

STATE OF ARIZONA

Department of Revenue
Office of the Director
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Janice K. Brewer
Governor

John A. Greene
Director

CERTIFIED MAIL [Redacted]

The Director's Review of the Decision
of the Hearing Officer Regarding:

[Redacted]

UTI #[Redacted]

ORDER

Case No. 201200106-I

On December 14, 2012 the Hearing Officer issued a decision regarding the protest of [Redacted] ("Taxpayer"). Taxpayer appealed this decision. Because the appeal was timely, the Director of the Department of Revenue ("Director") issued a notice of intent to review the decision.

In accordance with the notice given the parties, the Director has reviewed the Hearing Officer's decision and now issues this order.

Statement of Case

Taxpayer timely filed his 2006 federal and Arizona income tax returns. The Individual Income Tax Audit Section of the Audit Division ("Division") issued a proposed assessment to Taxpayer. Taxpayer protested the assessment. The issue on appeal is whether Taxpayer properly claimed Schedule C deductions in connection with scuba diving instructions (the "Scuba Lessons") and properly claimed a Schedule A deduction for a charitable contributions. The Division argues that Taxpayer has not demonstrated that he engaged in the Scuba Lessons as a business for profit and has not provided sufficient documents to substantiate his expenses. The Division also argues that Taxpayer has not properly documented his claimed charitable deduction.

Findings of Fact

The Director adopts from the Hearing Officer's findings of fact and makes additional findings as follows:

1. Taxpayer timely filed his 2006 federal and Arizona individual income tax return.
2. Taxpayer was employed full time in 2006 by [Redacted]. His W2 lists wage income in the amount of \$150,938 for 2006.
3. The Internal Revenue Service ("IRS") audited Taxpayer and adjusted his federal adjusted gross income (FAGI) by \$17,937. Taxpayer did not report the federal adjustment to Arizona.
4. The Division issued an assessment increasing Taxpayer's Arizona income to match the IRS adjustment. Taxpayer does not dispute this adjustment.
5. The proposed assessment also disallowed Taxpayer's federal Schedule C expenses in the amount of \$45,328 and his Schedule A charitable contributions in the amount of \$3,800.
6. Taxpayer protested the Schedule C and Schedule A adjustments.
7. Taxpayer asserts that he had a home fire in December 2009 that destroyed his business records. The Division has no information concerning this fire.
8. Taxpayer has not presented a business plan, budget, or market analysis for the Scuba Lessons.
9. Taxpayer did not keep separate bank accounts for the Scuba Lessons.
10. Taxpayer has claimed substantial losses from the Scuba Lessons. From 2000 through 2007 Taxpayer reported cumulative income from the Scuba Lessons in the amount of \$5,675 and cumulative losses in the amount of \$262,208. Taxpayer did not make a profit in any year.
11. In 2006, after providing Scuba Lessons for more than five years, Taxpayer reported gross income from Scuba Lessons in the amount of \$1,023 and expenses in the amount of \$45,328, resulting in a loss in the amount of \$44,305.

12. Taxpayer had no business experience. He did not have any experience providing lessons for profit.
13. Taxpayer did not consult with any business professionals concerning how to operate a successful business.
14. Taxpayer lists expenses for food and travel on his Schedule C. Taxpayer has not identified the business purpose for the food and travel.
15. Taxpayer lists depreciation expenses in the amount of \$12,654 on his Schedule C. This includes \$6,324 for a webserver and \$6,330 for BMW and Porsche automobiles.
16. Taxpayer's tax filings indicate that he used both the BMW and Porsche 100% for business. Taxpayer has not provided any information about the business use of these vehicles.
17. Taxpayer claimed expenses for the business use of his home. Taxpayer's return indicates that he used 39% of his home for business purposes. Taxpayer does not identify the business use of his home.
18. Taxpayer listed non-cash charitable contributions in the amount of \$3,800 on his Schedule A.
19. In August 2012, Taxpayer provided a Quicken download of a [Redacted] bank account. Taxpayer highlighted entries that he claims were used for the Scuba Lessons.
20. The bank account expenditures included food, gasoline, home maintenance and repairs, electricity, water and sewer, car payments for the BMW, and other miscellaneous items.
21. Taxpayer did not match the expenditures from his bank account to the categories of expenses listed on his Schedule C.

22. Taxpayer did not provide any logs or other explanation concerning the business purpose of the expenditures.
23. In a letter dated September 19, 2012, Taxpayer indicated that he donated a sound system to [Redacted] for their raffle. Taxpayer presented no evidence that the [Redacted] was a charitable organization under the Internal Revenue Code. The letter states that nobody with [Redacted] remembers the donation. Taxpayer offered to get an affidavit from his son.
24. In a letter dated May 20, 2012, the Division set forth factors that are considered when analyzing whether an activity is engaged in for profit. The factors were: (1) whether you carry on the activity in a businesslike manner; (2) the time and effort you put into the activity; (3) whether you depend on income from the activity for your livelihood; (4) whether your losses are due to circumstances beyond your control; (5) whether you change your methods of operation in an attempt to improve profitability; (6) whether you or your advisors have the knowledge needed to carry on the activity as a successful business; (7) whether you were successful in making a profit in similar activities in the past; (8) whether the activity makes a profit in some years and the amount of the profit; (9) whether you can expect to make a future profit from the appreciation of the assets used in the activity.
25. Taxpayer addressed these criteria in his September 2012 letter.
26. Taxpayer stated that he had the certification and insurance necessary to provide Scuba Lessons. He stated that he also had a website.
27. Taxpayer stated that the fact that he spent money on a website and equipment indicates that he intended to make a profit.

