BEFORE THE ARIZONA DEPARTMENT OF REVENUE

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| In the Matter of | ) | DECISION OF HEARING OFFICER |
| [REDACTED] | ) | |
| UTI # [REDACTED] | ) | Case No. 201300114-I |

A hearing was held on July 25, 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 2007. At the hearing leave to submit additional documentation was granted.

Taxpayers and the Section submitted their respective opening and response memoranda. Taxpayers did not submit a reply. This matter is ready for ruling.

FINDINGS OF FACT

1. Taxpayers timely filed their 2007 Arizona individual income tax return.
2. Taxpayers claimed a Schedule C loss of $[REDACTED].
3. The Section sent Taxpayers a letter dated December 16, 2011 asking Taxpayers to provide documentation to prove their Schedule C income and expenses.
4. On February 8, 2012, the Section issued a proposed assessment to Taxpayers disallowing Taxpayers' 2007 Schedule C loss of $[REDACTED].
5. The assessment calculated interest at the statutory rate but no penalties.
6. Taxpayers timely protested the assessment.
7. Taxpayers are [REDACTED] representatives or distributors.
8. [REDACTED] supplies various products and uses a direct marketing concept to promote sales of its products.
9. The program is based on a "pyramid" incentive system whereby, in addition to selling retail to consumers, distributors can also increase their proceeds by recruiting others ("downline" distributors) to sell the products. If the recruit of one

distributor recruited another downline distributor, the sales of the new downliner would also benefit the original distributor.

10. The original [REDACTED] distributor is called an "upline" distributor in relation to a "downline" distributor.

11. Taxpayers experienced the following gross receipts, expenses and losses for tax years 2005 through 2012:

| Year | Gross Receipts | Cost of Goods Sold | Expenses | (Loss) |
|---|---|---|---|---|
| 2005 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| 2006 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| 2007 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| 2008 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| 2009 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| 2010 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| 2011 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| 2012 | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |
| Totals | [REDACTED] | [REDACTED] | [REDACTED] | ([REDACTED]) |

12. Taxpayers were recognized as [REDACTED] producers in November 2012, [REDACTED] producers in May 2013 and [REDACTED] producers in July 2013.

13. Taxpayers did not register their activity as a separate entity.

14. Taxpayers did not provide an independent business plan, budget or written projections for their activity.

15. Taxpayers relied on the company and their upline distributors for advice.

16. Both Taxpayers were employed full-time and received wages and salaries of $[REDACTED] for tax year 2007.

17. Taxpayers were not relying on their income from their Schedule C activity to support themselves during 2007.

18. In the year at issue, Taxpayers claimed the following expenses:

| | |
|---|---|
| Advertising | [REDACTED] |
| Car & Truck Expenses | [REDACTED] |
| Depreciation | [REDACTED] |
| Legal & Professional | [REDACTED] |
| Supplies | [REDACTED] |
| Travel | [REDACTED] |
| Meals/Entertainment | [REDACTED] |
| Utilities | [REDACTED] |
| Other Expenses: | |
| Conference | [REDACTED] |
| Business Materials | [REDACTED] |
| Business Meetings | [REDACTED] |
| Gifts | [REDACTED] |
| Internet | [REDACTED] |
| Cell | [REDACTED] |
| Product Samples | [REDACTED] |
| Total | [REDACTED] |

19. The travel and auto expenses were based on business miles driven. On their Schedule C Taxpayers entered [REDACTED] for business miles, [REDACTED] for commuting miles and [REDACTED] for other miles.

20. Taxpayer [REDACTED] was employed at the [REDACTED].

21. Taxpayer [REDACTED] was employed in [REDACTED].

22. Taxpayers testified they would make personal deliveries of product to their customers and distributors or meet with prospective distributors or customers.

23. Taxpayers submitted a mileage log showing the date, destination, city and state, purpose, beginning and ending miles and daily and monthly miles.

24. The ending mileage listed for each entry was the starting mileage for the following entry. The log did not identify any commuting or other personal mileage that may have been included in the trip or that occurred that day.

25. Taxpayers' log recorded trips for most days of the year.

26. Most of the destination entries were to retail outlets such as [REDACTED], [REDACTED], [REDACTED] or a mall in Phoenix, Chandler or Tempe, Arizona.

27. The purpose of the trip was listed generally as Education Meeting, Meeting Partners, Prospective Business Partners, Clients, Entertainment or Service. The log did not identify the person Taxpayers were meeting with.

