

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of

[REDACTED]

UTI # [REDACTED]

DECISION OF
HEARING OFFICER

Case No. 201300106-I

A hearing was held on June 18, 2013 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 2008. At the hearing it was agreed that the record remain open to allow Taxpayer time to provide additional information.

Taxpayer and the Section have submitted their respective memoranda. This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayer filed a federal and an Arizona income tax return for 2008.
2. Taxpayer's filing status was married filing separately on both his federal and state income tax returns.
3. On his federal return, Taxpayer reported wages of \$[REDACTED] and subtracted \$[REDACTED] as an "IRC 66 SPLIT".
4. Taxpayer reported federal adjusted gross income (FAGI) of \$[REDACTED].
5. Taxpayer's Arizona income tax return reported FAGI of \$[REDACTED].
6. On line 15 of his Arizona income tax return Taxpayer subtracted \$[REDACTED] as a "Community Property Adjustment".
7. Taxpayer reported Arizona adjusted gross income of \$[REDACTED].
8. The Section reviewed Taxpayer's Arizona income tax return and issued a proposed assessment dated February 27, 2013 which:

- a. Included in Taxpayer's income \$[REDACTED] subtracted on the Arizona return.
 - b. Included in Taxpayer's income \$[REDACTED] subtracted on Taxpayer's federal return (\$[REDACTED] less \$[REDACTED] reported as "[REDACTED] AWARD").
 - c. Disallowed Taxpayer's Schedule A miscellaneous itemized deductions of \$[REDACTED].
9. The proposed assessment included interest but no penalties.
 10. Taxpayer protested the assessment stating that IRC 66 allows and requires community property split of income.
 11. The Section sent Taxpayer a letter dated April 12, 2013 stating that Taxpayer already took the community property split on his federal return. In addition, there was no verification of Schedule A Form 2106 in the amount of \$[REDACTED].
 12. Taxpayer disagreed and requested a formal hearing.
 13. During tax year 2008 Taxpayer was separated from his wife and they did not live in the same household.
 14. Taxpayer and his wife had no communication during 2008 or afterwards.
 15. Taxpayer's wife also filed federal and state returns with filing status of married filing separately. Taxpayer's wife reported all of her earned income on her separate return.
 16. Taxpayers did not notify each other of their community income.
 17. During tax year 2008 Taxpayer and his wife had a joint checking account.
 18. Taxpayer provided bank statements for the account for seven months of 2008.
 19. The bank statements that were provided indicated that:
 - a. Taxpayer's wife made five deposits to the account during January through March of 2008 in the total amount of \$[REDACTED].

- b. There were withdrawals of \$[REDACTED] each month for [REDACTED] Life Insurance payment.
 - c. There were monthly deposits of \$[REDACTED] for child support from a prior marriage.
20. Taxpayer stated in his reply memorandum that:
- a. His wife made other deposits during January and February 2008 in the total amount of \$[REDACTED].
 - b. Taxpayer was not required to report any of his wife's earned income on his return pursuant to Treas. Reg. 1.66-3.
21. The Section's response memorandum indicated that the community income of Taxpayer and his wife was in excess of \$[REDACTED].
22. Taxpayer provided a fuel purchase log to substantiate vehicle mileage.
23. The log was for June 2008 through December 2008.
24. The log showed the odometer reading when Taxpayer purchased fuel. The log did not list the destination, mileage or business purpose of each trip for which Taxpayer claimed mileage.
25. The miles shown on Taxpayer's log for June through December 2008 totaled 16,512.
26. Taxpayer's form 2106, Unreimbursed Employee Business Expenses, claimed business miles driven after June 30, 2008 of 18,325.
27. Taxpayer claimed travel expenses of \$[REDACTED] on form 2106.
28. Taxpayer provided hotel receipts totaling \$[REDACTED]. The hotel receipts did not indicate the business nature or purpose of the travel.
29. Taxpayer provided receipts for meals.
30. The adding machine tape compiling total meal charges of \$[REDACTED] shows an entry for \$3,146.00.
31. The corresponding receipt from [REDACTED] shows a charge of \$31.46.

32. The total claimed meal charges should have been \$[REDACTED].
33. The meal receipts do not specify the business purpose of the meal or who attended. Some of the receipts had hand written notation of “customer” or “customer prospect”.
34. Taxpayer’s employer had a policy of reimbursing certain job-related travel and other expenses.

