BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	DECISION OF HEARING OFFICER
	)	
[REDACTED]	)	
	)	Case No. 201300259-I
UTI # [REDACTED]	)	
	)	

A hearing was held on August 12, 2014 in the matter of the protest of [REDACTED] (Taxpayers) to an assessment of income tax, interest and penalty by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2006. At the hearing it was agreed that the record remain open to allow the parties time to provide additional information.

Taxpayers and the Section timely submitted respective Opening information and Response memorandum. The Section's Response memorandum included a third modified proposed assessment. Taxpayers did not submit a Reply or respond to the Section's third modified proposed assessment. Neither party requested that the matter be reset for another hearing. This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayers filed a federal and an Arizona income return for tax year 2006.
2. Taxpayers' Arizona income tax return was received by the Department on February 28, 2011.
3. Taxpayers' federal return included a Schedule C showing gross income of $[REDACTED], expenses of $[REDACTED] and a net loss of $[REDACTED].
4. The Section sent Taxpayers a letter dated July 11, 2011 that their return for 2006 was selected for audit and asked Taxpayers to provide information including a copy of their federal return and documentation to substantiate selected Schedule A and Schedule C items.

5. Taxpayers did not respond to the Section's letter.

6. The Section issued a proposed assessment dated September 14, 2011 disallowing Schedule A medical expenses of $[REDACTED], miscellaneous itemized deductions of $[REDACTED] and Schedule C expenses of $[REDACTED].

7. The proposed assessment included interest and a penalty for failure to file when due.

8. Taxpayers protested the proposed assessment stating that proof of expenses was attached.

9. Based on information submitted by Taxpayers the Section issued two modified proposed assessments. The second modification dated April 2, 2014 allowed Schedule A medical expenses of $[REDACTED] and miscellaneous itemized deductions of $[REDACTED]. The second modified proposed assessment continued to disallow Schedule A medical expenses of $[REDACTED], miscellaneous itemized deductions of $[REDACTED] (because of a 2% limitation) and the Schedule C expenses.

10. Taxpayers did not agree with the second modified proposed assessment and the matter was scheduled for a formal hearing.

11. At the hearing Taxpayers testified that:

    a. Taxpayers purchased property, fixed them up and rented them with an option to purchase.

    b. Taxpayer [REDACTED] spent considerable time and travel mileage working with the properties.

12. At the hearing the Section testified:

    a. Some of the expenses Taxpayers deducted on their Schedule C were capital expenditures that are required to be added to the basis of the property and were not an allowable expense deduction in the year paid.

    b. Taxpayers deducted some of the same expense items more than once.

c. Taxpayers included mortgage payments as deductible expenses.

d. Taxpayers' activity of real estate rental/investment should have been reported on a federal Schedule E and not a Schedule C.

e. Taxpayers' rental activity is considered a passive activity under Internal Revenue Code (I.R.C.) § 469.

f. Generally the deduction of passive activity expenses is limited to passive activity income.

g. Taxpayers reported passive activity income of $[REDACTED].

h. Taxpayers had verified $[REDACTED] of the expenses they had claimed on their Schedule C.

i. Taxpayers' Schedule E would have reported a net loss of $[REDACTED] ($[REDACTED] - $[REDACTED]). However, because of the passive activity loss limitation, Taxpayers' deduction of the expenses was limited to Taxpayers' passive activity income of $[REDACTED].

j. I.R.C. § 469 provides two exceptions to the passive activity loss limitation.

k. Taxpayers have not shown they meet either exception to the passive activity loss limitation that would allow them to deduct more than $[REDACTED].

13. Leave to submit additional information and documentation was granted after the hearing.

14. Taxpayers' opening submission consisted of a copy of a Form 1099-misc for $[REDACTED] and a copy of a residential lease agreement showing [REDACTED] as landlord for the period October 1, 2005 through October 1, 2006.

15. Taxpayers did not submit any other information with their submission.

16. The Section's response memorandum included a third modified proposed assessment dated October 27, 2014 that also allowed a loss of $[REDACTED] for Schedule E real estate expenses.

17. Taxpayers did not submit a reply or respond to the Section's October 27, 2014 modified proposed assessment.

18. Taxpayers have not provided a time log, mileage log or other documentation showing the time spent and miles driven by Taxpayer [REDACTED] for the real property activity.

