BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of [REDACTED] UTI # [REDACTED]	)	DECISION OF HEARING OFFICER Case No. 201100255-I

A hearing was held on December 6, 2011 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. At the hearing leave to submit additional documentation was granted.

Taxpayer and the Section timely filed their respective opening and response memoranda. Taxpayer did not file a reply memorandum. This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayer filed a federal and an Arizona income tax return for 2006.
2. Taxpayer's federal tax return showed a Schedule C loss of $[REDACTED] and Schedule C expenses of $[REDACTED], and a Schedule A miscellaneous itemized deduction for unreimbursed employee expenses.
3. The Section reviewed Taxpayer's Arizona income tax return and issued a proposed assessment dated December 15, 2010 which disallowed Taxpayer's Schedule C loss and expenses and the Schedule A miscellaneous itemized deduction, and allowed Taxpayer a capital loss of $3,000 and Schedule A miscellaneous itemized deductions of $[REDACTED].
4. The Section disallowed Taxpayer's Schedule C loss because the loss was a capital loss generated by Taxpayer's activities of buying and selling securities and thus limited to $3,000 per year.

5. The Section disallowed Taxpayer's Schedule C expenses because it considered Taxpayer an investor rather than a trader in securities and an investor can only deduct his investment expenses as a miscellaneous itemized deduction on his Schedule A.

6. Taxpayer's miscellaneous itemized deductions for unreimbursed employee expenses was disallowed because Taxpayer had not submitted substantiation for the deduction.

7. Taxpayer has not submitted substantiation for the disallowed unreimbursed employee expenses.

8. Taxpayer's miscellaneous itemized deduction for his investment expenses was subject to a federal limitation.

9. The proposed assessment included interest but no penalties.

10. Taxpayer protested the assessment stating that he traded commodities and options for a pool of investors and that his daily investment business activity was greater than 40 hours per week.

11. Taxpayer's 2006 federal income tax return showed wages and salaries of $[REDACTED].

12. Taxpayer testified at the hearing that he was trading for a commodity pool and not for himself. Taxpayer also argued that he made over 500 trades during the year for the pool and he should therefore be classified as a trader and not an investor.

13. Taxpayer testified that the loss from his trading activity was not a personal loss but a loss by the pool.

14. Taxpayer testified that the funds for trading were supplied by the members of the pool and the loss reflected a combined loss by the pool.

15. Taxpayer has not provided documentation relating to the commodity pool referenced in his protest and at the hearing, or information regarding the

members of the pool or the distribution of the pool's income or losses to the members.

16. Taxpayer testified that the expenses included on his Schedule C related to his trading activity for the pool.

17. Taxpayer testified that the broker he used for his trades was no longer in business and Taxpayer was not able to obtain a list of his daily trades for tax year 2006.

18. Taxpayer's post-hearing submission included a hand prepared spreadsheet showing certain abbreviations, code numbers and what might be dollar amounts. The columns are not labeled and there is no identification for the abbreviations and code numbers.

19. Taxpayer's post-hearing submission did not specify the commodities traded or the holding period for the commodities traded.

20. Taxpayer did not specify whether the commodities pool he referenced in his protest and at the hearing was an investment club.

21. Taxpayer did not provide information regarding the tax treatment of the pool.

22. Taxpayer's Schedule C indicated he conducted his securities transactions under the business name of "[REDACTED]."

23. Taxpayer's submission included a copy of a letter from the Internal Revenue Service (I.R.S.) indicating that it approved Taxpayer's election to have [REDACTED], a single owner entity, to be disregarded as a separate entity.

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. § 1211(b) provides that in the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus, if the losses exceed the gains, the lower of $3,000 or the excess of the losses over the gains.

6. 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.

7. 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).

8. Securities not held by a dealer of such securities fall within the definition of a “capital asset” in I.R.C. § 1221, and are outside the statutory exclusions. See,

Arkansas Best Corp. v. C.I.R. 485 U.S. 212, 108 S.Ct. 971 (1988); *Frank Chen v. Commissioner,* TC Memo 2004-132 (2004).