28. Taxpayer indicated that he did not depend on the Scuba Lessons for his livelihood. He further indicated that he could not obtain loans due to the “market saturation” of dive shops in the greater Phoenix area in the early 2000s.
29. With respect to losses beyond his control, Taxpayer indicated that his lack of access to start-up capital was the largest factor in his inability to control his losses.
30. Taxpayer indicated that while he had diving credentials, he lacked business knowledge. Taxpayer indicated that he enrolled in a [Redacted] in 2007 to gain the necessary business knowledge.
31. Taxpayer admitted that he was a first time business owner with no previous business success.
32. Taxpayer also admitted that the Scuba Lessons had not shown any profit. Taxpayer asserted that it could take eight or more years for a business to show a profit.
33. Finally, Taxpayer did not address whether he had property for the Scuba Lessons that could generate a profit from appreciation. Instead he merely stated that he hoped to make a profit someday. Taxpayer has not identified any appreciable assets.
34. The Division reviewed the bank account information and Taxpayer’s September 2012 letter. In a letter dated October 19, 2012, the Division informed Taxpayer that the information provided was not sufficient to demonstrate that the expenses claimed on the Schedule C were deductible. The letter referenced the documentation requirements set forth in IRS Publication 463 for meal and auto expenses. It also explained the documents needed to deduct home maintenance expenses. The letter also identified the requirements to document a charitable deduction of \$250 or more.

35. Taxpayer responded in a letter dated November 7, 2012. The letter does not provide any additional information to support Taxpayer's Schedule A or Schedule C deductions.
36. The Hearing Office held a hearing on August 7, 2012. At the hearing the parties requested that the matter be returned to informal status. The Hearing Office granted this request and ordered the parties to submit a status update by October 9, 2012.
37. In October 2012, the Division requested additional time to work with Taxpayer to resolve this matter. The Hearing Officer ordered the parties to submit a status update by December 11, 2012.
38. In his November 7, 2012 letter, Taxpayer asked that the Hearing Officer decide the case based on the documents in the record and the post-hearing submissions.
39. The Hearing Officer issued a decision dated December 14, 2012 in which he upheld the Division's Assessment against Taxpayer in full.

Conclusions of Law

The Director adopts conclusions of law from the Hearing Officer's Decision and makes additional conclusions as follows:

1. A taxpayer may deduct the costs of operating a Schedule C business as business expenses.
2. To claim a deduction, the taxpayers must conduct the activity with an intent to make a profit. See Internal Revenue Code ("IRC") § 183(a); see also *Elliott v. Commissioner*, 90 T.C. 960, 970 (1988), *aff'd*, 899 F.2d 18 (9th Cir. 1990).
3. A Taxpayer bears the burden of proving that he possessed the necessary profit motive. See *Golanty v. Commissioner*, 72 T.C. 411, 426 (1979).
4. Treasury Regulation § 1.183-2(b) sets forth the following nonexclusive list of objective factors that should be taken into account in determining whether a

taxpayer entered into or continued an activity for profit: 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.

5. Objective facts surrounding a taxpayer's activities are given greater weight than a taxpayer's mere statements. *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982), *aff'd*, 702 F.2d 1205 (D.C. Cir. 1983).
6. A history of consistent and substantial losses from an activity is indicative of the lack of a profit objective. *Golanty v. Commissioner*, 72 T.C. at 426
7. In a genuine business, one would expect losses to be recouped by eventual profits. *Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967).
8. A thin line between alleged business activities and personal or recreational activities is another indication of a lack of a profit objective. See *Elliott v. Commissioner*, 90 T.C. at 973 (finding that petitioner's Amway activities did not require them to do much more than maintain an active social life).
9. Other factors that indicate the lack of a profit objective include the lack of experience with a similar type business, the lack of counsel from disinterested third parties, and the failure to maintain an independent business plan. *Nissley v. Commissioner*, T.C. Memo 2000-178.

10. The IRC authorizes a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a business. IRC § 162(a).
11. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's business. A necessary expense is one that is helpful and appropriate for the taxpayer's business. Internal Revenue Service ("IRS") Publication 535, page 2.
12. Car and depreciation expenses for a BMW and a Porsche are not ordinary and necessary expenses for a scuba lesson business.
13. To claim a deduction for business use of a home, a taxpayer must demonstrate that the use was exclusive, regular, and for a business purpose. IRS Publication 334, page 39.
14. Taxpayer has not demonstrated that any portion of his home was used exclusively or regularly for a business purpose.
15. To claim a deduction for business travel, meals or entertainment, a taxpayer must keep a log or similar record that sets forth the amount, date, description and business purpose for the expense. In addition, the taxpayer must keep documentary evidence, such as receipts, cancelled checks, or bills to support the expense. IRS Publication 463, page 26-27.
16. Taxpayer has not demonstrated that any travel or meal expense was for a business purpose.
17. The Hearing Officer correctly determined that Taxpayer may not deduct his expenses listed on his Schedule C for tax year 2006.
18. The Internal Revenue Code ("I.R.C.") § 170(a) allows a deduction for charitable contributions made to qualifying charities.