19. Taxpayers have not provided any additional substantiation for the disallowed Schedule A medical expenses.

20. Both Taxpayers were employed and their adjusted gross income for 2006 was $[REDACTED].

CONCLUSIONS OF LAW

1. The presumption is that an assessment of additional income tax is correct. A*rizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948).

2. Once the presumption of correctness attaches, the taxpayer must present substantial credible and relevant evidence sufficient to establish that the assessment was erroneous. *U.S. v. McMullin,* 948 F.2d 1188 (10th Cir.,1991); *Anastasato v. C.I.R.*, 794 F.2d 884 (3rd Cir.,1986).

3. Taxpayers are required to keep and preserve "copies of filed tax returns, including any attachments to the tax return, any signature documents used for the tax return, 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).

4. Arizona taxpayers may deduct on their Arizona income tax return itemized deductions calculated under the Internal Revenue Code. A.R.S. § 43-1042.

5. 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).

6. Records adequate to substantiate deductible expenses include sales slips or receipts, invoices and canceled checks or other proof of payment. Internal Revenue Service (IRS) Pub. 552 (2006), p. 3 (now Pub. 17, p.14).

7. For tax year 2006 I.R.C. § 213 allowed a deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of a taxpayer to the extent that such expenses exceed 7.5 percent of adjusted gross income.[1]

8. Treas. Reg. § 1.213-1(h) requires that in connection with claims for medical expense deductions, the taxpayer shall furnish the name and address of each person to whom payment for medical expenses was made and the amount and date of the payment thereof in each case.

9. Claims for deductions must be substantiated, when requested by the district director, by a statement or itemized invoice from the individual or entity to which payment for medical expenses was made showing the nature of the service rendered, and to or for whom rendered; the nature of any other item of expense and for whom incurred and for what specific purpose, the amount paid and the date of the payment; and such other information as the district director may deem necessary.

10. Taxpayers have not provided the requisite substantiation for the disallowed medical expenses or verification that the expenses were not compensated by insurance.

11. Taxpayers have not presented any evidence to substantiate a medical expense deduction in excess of $[REDACTED].

12. I.R.C. §§ 162 and 212 allowed deductions for certain business and investment expenses.

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[1] The Arizona medical expense deduction is not subject to a 7.5% limitation. A.R.S. § 43-1042(B).

13. For individuals, I.R.C. § 469(a) disallows a "passive activity loss" for the taxable year.[2]

14. Passive activities include any rental activity. I.R.C. § 469(c).

15. Taxpayers' rental activity was a passive activity under I.R.C. § 469 and related expenses were subject to the passive activity loss limitation.

16. As relevant here, the passive activity loss limitation may not apply to:

    a. real estate professionals under I.R.C. § 469(c)(7), and

    b. passive activity losses up to $25,000 under I.R.C. § 469(i), subject to a phase-out based on adjusted gross income.

17. To qualify as a real estate professional, a taxpayer must own at least one interest in rental real estate and the taxpayer must show that:

    a. more than one-half of the personal services the taxpayer performed in trades or businesses during the taxable year were performed in real property trades or businesses in which the taxpayer materially participated, and

    b. the taxpayer performed more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. I.R.C. § 469(c)(7)(B).

18. Material participation may be established by contemporaneous daily time reports, logs, or similar documents or other reasonable means, such as appointment books, calendars, or narrative summaries that identify the services performed and the approximate number of hours spent performing such services. Treas. Reg. § 1.469-5T(f)(4).

19. Taxpayers have not provided a contemporaneous log or appointment calendar or other contemporaneous documentation detailing services performed and time spent on the real estate activities.

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[2] Passive activity expenses may be allowed up to the amount of passive activity income.

20. Taxpayers have not established that Taxpayer [REDACTED] was a real estate professional under I.R.C. § 469.

21. The exception to the passive activity loss disallowance rule which allows taxpayers who actively participate in a real estate rental activity to deduct up to $25,000 of passive activity losses annually begins to phase out when a taxpayer's adjusted gross income (AGI) (without regard to Taxpayers' passive activity loss) exceeds $100,000, and phases out entirely when AGI reaches $150,000. I.R.C. § 469(i)(3)(A).

22. Because Taxpayers' AGI was over $[REDACTED], the up to $25,000 exception is not applicable.

23. Because Taxpayers' passive real estate activity did not qualify for an exception, the deduction for Taxpayers' verified expenses of $[REDACTED] was limited to Taxpayers' passive activity income of $[REDACTED] for tax year 2006.