9. A dealer's business involves sales of securities to customers in the ordinary course of that business. *Frank Chen v. Commissioner, supra.*

10. Only a dealer's securities fall within the exception to capital asset status provided for property held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business. *Frank Chen v. Commissioner, supra.*

11. Taxpayer did not hold securities for sale to his customers in the ordinary course of his business. Taxpayer was not a dealer of securities.

12. The income or loss from sales or exchanges of securities by a trader or by an investor produces a capital gain or loss rather than ordinary income or loss. *Frank Chen v. Commissioner, supra.*

13. Whether Taxpayer was a trader or an investor, his losses from his commodities transactions were capital losses limited to a maximum of $3,000 in excess of his capital gains for tax year 2006.

14. A trader is engaged in the trade or business of buying and selling securities for his own account. *Frank Chen v. Commissioner, supra.*

15. 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."

16. Investment expenses incurred by an investor for the production or collection of income are not ordinary and necessary business expenses.

17. Such investment expenses may only be deducted as a miscellaneous itemized deduction on the investor's Schedule A. I.R.C. § 212.

18. The deduction allowed by I.R.C. § 212 is limited to the extent that the aggregate of such deductions exceeds two percent of the taxpayer's adjusted gross income. I.R.C. § 67(a).

19. In order to qualify as a trader (as opposed to an investor) Taxpayer's purchases and sales of securities during the tax year must have constituted a trade or business.

20. 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).

21. For a taxpayer to be considered a trader, the taxpayer's trading activity must be "substantial," and it must be frequent, regular, and continuous to be considered part of a trade or business. *Boatner v. Commissioner,* T.C. Memo. 1997-379 (1997), affd. 164 F.3d 629 (9th Cir. 1998).

22. In general, investors 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).

23. It is not possible to determine the frequency, extent and regularity of Taxpayer's securities transactions from his post-hearing submission.

24. Taxpayer has not provided sufficient documentation to show he was a trader in securities.

25. Taxpayer was an investor in securities in tax year 2006.

26. Taxpayer has not produced documentation to substantiate the unreimbursed employee expenses disallowed by the Section.

27. The Section properly disallowed Taxpayer's Schedule C loss and business expenses and unreimbursed employee expenses, and properly allowed Taxpayer a capital loss of $3,000 and a miscellaneous itemized deduction for his investment expenses subject to the federal limitation.

28. 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.

29. The Section's proposed assessment dated December 15, 2010 for tax year 2006 was proper.

DISCUSSION

Taxpayer timely filed his 2006 Arizona income tax return. Taxpayer's federal tax return had showed a Schedule C loss of $[REDACTED] and Schedule C expenses of $[REDACTED]. Taxpayer's Schedule C loss and expenses were generated by Taxpayer's investment activities in securities (commodities). The Section audited Taxpayer and disallowed his Schedule C loss and allowed him a capital loss of $3,000. The Section also disallowed Taxpayer's Schedule C investment expenses and instead allowed Taxpayer 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.

Taxpayer protested arguing that he traded commodities and options for a pool of investors and that his daily investment business activity was greater than 40 hours per week. Taxpayer contends he properly deducted all of his investment losses and expenses on his Schedule C. This addresses the question of how taxpayers may deduct their investment losses and their investment expenses on their tax return.

Income and losses may be categorized as ordinary income and losses or capital gains and losses. Capital losses in excess of capital gains are limited to a maximum of $3,000 per year. Any excess loss may be carried forward to future tax years. There is no similar limitation on a taxpayer's losses from engaging in a business.

A taxpayer may also 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.

How a taxpayer reports his investment income and losses and expenses depends on how the taxpayer is categorized. As the court stated in *King v. Commissioner*, *supra,* a person who purchases and sells securities falls into one of three distinct categories: dealer, trader, or investor.

Security Dealers.

A dealer in securities is engaged in the business of selling securities to his customers in the ordinary course of that business. A dealer's securities fall within the exception to capital asset status because the securities constitute property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Because a dealer is selling inventory and not a capital asset, his income or loss from the sales of securities constitutes ordinary income or loss.

