

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of  
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DECISION OF  
HEARING OFFICER  
Case No. 201100236-I

Hearings were held on April 3, 2012 and February 21, 2013 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 2005.<sup>1</sup>

This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayers filed a federal and an Arizona income tax return for 2005.
2. The Section reviewed Taxpayers' Arizona income tax return and issued a proposed assessment dated March 3, 2010 disallowing Taxpayers' \$[REDACTED] subtraction for selling an energy efficient home and Schedule C expenses of \$[REDACTED].
3. The proposed assessment included interest but no penalties.
4. Taxpayers protested the assessment stating that the Schedule C expenses were fully justified and Taxpayers intended to make a profit from their activity.
5. Taxpayers did not protest the disallowance of the subtraction for the sale of an energy efficient home.
6. Taxpayers paid the assessment for 2005 at the time of their protest.
7. Taxpayers' Schedule C deductions included car and truck expenses of \$[REDACTED] calculated on 11,505 miles, legal expenses of \$[REDACTED],

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<sup>1</sup> An assessment was also issued for tax year 2006. That assessment is no longer at issue before the Hearing Office.

travel of \$[REDACTED], deductible meals of \$[REDACTED] and depreciation of \$[REDACTED].

8. Taxpayers also submitted a hand written log of miles driven, travel and meal expenses resulting from Taxpayers' investment related activities.
9. Taxpayers were involved in investing in real property.
10. During April and May of 2005 Taxpayers entered into two purchase agreements for the purchase of real property in [REDACTED], Arizona.
11. Taxpayers stated in their protest and testified that:
  - a. Taxpayers operated a business of identifying property for purchase and resale or rental.
  - b. Taxpayers' auto, travel and food expenses were related to this activity.
  - c. In 2005 the activity yielded purchase agreements for two properties in Arizona.
  - d. The two properties were located close to each other in [REDACTED] and were about 50 miles from Taxpayers' home.
  - e. The first [REDACTED] property was a new home construction and Taxpayers made a down payment of \$[REDACTED].
    - i. The purchase agreement provided at ¶ 3.2 that the purchase price would be adjusted to reflect options, upgrades, custom features change orders and other modifications in the finishing specifications selected by the buyer.
    - ii. After entering into the purchase agreement, Taxpayers met with the builder on numerous occasions to configure the property and to pick various options and upgrades.
    - iii. It took the builder two and one-half years to build the home.
    - iv. In mid 2007 the economy was beginning to decline and Taxpayers decided to abandon their purchase of the property.

- v. Taxpayers claimed a loss of approximately \$[REDACTED] on their 2007 income tax return.
  - vi. Taxpayers testified the difference between the amount taken as a loss and the \$[REDACTED] down payment was attributable to the adjustments in the purchase price due to upgrades and other changes.
  - f. Taxpayers had made a \$[REDACTED] deposit on the second [REDACTED] property.
  - g. Taxpayers exercised their option to rescind the purchase of the second property and their deposit was refunded.
  - h. Other expenses incurred during the tax year were for investigating into purchasing property.
12. The record here indicates that Taxpayers' expenses during tax year 2005 were for investigating into purchasing property and activities surrounding efforts to purchase property.
  13. Taxpayers did not obtain title to either [REDACTED] property.
  14. Taxpayers did not provide documentation relating to their travel expenses, legal expenses, meals and depreciation.

#### CONCLUSIONS OF LAW

1. Arizona taxpayers may deduct on their Arizona income tax return itemized deductions calculated under the Internal Revenue Code (IRC). Arizona Revised Statutes (A.R.S.) § 43-1042.
2. 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).
3. Investment property is a capital asset. See, Internal Revenue Service Publication 17, p. 103.

4. An individual may deduct the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. IRC § 212.
5. The deductions under IRC § 212 are subject to certain exceptions. IRC § 211.
6. Amounts paid to acquire, produce, or improve real or personal tangible property must be capitalized. IRC § 263; *Woodward v. Commissioner*, 397 U.S. 572, 90 S.Ct. 1302 (1970).
7. An expense cannot be deducted as an ordinary and necessary expenses if the expense is capital. *Woodward v. Commissioner, supra*; Treas. Reg. § 1.212-1(n).
8. If an expense was incurred in the process of the acquisition or sale of a capital asset, the expense cannot be deducted but must be added to the cost or the basis of the asset. *See, Kutz v. United States*, 392 F. Supp. 539 (M.D. Penn. 1975).
9. Taxpayers' expenses during 2005 regarding the [REDACTED] properties were incurred in the process of the acquisition of the properties and were thus not deductible as expenses incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income.
10. Investigatory expenses incurred in identifying potential investments are not deductible either as business expenses or expenses incurred in the production or collection of income or in the management, conservation or maintenance of property held for the production of income. *See, Morton Frank*, 20 TC 511, (1953); Rev. Rul. 77-254, 1977-2 CB 63.
11. Taxpayers have not met the burden to show they were entitled to a deduction for their claimed Schedule C expenses for tax year 2005.

12. The Section properly disallowed Taxpayers' claimed Schedule C business expenses for tax year 2005.
13. 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.
14. The Section's proposed assessment dated March 3, 2010 for 2005 was proper.
15. Because Taxpayers paid the tax and interest protested, this matter is treated as a protest of a denial of a claim for refund. A.R.S. § 42-1118(I).
16. Taxpayers are not entitled to a refund of their payment of the proposed assessment.

#### DISCUSSION

Taxpayers timely filed their 2005 Arizona income tax return. Taxpayers claimed a \$[REDACTED] subtraction for selling an energy efficient home and claimed Schedule C expenses of \$[REDACTED] shown on their federal tax return. Taxpayers' Schedule C expenses were generated by looking for investment property and entering into two purchase agreements for the purchase of real property. Taxpayers did not complete the purchase of or take title to either property.

The Section audited Taxpayers and disallowed their Schedule C expenses and the subtraction for the sale of an energy efficient home. Taxpayers protested contending they properly deducted their expenses on Schedule C. The Section contends that while under IRC § 212 certain investment related expenses may be deducted as a miscellaneous itemized deduction on Schedule A, such expenses are not deductible on Schedule C. The Section also contends that because Taxpayers had not taken title to the properties, their expenses were not deductible under IRC § 212.

A taxpayer may generally deduct his ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Also, expenses incurred for the production or collection of income not from a business may be deducted

as a miscellaneous itemized deduction subject to a limitation. Capital expenses however may not be deducted as either business expenses or as expenses incurred for the production or collection of income.

Taxpayers here sought to purchase real property for investment. Taxpayers had entered into agreements for the purchase of two properties. Those properties, had they been purchased, would have been capital assets. The expenses incurred by Taxpayers in the process of configuring one of the properties and picking various options and upgrades were incurred in the process of the acquisition of the property. Those expenses were thus capital expenses that cannot be deducted. Such capital expenses would be included in the basis of the property.

Taxpayers also contend that some of the travel expenses were incurred in looking for potential investment properties. Such investigatory expenses are not deductible either as business expenses or expenses incurred in the production or collection of income or in the management, conservation or maintenance of property held for the production of income. The Section therefore properly disallowed Taxpayers' Schedule C expenses.

Based on the foregoing, the Section's proposed assessment dated March 3, 2010 is upheld and Taxpayers' claim for refund is denied.

DATED this 4th day of April, 2013.

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