

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of)	DECISION OF
)	HEARING OFFICER
[REDACTED])	
)	Case No. 201200088-I
UTI # [REDACTED])	
_____)	

A hearing was held on April 26, 2012 in the matter of the protest of [REDACTED] (Taxpayers) 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.

Taxpayers and the Section timely filed their opening and response memoranda. Taxpayers did not submit a reply memorandum. The case is now ready for ruling.

FINDINGS OF FACT

1. Taxpayers filed their Arizona income tax return for tax year 2006.
2. Based on information obtained from the Internal Revenue Service (IRS) through the Department's exchange of information agreement with that agency [I.R.C. § 6103(d)(1)], the Section learned that during the years 2003 through 2008 Taxpayers had reported Schedule C business expenses of \$[REDACTED] and [REDACTED] income.
3. The Section issued Taxpayers a notice of proposed assessment of income tax dated December 15, 2010 for the tax year 2006 disallowing Taxpayers' Schedule C expenses of \$[REDACTED].
4. The proposed assessment included interest as provided by law. No penalties were assessed.
5. The Section received Taxpayers' protest to the assessment on May 12, 2011.
6. It was the Section's position that a protest was due no later than March 15, 2011 and therefore considered Taxpayers' protest untimely.

7. The Section reviewed the information submitted by Taxpayers with their protest and issued a Closing Agreement dated September 14, 2011 allowing Taxpayers 16.67% of their verified expenses originally claimed on the Schedule C.
8. Taxpayers did not agree to the Closing Agreement, paid the amount shown due under the Closing Agreement and filed a timely claim for refund.
9. Taxpayers' claim for refund was denied and Taxpayers timely protested the denial.
10. Taxpayers were members of [REDACTED] (the LLC), which operated a [REDACTED] in [REDACTED].
11. Taxpayers entered into an Operating Agreement for the LLC dated [REDACTED].
12. The LLC had two classes of membership, Class A and Class B.
13. Taxpayers had a 16.67% Class A membership interest.
14. Taxpayers were the only Class B members and had a 100% Class B interest.
15. Taxpayer [REDACTED] was the managing member of the LLC.
16. The owner or owners of Class B membership interest had the right and obligation to manage the affairs of the LLC or to retain others to do so. Operating Agreement ¶ [REDACTED].
17. The manager had all authority incident or necessary to the operation of the LLC including retaining employees, assistant managers or other agents to act pursuant to the manager's instructions. Operating Agreement ¶ [REDACTED].
18. Any increase or decrease in the compensation paid to the manager was required to be approved by the majority of each Class of membership interest. Operating Agreement ¶ [REDACTED].
19. Members could make loans to the LLC to be evidenced by a promissory note. Loans from members were required to be repaid in full before any distribution of capital is made by the LLC. Operating Agreement ¶ [REDACTED].
20. The manager had the authority to borrow monies from third parties for purposes other than to reimburse the Class B member for losses the Class B member is obligated to pay. Operating Agreement ¶ [REDACTED].

21. The LLC was required to maintain one or more bank accounts in the name of the LLC from which the manager or his agents could withdraw funds. Operating Agreement ¶ [REDACTED].
22. In the event the LLC incurred operating losses in any fiscal year which exceeded \$[REDACTED], the manager had the authority to request Class A members to contribute to the LLC cash necessary to reimburse the LLC for losses over \$[REDACTED]. Operating Agreement ¶ [REDACTED].
23. Any operating loss not exceeding \$[REDACTED] in one fiscal year was required to be paid in full by the holder of the Class B membership interest. Operating Agreement ¶ [REDACTED].
24. Operating Agreement ¶ [REDACTED]. was titled “Additional Capital Contributions.”
25. The Operating Agreement was silent regarding the payment of LLC expenses directly by a member on behalf of the LLC.
26. Taxpayer [REDACTED] testified that he would sometime pay a LLC obligation if the LLC was low on money.
27. The Section verified Taxpayers paying the following expenses claimed on their Schedule C:

Direct TV	\$[REDACTED]
Long Distance	\$[REDACTED]
Postage	\$[REDACTED]
Meals and Travel	\$[REDACTED]
Fuel	\$[REDACTED]
Airport Parking	\$[REDACTED]
Outdoor Gear	\$[REDACTED]
Supplies	\$[REDACTED]
Advertising	\$[REDACTED]
MBNA Visa	\$[REDACTED]
Alaska Airlines	\$[REDACTED]
American Express	\$[REDACTED]
Total	\$[REDACTED]

28. In 2006 the LLC received \$[REDACTED] in gross receipts and claimed expenses in the amount of \$[REDACTED] resulting in an operating loss of \$[REDACTED].