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. The Department has the authority to examine tax returns, determine Arizona gross income and make assessments notwithstanding a failure by the Internal Revenue Service to make a similar determination. ITR 93-6.
4. Community income received by spouses who live apart at all times during the calendar year, do not file a joint return, one or both have earned community income and no portion of such earned income is transferred (directly or indirectly) between the spouses before the close of the calendar year will be taxed to the spouse who earned the income rather than according to community property laws. IRC § 66(a).
5. In determining whether earned income was transferred between the spouses, transferred income does not include a de minimis amount of earned income that is transferred between the spouses. In addition, any amount of earned income

transferred for the benefit of the spouses' child will not be treated as an indirect transfer to one spouse. Treas. Reg. § 1.66-2(c).

6. Here the amount of income deposited by Taxpayer's wife into the joint account at the beginning of 2008 is de minimis when compared to the total amount of community income received by Taxpayer and his wife.
7. The benefits of community property law may be denied to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to such income and failed to notify the taxpayer's spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income. IRC § 66(b).
8. Taxpayer argues that he did not have to include any of his wife's community income under IT Reg. 1.66-3 because she did not notify him of her income totals.
9. The Section was authorized to disallow the benefits of Arizona's community property law to Taxpayer pursuant to IRC § 66(b).
10. Travel expenses and expenses with respect to listed property (passenger automobiles) must be substantiated by adequate records or sufficient evidence corroborating the taxpayer's own statement (1) the amount of such expense, (2) the time and place of the travel, (3) the business purpose of the expense. See, IRC § 274(d).
11. To claim a deduction for business travel, meals or entertainment, a taxpayer must keep a log or similar record that sets forth the amounts, 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 Pub. 463, pp. 26-27.
12. For entertainment, including meals, the records must also identify the occupation or other information relating to the person or persons entertained, including

name, title, or other designation, sufficient to establish a business relationship to the taxpayer. Treas. Reg. 1.274-5T(b)(3)(v).

13. Based on the hearing record, Taxpayer has not met his burden to show he is entitled to a deduction for his claimed travel and meal expenses.
14. Taxpayer has not demonstrated entitlement to a deduction of his claimed unreimbursed employee expenses.
15. 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.
16. The Section’s proposed assessment dated February 27, 2013 for tax year 2008 is upheld.

DISCUSSION

Taxpayer timely filed his 2008 federal and state personal income tax returns indicating a filing status of married filing separately on both returns. On his federal return, Taxpayer reported wages of \$[REDACTED], subtracted \$[REDACTED] as an “IRC 66 SPLIT” and showed FAGI of \$[REDACTED].

Taxpayer’s Arizona income tax return reported FAGI of \$[REDACTED]. On line 15 of his Arizona income tax return Taxpayer subtracted \$[REDACTED] as a “Community Property Adjustment” reporting total Arizona adjusted gross income of \$[REDACTED].

The Section reviewed Taxpayer’s return and issued a proposed assessment which added back to Taxpayer’s income the \$[REDACTED] subtracted on the Arizona return, the \$[REDACTED] subtracted on Taxpayer’s federal return and disallowed Taxpayer’s Schedule A miscellaneous itemized deductions of \$[REDACTED].¹

¹ The Department can determine Arizona gross income and make assessments notwithstanding a failure by the Internal Revenue Service to make a similar determination. ITR 93-6.

Taxpayer protested the assessment because IRC § 66 allowed and required a community property split of income. Taxpayer acknowledged at the hearing that subtracting one-half of his wages on the state return after calculating a community property split on the federal return was in error. Taxpayer is therefore not contesting the addition of the \$[REDACTED] to his Arizona income. The questions presented are therefore:

- Was Taxpayer required to report all of his community property income on his return, and
- Was Taxpayer entitled to claim \$[REDACTED] for unreimbursed employee expenses?

Community Property Split.

In general, income earned by each spouse during marriage is considered community income. Each spouse would be required to report one-half of the total community income on their separately filed income tax returns. IRC § 66 however provides that in certain circumstances community property laws may be disregarded and community income treated as the income of the spouse earning the income. For the reasons that follow, we believe Taxpayer was required to include all of his earned wages of \$[REDACTED] in his 2008 Arizona income tax return.

IRC § 66(a).