28. The Section contends in its Memorandum that Taxpayers' activity was not conducted for profit because:

a. Taxpayers did not maintain a separate bank account or separate records for their activity.

b. Taxpayers did not maintain a written budget, a monthly report of expenses or a statement with a projected profit or loss calculation.

c. Taxpayers did not present evidence that they had any experience with an [REDACTED] type of activity or that they sought advice from disinterested third parties.

d. Taxpayers testified they spent a substantial amount of time pursuing their [REDACTED] activity. However, they only provided a mileage log showing they traveled over [REDACTED] miles for the activity. The Section questioned whether traveling that amount for the activity was realistic given both Taxpayers were employed full time.

e. Taxpayers have not shown they were successful in making a profit in similar activities in the past.

f. Taxpayers have a history of consistent and substantial losses.

g. Taxpayers received substantial wage income from full-time employment and were able to use the loss from the activity to reduce their taxable income and achieve substantial tax savings.

h. Taxpayers took pleasure in attending seminars and conventions held for [REDACTED] distributors and in establishing a network of friends.

i. Taxpayers have not shown their claimed expenses for utilities, internet and cell phone were wholly attributable to their [REDACTED] activity.

29. The Section has also contended that Taxpayers have not established that the Schedule C expenses were ordinary and necessary business expenses.

30. Taxpayers did not submit a reply memorandum.

CONCLUSIONS OF LAW

1. 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).

2. 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.

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. I.R.C. § 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

5. The activity must have been conducted with an intent to make a profit. *See* I.R.C. § 183(a); *see also Elliott v. Commissioner*, 90 T.C. 960, 970 (1988), *aff'd,* 899 F.2d 18 (9th Cir. 1990).

6. I.R.C. § 183(d) provides that if the gross income exceeds the deductions from such activity for three or more of the immediately preceding five years, the activity is presumed to be engaged in for profit and the taxing entity has the burden of proof to rebut this presumption.

7. If a taxpayer's income does not exceed expenses for the required period, the taxpayer does not enjoy the presumption that the activity was engaged in for profit.

8. Taxpayers do not meet the qualification to presume that their [REDACTED] activity was engaged in for profit.

9. Taxpayers bear the burden of proving that they possessed the necessary profit motive for the activity. *See Golanty v. Commissioner*, 72 T.C. 411, 426 (1979).

10. Treas. Reg. § 1.183-2(a) states that "[t]he determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case." The regulation further states that "the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit." *Id*.

11. In determining whether a taxpayer entered into or continued an activity for profit, Treas. Reg. § 1.183-2(b) sets forth the following nonexclusive list of objective factors that should be taken into account: 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.

12. No single factor is conclusive. Rather, determining whether a taxpayer possesses the relevant profit objective is a question of fact to be determined in light of all the facts and circumstances. *See* Treas. Reg. § 1.183-2(b).

13. The potential to profit in a given year is not enough. In a genuine business, one would expect losses to be recouped by eventual profits. *See Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967).

14. A series of losses during the startup period of an activity is not necessarily an indication that the activity is not engaged in for profit. *Bessenyey v. Commissioner, supra*.

15. Taxpayers have not provided objective evidence demonstrating that their activity was engaged in for profit during tax year 2007.

16. The Section's proposed assessment disallowing Taxpayers' Schedule C losses for tax year 2007 is upheld.

17. 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.

18. The Section's proposed assessment dated February 8, 2012 is upheld.

## DISCUSSION

Taxpayers timely filed their tax year 2007 personal income tax return and claimed Schedule C business losses in the total amount of $[REDACTED]. The Section reviewed Taxpayers' return and issued a proposed assessment disallowing Taxpayers' deduction of their Schedule C business loss because the activities were not engaged in for a profit. The Section also contends that even if Taxpayers were engaged in business for a profit, Taxpayers' Schedule C expenses were not valid business expenses.

I.R.C. § 162(a) provides in pertinent part that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." However, in order for business expenses to be deductible in excess of gross income from an activity, a taxpayer must have conducted the activity with the intent to make a profit. *See* I.R.C. § 183(a); *see also Elliott v. Commissioner*, *supra*.