19. Charitable contributions of \$250 or more are only allowed if the taxpayer obtains a contemporaneous written acknowledgment of the contribution by the organization receiving the contribution. I.R.S. § 170(f)(8)(a). The taxpayer must receive the acknowledgment by the date the return is filed for the tax year the contribution is made or the date the return is due, whichever comes first. I.R.C. § 170(f)(8)(c).
20. Taxpayer has not demonstrated that he made charitable contributions to qualifying charities.

Discussion

The first issue is whether Taxpayer engaged in Scuba Lessons for profit. This must be determined on the facts and circumstances of each case. 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. The determination is based on the totality of the circumstances and no single factor is conclusive. Taxpayer asserts that the Division's May 20, 2012 letter lists different factors. The factors listed in the letter, while phrased slightly differently, are substantially the same inquiry.

The facts and circumstances of this case indicate that Taxpayer did not operate the Scuba Lessons with the objective of making a profit for tax year 2006.

Taxpayer did not engage in the Scuba Lessons in a businesslike manner. There are certain elementary business practices a reasonable person would expect to see in a

business operated for profit. This includes preparing and maintaining a business plan, maintaining a budget, and periodically reviewing records to either cut expenses or find other ways to become more profitable. Taxpayer, however, presents no evidence of a business plan or budget for the Scuba Lessons.

Taxpayer did not have prior experience running a training business. He did not seek out business advice from successful business operators or professions. Taxpayer indicates that banks would not loan him money due to an oversaturation of dive shops in the Phoenix metropolitan area. Despite this warning that the market was overcrowded already, Taxpayer entered the field. Taxpayer did not present evidence regarding the time and effort he expended in carrying on the Scuba Lessons. Taxpayer was employed full time, so the Scuba Lessons had to be performed in his off hours. There are also elements of personal pleasure and recreation involved in Taxpayer's activities.

Taxpayer has a consistent history of losses dating back to 2003. Taxpayer's losses remained disproportionately large compared to his receipts for many years. There is no evidence that Taxpayer ever reconsidered his spending to determine if he was operating in a cost efficient manner. The losses were not due to factors beyond Taxpayer's control. There is no evidence that market conditions changed between 2003 and 2006. Nor is there evidence of extraordinary and unexpected expenses.

In addition, Taxpayer has failed to demonstrate that the expenses he claimed were appropriate. Taxpayer claims 39% of his house was used regularly and exclusively for the Scuba Lessons, but does not identify the rooms involved or how they were used. Taxpayer has not provided documents concerning the business purpose for travel and meal expenses. The QuickBooks records merely list expenses but do not comply with IRS requirements. Taxpayer took no effort to identify the business purpose for the gasoline and meals. There is no evidence why Taxpayer needed the exclusive use of one much less

two vehicles in connection with the Scuba Lessons. He has never even suggested a business need for use of a BMW and Porsche.

Taxpayer asserts that all his records were destroyed in a house fire. That does not relieve Taxpayer of his obligation to reconstruct his records to the best of his ability. For example, there is no reason why Taxpayer could not create a floor plan for his home and identify what portion of the home was used for business. Taxpayer should be able to piece together the business purpose for travel and meal expenses. Taxpayer should also explain how and why he used the BMW and Porsche. Taxpayer, however, has never identified his business activities in 2006 and explained how the deductions he claims apply to those activities.

The Internal Revenue Code ("I.R.C.") § 170(a) allows a deduction for charitable contributions made to qualifying charities but for contributions of \$250 or more the taxpayer must obtain a contemporaneous written acknowledgment of the contribution by the organization receiving the contribution. I.R.S. § 170(f)(8)(a). In this case, Taxpayer admits that he did not receive a written acknowledgment from the recipient. There is not even proof that the alleged contribution was made to a qualifying charity. All Taxpayer has offered to provide is a statement from his son. That is insufficient documentation to support a charitable contribution deduction.

Based on the foregoing, the Hearing Officer's Decision and the Division's proposed assessment for tax year 2006 are affirmed.

ORDER

The Hearing Officer's decision is affirmed.

This decision is the final order of the Department of Revenue. Taxpayer may contest this order by filing an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140 Phoenix, AZ 85007, within 60 days of the receipt of the order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102.

Dated this 14th day of March, 2013.

ARIZONA DEPARTMENT OF REVENUE

John A. Greene
Director

Certified original of the foregoing
mailed to:

[Redacted]

JAG:

cc: Individual Income Tax Appeals Section
Individual Income Tax Audit Section
Audit Division