29. Some of the expenses reported by the LLC included payments for advertising, maintenance, utilities, Direct TV, telephone and office expenses.
30. The record does not disclose how the LLC recorded LLC expenses paid directly by Taxpayers or the payments made by Taxpayers.
31. The record does not disclose how the LLC calculated each member's distributive share of the LLC's losses.
32. The record does not disclose whether Taxpayers' interest in the LLC was adjusted based on Taxpayers' payment of certain LLC expenses.

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 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." Arizona Revised Statutes (A.R.S.) § 42-1105(D).
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.). A.R.S. § 43-1042.
5. Schedule E is to be used to report income or loss from rental real estate, royalties, partnerships, S corporations, estates, trusts and residential interests in REMICS. Instructions for Schedule E.
6. The 2006 Instructions for Schedule E (Form 1040) provides that a taxpayer may deduct unreimbursed ordinary and necessary partnership expenses the taxpayer paid on behalf of the partnership on Schedule E if the taxpayer were required to pay those expenses under the partnership agreement.

7. The LLC Operating Agreement did not require Taxpayers to pay expenses or categories of expenses on behalf of the LLC.
8. Taxpayers were not entitled to a deduction on form Schedule E of the LLC expenses they paid.
9. Taxpayers have not established that they were entitled to a deduction of their payment of LLC expenses on their individual income tax return.
10. Taxpayers have not overcome the presumption of correctness.
11. 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.
12. The Section’s denial of Taxpayers’ claim for refund was proper.

DISCUSSION

Taxpayers were members of a LLC. Taxpayers filed their resident Arizona individual income tax return for tax year 2006 claiming Schedule C expenses for expenses Taxpayers paid on behalf of the LLC. The Section disallowed the total deduction and allowed a deduction of 16.67% of Taxpayers’ verified expenses originally claimed on the Schedule C.

Taxpayers disagreed with the adjustment, paid the tax and interest due and filed a claim for refund which was denied by the Section. Taxpayers timely protested the denial. The question presented is whether Taxpayers’ may deduct on their individual income tax return expenses they paid on behalf of the LLC.

Taxpayers contend that their payment of LLC expenses are deductible on federal Schedule E as unreimbursed ordinary and necessary partnership expenses the taxpayer paid on behalf of the partnership. However, as the instructions to Schedule E state, the amounts may only be deducted if Taxpayers were required to pay those expenses under the partnership (LLC) agreement. There is no indication in the record that Taxpayers were required to pay certain expenses. Taxpayers would sometime pay LLC obligations if the

LLC was low on money. Those payments are therefore not deductible by Taxpayers on their individual income tax return.

Paragraph [REDACTED]. of the LLC agreement did not require Taxpayers to pay certain LLC expenses. Paragraph [REDACTED]. obligated Taxpayers to pay any operating loss not exceeding \$[REDACTED] in one fiscal year as an additional capital contribution. While an additional capital contribution by Taxpayers might result in an adjustment to their interest in the LLC, It does not generate a deductible expense.

"The presumption is that an additional assessment of income tax is correct and the burden is on the taxpayer to overcome such presumption." *Arizona State Tax Commission v. Kieckhefer, supra.* The burden is on the taxpayer to show he is entitled to a deduction or exemption from tax. Taxpayers have not shown that they are entitled to a personal deduction of the LLC expenses they paid.

Based on the foregoing, the Section's denial of Taxpayers' claim for refund for tax year 2006 is upheld.

DATED this 28th 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 delivered to:

Arizona Department of Revenue
Individual Income Tax Audit Section

Copy of the foregoing mailed to:

[REDACTED]