I.R.C. § 183(d) provides that if the gross income exceeds the deductions from such activity for three or more of the immediately preceding five years, the activity is presumed to be engaged in for profit and the taxing entity has the burden of proof to rebut this presumption. Taxpayers have not made a profit in either their activity in any of the tax years from 2005. Therefore, Taxpayers are not entitled to the presumption under I.R.C. § 183(d). Absent such presumption, Taxpayers bear the burden of proving that they possessed the required profit motive. *See Golanty v. Commissioner*, *supra.*

Treas. Reg. § 1.183-2(a) states that "[t]he determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case." The regulation further states that "the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit." *Id*. The United States Supreme Court noted that "the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987) (emphasis added).

In determining whether a taxpayer entered into or continued an activity for profit, Treas. Reg. § 1.183-2(b) sets forth the following nonexclusive list of factors that should normally be taken into account: 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.

No single factor is conclusive. Rather, determining whether a taxpayer possesses the relevant profit objective is a question of fact to be determined in light of

all the facts and circumstances. *See* Treas. Reg. § 1.183-2(b). However, "greater weight is given to objective facts than to the taxpayer's mere statement of his intent." Treas. Reg. § 1.183-2(a).

Factor (1) *The Manner in Which the Taxpayer Carries on the Activity.*

Taxpayers have not presented evidence that the activity was carried on in a business-like manner. Taxpayers did not maintain a separate bank account or keep separate records. Taxpayers did not provide a business plan for earning a profit and relied solely on the plan provided to them by interested [REDACTED] individuals. Taxpayers did not provide a budget, business projections, or other indication of potential for economic growth. While Taxpayers gross income increased each year, they continued to incur losses of more than $[REDACTED].

Factor (2) *The Expertise of the Taxpayer or His Advisors*.

Taxpayers did not demonstrate expertise in the multi-level marketing activity and did not show they consulted with or sought the advice of disinterested parties.

Factors (3), (8) and (9) *The Time and Effort Expended by Taxpayer in Carrying on the Activity, Taxpayer's Financial Status and the Elements of Personal Pleasure or Recreation*.

Taxpayers did not present evidence regarding the time and effort they expended in carrying on the activity. Both Taxpayers had full-time jobs. Taxpayers testified they would spend 30 to 40 hours a week on the activity mainly in the evenings, on weekends and during annual leave but no time records were provided.

Taxpayers received significant wage income and were not dependent on income from the activity for their living expenses. Income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit. Here, losses from Taxpayers' activity generated tax benefits to offset their wage income.

The Section also stated in its Response that Taxpayers involvement in [REDACTED] conventions and seminars was fun and enjoyable. Taxpayers did not file a Reply.

Factor (4) *The Expectation That Assets Used in the Activity May Appreciate in Value*.

This criteria does not appear applicable here.

Factor (5) *The Success of the Taxpayer in Carrying On Similar or Dissimilar Activities*.

Taxpayers did not demonstrate an ability to succeed in similar or dissimilar endeavors in the past.

Factors (6) and (7) *The Taxpayer's History of Income or Losses With Respect to the Activity and the Amount of Occasional Profits, If Any, Which Are Earned*.

Taxpayers have a history of losses dating back to 2005. From 2005 to 2012 the Schedule C activity incurred over [REDACTED] of total expenses compared to about $[REDACTED] in total receipts. A history of losses may be indicative that Taxpayers did not have a profit motive. Here, even though Taxpayers' income has increased over the years, their losses have remained disproportionately large compared to their receipts.

The ultimate question to be decided, based on objective facts, is whether Taxpayers had a genuine profit objective during the tax year at issue. While Taxpayers may have subjectively hoped to earn a profit, their objective actions did not reflect that they took appropriate actions to operate a business for profit. The only objective indicator favoring Taxpayers is the increase in Taxpayers' gross income over the years. All the other relevant indicators, including their history of losses, support the Section's contention that Taxpayers' activity was not conducted with a profit motive. In weighing the facts and circumstances presented in this case, the Hearing Officer finds that

Taxpayers' activity was not operated with the objective of making a profit for tax year 2007.

Because we hold that Taxpayers' activity was not engaged in for profit, it is not necessary to address whether their claimed expenses were ordinary and necessary business 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" when due "the department shall collect, as a part of the tax, interest on the unpaid amount" until the tax has been paid. For Arizona purposes, therefore, interest is a part of the tax and generally may not be abated unless the tax to which it relates is found not to be due for whatever reason. The assessment properly included interest.

The Section's proposed assessment dated February 8, 2012 for tax year 2007 is affirmed.

DATED this10th day of December, 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