

5. On March 21, 2012 the Section issued a proposed assessment disallowing Taxpayers' Schedule C expenses of \$[REDACTED].
6. The proposed assessment included interest but no penalties.
7. Taxpayers protested the assessment and requested a formal hearing.
8. Taxpayers' Schedule C expenses were identified at the hearing as education expenses of \$[REDACTED], travel/mileage of \$[REDACTED], deductible meals of \$[REDACTED], depreciation of \$[REDACTED], telephone of \$[REDACTED], postage of \$[REDACTED], dues of \$[REDACTED], tax and license of \$[REDACTED] and other supplies of \$[REDACTED] for a total of \$[REDACTED].
9. The record does not contain a copy of Taxpayers' Schedule C or identify the claimed expenses of \$[REDACTED], the difference between the amount identified at the hearing and the amount claimed on the Schedule C.
10. The expenses listed in Finding of Fact No. 8 have been substantiated by Taxpayers.
11. Taxpayers purchased a residential property in 2007 with the intent of rehabilitating the property and selling it.
12. Taxpayers completed the rehabilitation of the property in January 2008 but were not successful in selling the property.
13. Taxpayers decided to keep the property and turn it into a rental property. Taxpayers still have the property as a rental.
14. Taxpayers have not since purchased other properties.
15. During 2007 Taxpayer [REDACTED] (Taxpayer) quit his employment to concentrate on his real property activity.
16. During 2007 Taxpayer received training from the [REDACTED]. The training was real estate related regarding how to find and rehabilitate real property and how to find buyers for the property.

17. Taxpayer was not previously familiar with real estate transactions. Taxpayer's training from [REDACTED] was not required by his employer and did not relate to his prior employment. The classes were to gain knowledge regarding buying and selling property.
18. The cost of the training from [REDACTED] was \$[REDACTED].
19. Taxpayer's travel/mileage expenses and meals related to attending the training.
20. Taxpayers reported federal adjusted gross income of \$[REDACTED] on their 2007 federal income tax return.

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. 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. To be deductible as an ordinary and necessary business expense, an item must be paid or incurred during the taxable year for carrying on any trade or business. I.R.C. § 162.
4. Not every income-producing endeavor constitutes a trade or business. *Commissioner v. Groetzinger*, 480 U.S. 23, 107 S.Ct. 980 (1987).
5. An individual may deduct non-business 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 as a miscellaneous itemized deduction. I.R.C. § 212.
6. 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 federal adjusted gross income. I.R.C. § 67(a).

7. Although an individual who is engaged in the business of selling real estate to customers may be characterized as a real estate dealer, an individual who holds real estate for investment or speculation, and receives rentals therefrom, is not a real estate dealer. Treas. Reg. § 1.1402(a)-4(a).
8. Whether Taxpayers here were real estate dealers depends on the facts and circumstances of this case.
9. In deciding whether a taxpayer holds property primarily for sale to customers in the ordinary course of his trade or business, courts consider various factors such as: (1) The purpose for which the property was initially acquired; (2) the purpose for which the property was subsequently held; (3) the extent to which improvements, if any, were made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and nature of the transactions involved; (6) the ordinary business of the taxpayer; (7) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property; (8) the listing of property with brokers; and (9) the purpose for which the property was held at the time of sale. See *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278 (1970).
10. The record does not support a finding that Taxpayers were in the business of renovating buildings for resale. At most, the record supports that Taxpayers made an investment in the property, which was subsequently converted into rental real estate as a result of a depressed real estate market. See, *William J. Ashley*, TC Memo 2000-376, (2000).
11. Taxpayers' claimed Schedule C expenses were deductible, if at all, as a miscellaneous itemized deduction on Schedule A subject to the 2% limitation.
12. A taxpayer may deduct education expenses that maintains or improves skills required in his trade or business or that is required by law or by the taxpayer's employer. Internal Revenue Service (IRS) Pub. 970.

13. Taxpayer's education here was not required by law, by Taxpayer's employer or to maintain or improve Taxpayer's skills needed in his present work.
14. The education intended to allow Taxpayer to gain knowledge regarding buying and selling property. It was a program to qualify Taxpayer for a new trade or business.
15. Taxpayer's claimed education expense of \$[REDACTED] was not an allowable education expense deduction.
16. Taxpayer's claimed travel/mileage expense of \$[REDACTED] and meals of \$[REDACTED] were incurred in connection with his education activity and are thus not deductible.
17. Taxpayers may be entitled to claim expenses of \$[REDACTED] (the amounts reported on Schedule C for depreciation of \$[REDACTED], telephone of \$[REDACTED], postage of \$[REDACTED], dues of \$[REDACTED], tax and license of \$[REDACTED] and other supplies of \$[REDACTED]) on Schedule A as a miscellaneous itemized deduction subject to the 2% limitation.
18. Taxpayers' federal adjusted gross income was \$[REDACTED] (\$[REDACTED] reported on the federal return plus \$[REDACTED] not allowable on Schedule C).
19. The claimed expenses of \$[REDACTED] do not exceed 2% of Taxpayers' federal adjusted gross income (\$[REDACTED]) and are therefore not deductible on Schedule A.
20. Taxpayers have not met the burden to show they were entitled to a deduction for the expenses claimed on their Schedule C for tax year 2007.
21. The Section properly disallowed Taxpayers' claimed Schedule C business expenses for tax year 2007.
22. 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.