Community property laws may be disregarded if spouses live apart during the calendar year, do not file a joint return, one or both have earned community income and no portion of such earned income is transferred (directly or indirectly) between the spouses. The only question is to determine whether earned income was transferred between the spouses.

Treas. Reg. 1.66-2(c) provides that in making that determination, transferred income does not include a de minimis amount of earned income or payments for child support. Here the amount of income Taxpayer's wife deposited into the joint account at

the beginning of 2008 is de minimis when compared to the total amount of community income of over \$[REDACTED] received by Taxpayer and his wife.

Not only were the amounts deposited by Taxpayer's wife minimal, her withdrawals from the account were also minimal. Based on the record here, we conclude that no amount of earned income was transferred between the spouses within the meaning of IRC § 66(a).

IRC § 66(b).

Community property laws may also be disregarded if the taxpayer acted as if solely entitled to such income and failed to notify the taxpayer's spouse before the due date for filing the return for the taxable year in which the income was derived of the nature and amount of such income.

The Section in its response memorandum contended that if Taxpayer was entitled to a community property split, Taxpayer was required to include in his income one-half of his wife's community income. Taxpayer responded that under Treas. Reg. 1.66-3 he did not have to include a portion of his wife's community income. This supports the testimony at the hearing that the parties did not communicate during 2008 or thereafter. It also supports a finding that the amounts deposited into the account by Taxpayer and his wife were for the use of Taxpayer and his wife respectively. Each person treated the income as his or her income. The Section was therefore authorized to disallow the benefits of Arizona's community property law to Taxpayer pursuant to IRC § 66(b).

Disallowed Unreimbursed Employee Expenses.

Taxpayer had claimed a deduction on his Schedule A for unreimbursed employee expenses of \$[REDACTED]. The expenses were comprised of \$[REDACTED] mileage, \$[REDACTED] travel and \$[REDACTED] meals and entertainment.

Mileage.

Taxpayer claimed total business miles of 27,490, 9,165 driven before July 1, 2008 and 18,325 miles driven after June 30, 2008. Taxpayer provided a fuel purchase log for the period June 2008 through December 2008 showing the odometer reading when Taxpayer purchased fuel. The log did not list the destination, mileage or business purpose of each trip for which Taxpayer claimed mileage.

The miles shown on Taxpayer's log for the period June through December 2008 totaled 16,512 miles. Taxpayer's form 2106 claimed business miles driven after June 30, 2008 of 18,325. No log was provided for periods before June 2008. No reconciliation was provided between Taxpayer's log and the amounts claimed on the return or how the mileage claimed on the return was calculated. We find that the documents in the record do not adequately substantiate Taxpayer's claimed business miles.

Travel Expenses.

Taxpayer claimed travel expenses of \$[REDACTED]. Taxpayer provided hotel receipts totaling \$[REDACTED] to support the deduction. The information did not show how the deducted amounts were calculated and did not provide information to establish the business purpose of the travel. In addition, information submitted by Taxpayer indicated that his employer had a policy of reimbursing certain job-related travel and other expenses. We find that the documents in the record do not adequately substantiate Taxpayer's entitlement to the claimed travel expenses.

Meals.

Taxpayer had claimed deductible meals of \$[REDACTED]. Taxpayer's response stated that he provided receipts for meals in the amount of \$[REDACTED] and requested a deduction in the amount of \$[REDACTED], one-half of the total expense. Some of the receipts had hand written notation of "customer" or "customer prospect". For entertainment, including meals, Taxpayer's records must identify the occupation or other information relating to the person or persons entertained, including name, title, or

other designation, sufficient to establish a business relationship to the taxpayer. Taxpayer's receipts did not provide the necessary information.

In addition, Taxpayer inadvertently entered a receipt for \$31.46 as \$3,146 in totaling the receipts. Substituting \$31.46 for \$3,146 reduces meal expenses to \$[REDACTED]. One-half of the revised amount is \$938.89, less than originally claimed by Taxpayer. Taxpayer has not shown entitlement to the claimed meal expenses.

Other Expenses.

Taxpayer also included \$[REDACTED] for cell phone and \$[REDACTED] for tax preparation fees as miscellaneous itemized deductions. Those amounts do not exceed the 2% limitation for miscellaneous itemized deductions and are not allowable in any event.

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 for tax year 2008 dated February 27, 2013 is upheld.

DATED this 2nd day of October, 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