A dealer is also engaged in a business. Therefore his expenses are deductible as ordinary and necessary business expenses on his Schedule C. Neither the dealer's ordinary losses nor his business expenses are subject to the federal limit on capital losses and miscellaneous itemized deductions. Taxpayer has not contended that he was a dealer of securities.

Security Traders.

Both traders and investors buy and sell securities for their own account. A trader however is engaged in the business of buying and selling securities for his own account. 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*.

A securities trader is engaged in the business of buying and selling securities. Because the trader is engaged in business, his investment expenses are ordinary and

necessary business expenses that he may deduct on his Schedule C. However, because the trader is buying and selling securities for his own account and not selling inventory to his customers, a trader is selling a capital asset. As such, any gain or loss from the trader's transactions in securities is a capital gain or loss to be reported on the trader's Schedule D. Therefore, even though a trader is engaged in business, his investment loss is a capital loss and not an ordinary loss. Capital losses, even if incurred in conducting a business, are limited each year to a maximum of $3,000 in excess of capital gains. Thus, even if Taxpayer were a trader in securities, the Section properly disallowed his Schedule C loss and properly allowed Taxpayer a capital loss of $[REDACTED].

The burden was on Taxpayer to show he was a trader and therefore entitled to deduct his investment expenses as ordinary and necessary business expenses. In support of his argument that he was a trader, Taxpayer submitted a hand prepared spreadsheet showing certain abbreviations, code numbers and what might be dollar amounts. The columns were not labeled and there was no identification for the abbreviations and code numbers. It is not possible to determine the frequency, extent, nature and regularity of Taxpayer's securities transactions from his post-hearing submission.

In addition, Taxpayer appeared to have full-time employment, earning wages in excess of $[REDACTED]. As the court stated in *Frank Chen v. Commissioner, supra.*, in cases where taxpayers have been held to be traders in securities, the number and frequency of transactions indicated that they were engaged in market transactions almost daily for a substantial and continuous period, generally exceeding a single taxable year, and those activities constituted the taxpayers' sole or primary income-producing activity. Taxpayer has not established that he was a trader in commodities for tax year 2006.

Security Investors.

In general, investors purchase and hold securities for capital appreciation and income. Because Taxpayer did not show he was a trader, the Section properly considered Taxpayer an investor. 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 taxpayer's Schedule A. The deduction is limited to amounts in excess of two percent of the taxpayer's adjusted gross income. The Section properly disallowed Taxpayer's Schedule C loss and Schedule C expenses and properly allowed Taxpayer a capital loss of $[REDACTED] and a Schedule A miscellaneous itemized deduction for amounts in excess of the limit.

Commodities pool.

Taxpayer stated in his protest and testified at the hearing that he was trading for a commodity pool and not for himself. Taxpayer testified that the loss from his trading activity was not a personal loss but a loss by the pool, the funds for trading were supplied by the members of the pool and the loss reflected a combined loss by the pool.

Special at-risk rules operate to limit the amount of loss a taxpayer may take to the amount the taxpayer risks losing in the activity. This is generally the amount of cash and the adjusted basis of the property the taxpayer contributed to the activity. *See* I.R.S. Publication 550, p.32. Taxpayer would not be at risk to the extent funds used for trading were supplied by other members of a pool.

The Section did not raise the at-risk rule as a basis for its disallowance of the investment loss reported by Taxpayer on his Schedule C and Taxpayer has not provided documentation relating to the commodity pool or information regarding the members of the pool, the distribution of the pool's income or losses to the members or the tax treatment of the pool.[1] The at-risk rule is therefore not an issue here for tax year

[1] Taxpayer's Schedule C indicated he conducted his securities transactions under the business name of "[REDACTED]." The LLC was a single owner entity, disregarded as a

2006. It is briefly mentioned because Taxpayer stated he was trading for a commodities pool and the at-risk rule might be an issue in future years with regard to Taxpayer's carry-forward of his reported 2006 loss.

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 proposed assessment dated December 15, 2010 is upheld.

DATED this 11th day of April, 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

separate entity. Being a single member entity, the LLC would not have been used as an investment club or commodities pool. See I.R.S. Publication 550, p.28.