23. The Section's proposed assessment dated March 21, 2012 for tax year 2007 was proper.

DISCUSSION

Taxpayers timely filed their 2007 Arizona income tax return. Taxpayers claimed Schedule C expenses of \$[REDACTED] shown on their federal tax return. Taxpayers' Schedule C expenses consisted of education expenses of \$[REDACTED], travel/mileage of \$[REDACTED], deductible meals of \$[REDACTED], depreciation of \$[REDACTED], telephone of \$[REDACTED], postage of \$[REDACTED], dues of \$[REDACTED], tax and license of \$[REDACTED] and other supplies of \$[REDACTED] for a total of \$[REDACTED] specified in the record.

In 2007 Taxpayers purchased a residence to rehabilitate and sell. The rehabilitation was completed in January 2008 but Taxpayers were not able to sell the property at a profit. They therefore leased the property and have continued to lease it. Taxpayers have not purchased any other properties.

Taxpayers claimed Schedule C expenses because they were in the business of rehabilitating the property for sale. The Section disallowed Taxpayer's Schedule C deduction because the activity was not engaged in for profit. The Section also questioned whether some of the expenses, such as for education, were deductible in any event. The questions therefore presented are:

- Were Taxpayers' expenses deductible on their Schedule C?
- If not deductible on Schedule C, may they still be deducted somewhere?
- Were all of the claimed expenses entitled to be deducted?

Taxpayers' Expenses Were not Deductible on Schedule C.

A person may be a dealer in the business of selling real estate to customers. In that case the person's expenses would qualify as ordinary and necessary business expenses deductible on Schedule C. However, not every income-producing endeavor

constitutes a trade or business. The question here is whether Taxpayers were dealers in real estate.

In deciding whether a taxpayer holds property primarily for sale to customers in the ordinary course of his trade or business, courts have evaluated the particular facts of each case considering factors such as: (1) The purpose for which the property was initially acquired; (2) the purpose for which the property was subsequently held; (3) the extent to which improvements, if any, were made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and nature of the transactions involved; (6) the ordinary business of the taxpayer; (7) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property; (8) the listing of property with brokers; and (9) the purpose for which the property was held at the time of sale.

The above factors do not show that Taxpayers were real estate dealers. While Taxpayers purchased the property with the intent to sell it, the property was never sold, was used as rental property and Taxpayers have not purchased any other properties. As the court in *William J. Ashley, supra*, stated, at most, the record supports that Taxpayers made an investment in the property, which was subsequently converted into a rental real estate business as a result of a depressed real estate market. That does not support a finding that Taxpayers were in the business of renovating properties for resale. Taxpayers were therefore not entitled to deduct their expenses as ordinary and necessary business expenses on their Schedule C.

Taxpayers' Allowable Expenses Were Deductible on Schedule A.

A taxpayer may generally deduct his ordinary and necessary expenses incurred for the production or collection of income not from a business as a miscellaneous itemized deduction on Schedule A, subject to a limitation. Those expenses are only deductible to the extent they exceed 2% of Taxpayers' federal adjusted gross income.

Taxpayers reported \$[REDACTED] as their federal adjusted gross income on their federal income tax return. That amount did not include Taxpayers' claimed Schedule C expenses of \$[REDACTED]. Because Taxpayers were not entitled to claim Schedule C expenses for their real estate activity, Taxpayers' actual federal adjusted gross income was \$[REDACTED].

Two percent of Taxpayers' federal adjusted gross income of \$[REDACTED] is \$[REDACTED]. Allowable deductions over \$[REDACTED] would therefore be deductible as a miscellaneous itemized deduction.

Taxpayers' Allowable Deductions did not Exceed the 2% Limit.

The bulk of Taxpayers' Schedule C expenses were for education and related travel and meals. Education expenses may be deductible if the education is to maintain or improve skills required in a taxpayer's trade or business at the time or is required by law or by a taxpayer's employer. Taxpayer's education here was not required by law, by Taxpayer's employer or to maintain or improve Taxpayer's skills needed in his work at that time. The education intended to allow Taxpayer to gain knowledge regarding buying and selling property. It was a program to qualify Taxpayer for a new or different trade or business. Therefore, Taxpayers' claimed education expense and related travel and meals were not allowable deductions.

At the hearing the parties identified other expenses of \$[REDACTED] comprised of depreciation of \$[REDACTED], telephone of \$[REDACTED], postage of \$[REDACTED], dues of \$[REDACTED], tax and license of \$[REDACTED] and other supplies of \$[REDACTED]. While those amounts could be eligible for deduction on Taxpayers' Schedule A, they do not exceed the 2% limitation. Taxpayers are therefore not entitled to deduct any of their claimed Schedule C expenses.

The proposed assessment included interest. A.R.S. § 42-1123(C) provides that if the tax or any portion of the tax is not paid on or before the date prescribed for its

payment, the Department shall collect, as a part of the tax, interest on the unpaid amount from the date prescribed for its payment until it is paid.

Based on the foregoing, the Section's proposed assessment of tax and interest dated March 21, 2012 is upheld.

DATED this 14th day of June, 2013.

ARIZONA DEPARTMENT OF REVENUE
HEARING OFFICE

[REDACTED]
Hearing Officer

Original of the foregoing sent by
certified mail to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Individual Income Tax Audit Section