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2006.

This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayer timely filed his 2006 Arizona individual income tax return.
2. On April 13, 2011, the Section issued a proposed assessment to Taxpayer which disallowed Taxpayer's Schedule C expenses in the amount of \$[REDACTED] and included rent/royalty income of \$[REDACTED].
3. The proposed assessment stated that the Schedule C expenses were modified based on information received by the Department, but did not state the reason for the disallowance.
4. The assessment calculated interest at the statutory rate. No penalties were imposed.
5. Taxpayer timely protested the assessment stating that the royalty income of \$[REDACTED] was reported on Taxpayer's Schedule C and that Taxpayer's deductions on his Schedule C were supported by receipts.
6. Taxpayer has paid the amount of the assessment in full.
7. On his Schedule C Taxpayer reported gross receipts of \$[REDACTED] and expenses of \$[REDACTED].

8. The Section responded to Taxpayer's protest by letter dated May 20, 2011 stating that Taxpayer needed to provide documentation in order to prove and verify all schedule C amounts claimed. The letter gave Taxpayer three options.
9. Taxpayer responded by checking the box stating Taxpayer does not agree to withdraw his protest and that he is enclosing copies of documents or other information to support his protest.
10. The Section then sent Taxpayer a letter dated June 17, 2011 stating that the Section cannot modify the assessment and Taxpayer's business loss was disallowed because an activity is considered a for-profit business if gross income exceeds deductions for three out of five consecutive years. Taxpayer's business had shown no profit from 2003 through 2009.
11. The Section's June 17, 2011 letter did not indicate a need for additional verification for the expenses Taxpayer included on his Schedule C.
12. Taxpayer requested a formal hearing and attached a letter arguing that:
 - a. It was not profit that determined whether expenses incurred were justifiable but whether the efforts of the proprietor demonstrated he was working at it as a business or playing with it as a hobby.
 - b. In the case of writers there must be evidence of letters to editors, publishers and agents and responses that showed the writer was making an honest effort to make money from the business.
13. Taxpayer's Schedule C provided that Taxpayer was a "Writer - Novelist."
14. Taxpayer testified at the hearing that:
 - a. During 2006 he had three books he had written on the market.
 - b. During 2007 one of Taxpayer's books was re-printed. At that point Taxpayer had published five books (four of which were on the market).
 - c. During 2008 Taxpayer had another book on the market.

- d. Taxpayer had submitted query letters, had gone to seminars, met with editors and publishers, presented many proposals and over the years has grown.
 - e. In 2011 Taxpayer placed six new manuscripts with publishers because his reputation was starting to come out. Three of the books were already published. There are contracts for the other three books to be published.
 - f. Taxpayer included the \$[REDACTED] royalty payment in his Schedule C income.
15. Taxpayer received pension income of approximately \$[REDACTED] during tax year 2006.
16. The Section contended that an ordinary businessman would not continue the activity after 5 years of losses.

CONCLUSIONS OF LAW

1. 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.
2. 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.”
3. The activity must have been conducted with an 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).
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. § 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.
6. Taxpayer's gross income did not exceed the deductions from his activity for three or more of the immediately preceding five years.
7. Taxpayer is not entitled to the presumption under I.R.C. § 183(d). Taxpayer bears the burden of proving that he possessed the required profit motive. See *Golanty v. Commissioner*, 72 T.C. 411, 426 (1979).
8. The determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Treas. Reg. § 1.183-2(a).
9. The facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. Treas. Reg. § 1.183-2(a).
10. 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 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.

11. 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).
12. A taxpayer's expectation of profit need not be reasonable, but the taxpayer must establish that he continued his activities with a bona fide intention and expectation of making a profit. *Churchman v. Commissioner*, 68 TC 696 1977.
13. Taxpayer's business involved writing books.
14. Losses should be viewed in the context of the nature of the taxpayer's activity. *Vitale, Ralph Louis Jr.*, (1999) TC Memo 1999-131.
15. Works of fiction are difficult to write and to market. However, the field appears to pay large amounts of money to those who succeed in it. *Vitale, Ralph Louis Jr., supra*.
16. An opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated." *Vitale, Ralph Louis Jr., supra*.
17. Taxpayer testified he maintained accurate records of his expenses.
18. Taxpayer has pursued his writing activity in a businesslike manner by submitting query letters, attending seminars, meeting with editors and publishers and presenting proposals.
19. Taxpayer has had success in having books published and available for sale.
20. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved. Treas. Reg. § 1.183-2(b)(8).
21. Taxpayer received pension income. Taxpayer was not relying on the business income for his livelihood.

22. Taxpayer's losses have generated some, but not substantial, tax benefits.
23. Taxpayer did not seem to be extravagant in his expenses. The activities at issue seem to be of the type that are typically found in a profit-oriented enterprise. See *Ranciato v. Commissioner*, 52 F.3d 23 (2d Cir. 1995).
24. Considering all of the facts and circumstances, the Hearing Officer finds that Taxpayer was engaged in the activities at issue during tax year 2006 with the objective of making a profit.
25. Taxpayer is entitled to a deduction of his ordinary and necessary expenses paid or incurred during the taxable year in carrying on the business as claimed in Taxpayer's Schedule C. I.R.C. § 162(a).
26. The royalty payment of \$[REDACTED] to Taxpayer was included in Taxpayer's Schedule C.
27. Taxpayer adequately verified his Schedule C expenses in his response to the Section's May 20, 2011 letter stating that Taxpayer needed to provide documentation in order to prove and verify his schedule C expenses.
28. The Section's proposed assessment is reversed.

DISCUSSION

Taxpayer timely filed his 2006 tax year personal income tax return. The Section reviewed Taxpayer's return and issued a proposed assessment including in Taxpayer's income a \$[REDACTED] royalty payment and disallowing Taxpayer's Schedule C business expenses. The proposed disallowance was based on information received by the Department. The proposed assessment did not specify the basis for the disallowance.

The Section responded to Taxpayer's protest that Taxpayer needed to provide documentation in order to prove and verify his claimed schedule C expenses. Taxpayer responded by stating that he is enclosing copies of documents or other information to

support his protest. The Section then sent a letter dated June 17, 2011 stating that the Section cannot modify the assessment because Taxpayer's activity was not considered a for-profit business. The Section did not state that the information provided by Taxpayer was insufficient or that the Section needed additional verification of the expenses. Therefore Taxpayer's verification of the expenses is not an issue that will be considered in this case. The only question is whether Taxpayer had the necessary profit motive.

Whether a taxpayer is engaged in business for a profit depends on the facts and circumstances of each case.¹ 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, including the nature of the activity.

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

Taxpayer seemed to carry on his activities in a businesslike manner. Taxpayer met with editors and publishers, presented many proposals and has had a number of his books published. Taxpayer testified that he maintained accurate records of his

¹ Taxpayer is not entitled to a presumption that the activity was engaged in for profit. See Conclusions of Law Nos. 5 through 8. Taxpayer therefore bears the burden of proving that he possessed the required profit motive.

expenses. Taxpayer's testimony is accepted in light of the Section's June 17, 2011 letter.

Factor (2) *The Expertise of the Taxpayers or Their Advisors.*

Taxpayer had gone to seminars, met with editors and publishers, presented many proposals and has had some of his books published. Taxpayer appeared knowledgeable regarding publishing his works.

Factors (3), (8) and (9) *The Time and Effort Expended by Taxpayers in Carrying on the Activity, Taxpayers' Financial Status and the Elements of Personal Pleasure or Recreation.*

Taxpayer spent considerable time writing books and trying to get them published and marketed. Taxpayer was retired and did not have other full-time employment. Taxpayer could therefore devote considerable time to his writing activities.

While Taxpayer's efforts did not involve manual labor, writing, publishing and marketing books is work. There would appear to be little or no elements of personal pleasure or recreation involved in the actual writing and marketing activities. Where there are no elements of recreational or personal pleasure involved, courts are more likely to find that the activity was engaged in for profit. Taxpayer's time and effort expended in his activity tends to demonstrate that it was engaged in for profit.

Also, the tax benefits were relatively small. This does not seem to be the type of situation where Taxpayer's purpose in having a business was to offset substantial income from other sources. Accordingly, in this case, the fact that Taxpayer received pension income does not indicate that the activity is not engaged in for profit.

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

This criteria is not applicable here. Taxpayer's business did not own appreciating assets such as real estate.

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

Taxpayer did not demonstrate a significant ability to succeed in similar or dissimilar small business endeavors.

Factors (6) and (7) *The Taxpayers' History of Income or Losses With Respect to the Activity and the Amount of Occasional Profits, If Any, Which Are Earned.*

Taxpayer does have a history of losses dating back to 2003. Taxpayer also had losses in years after the tax year at issue. A history of losses may be indicative that Taxpayer did not have a profit motive. However, Taxpayer's history of losses has to be considered with the other facts and circumstances of this case.

Taxpayer's activity involved writing books for publication and sale. As with artists and actors, it can take years for a writer to be successful, if ever. The artist or writer must first achieve public acclaim before his serious work can command a price sufficient to provide him with a profit. Success is not guaranteed but success can produce significant income in later years. An opportunity to earn a substantial ultimate profit in a speculative venture tends to indicate that the activity is engaged in for profit.

In weighing the facts and circumstances of this case, the Hearing Officer finds that Taxpayer was engaged in a business with the objective of making a profit. Taxpayer had a bona fide intention to be successful and derive a profit from his writing. While there are factors indicating the absence of a profit motive, such as losses and that Taxpayer may not be dependent upon income from his writing activities, other factors indicate a profit motive. Success could generate substantial ultimate profit. Taxpayer's activity did not stop at the writing stage, but went into the publishing and marketing phases.

Based on the foregoing, the proposed assessment issued by the Section for tax year 2006 dated April 13, 2011 is reversed. The Section shall abate the assessment and grant Taxpayer a refund as provided by law.

DATED this 13th day of March, 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