24. Taxpayers have not produced documentation to support a change to the Section's third modified proposed assessment dated October 27, 2014.

25. 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.

26. A.R.S. § 42-1125(A) imposes a penalty for failure to file the tax return when due.

27. The due date for Taxpayers' 2006 Arizona income tax return was April 16, 2007.

28. Taxpayers' return filed February 28, 2011 was not timely filed.

29. The failure to file when due penalty may be abated if the failure to file is due to reasonable cause and not due to wilful neglect. A.R.S. § 42-1125(A).

30. Taxpayers have not presented evidence to establish reasonable cause.

31. The Section's third modified proposed assessment dated October 27, 2014 is upheld.

DISCUSSION

Taxpayers filed their resident Arizona individual income tax return for tax year 2006 late on February 28, 2011. The Section reviewed Taxpayers' return and issued a proposed assessment that disallowed Taxpayers' Schedule C expenses and Schedule A miscellaneous itemized deductions and medical expenses.

Taxpayers timely protested stating that proof of expenses was attached. Based on additional information, the Section has issued three modifications to the proposed assessment. The final modification dated October 27, 2014 allowed Schedule A medical expenses of $[REDACTED], miscellaneous itemized deductions of $[REDACTED] and a loss of $[REDACTED] for Schedule E real estate expenses (that were initially reported on Taxpayers' Schedule C.) The modification continued to disallow Schedule A medical expenses of $[REDACTED], miscellaneous itemized deductions of $[REDACTED] and Schedule E real estate expenses in excess of $[REDACTED].

The modified assessment issued by the Section is presumed correct and the burden is on Taxpayers to present substantial credible and relevant evidence to establish that the assessment was erroneous. Taxpayers bear the burden of proving their entitlement to deductions and substantiating the amounts of claimed deductions. Taxpayers are required to keep and preserve suitable records necessary to determine the tax for which Taxpayers were liable.

The two questions presented are whether Taxpayers were entitled to deductions for medical expenses and losses from their real estate activity greater than the amounts allowed by the Section.

Medical Expenses.

Deductible medical and dental expenses must be substantiated by providing the name and address of each person to whom medical and dental expenses have been paid, the amount and date of the payments. In addition, the IRS may request a statement or itemized invoice from the health care provider. The statement or invoice must show the

nature of the service rendered and to or for whom it was rendered; the nature of any other item of expense, for whom and for what specific purpose it was incurred, the amount paid and the date of the payment; and any other information IRS deems necessary. Taxpayers here have not provided any of the required documentation to support the medical expense deductions that were not allowed. The Section's disallowance of the claimed medical expenses in excess of the amounts allowed in the third modified proposed assessment is upheld.

Real Estate Activity.

Taxpayers are allowed deductions for certain business and investment expenses under I.R.C. §§ 162 and 212. However, if a taxpayer is an individual, I.R.C. § 469(a) disallows a "passive activity loss" for the taxable year. I.R.C. § 469(c) defines "passive activities" to include activities involving a trade or business in which the taxpayer does not "materially participate" and "any rental activity" regardless of whether the taxpayer "materially participates." I.R.C. § 469(c)(1) and (2). Here, Taxpayers' activity involved rental activity.

As relevant here, there are two exceptions to this disallowance rule: for real estate professionals under I.R.C. § 469(c)(7) and for passive activity losses up to $25,000 under I.R.C. § 469(i) (subject to phaseout based on adjusted gross income).

Real Estate Professional.

Rental activities of a taxpayer in a real property business (a real estate professional) are not per se passive activities. I.R.C. § 469(c)(7)(A). If the taxpayer materially participates in the rental real estate activities, then the activities are treated as nonpassive activities and the I.R.C. § 469(a) disallowance does not apply to that portion of the claimed losses.

A taxpayer qualifies as a real estate professional if he owns at least one interest in rental real estate and meets both of the following requirements:

> More than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
>
> Such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

I.R.C. § 469(c)(7)(B)(i) and (ii).

Taxpayers have not shown that Taxpayer [REDACTED] met either of the requirements to be considered a real estate professional under I.R.C. § 469. [REDACTED] was employed during 2006 and reported W-2 wages of over $[REDACTED]. While Taxpayers argued that Taxpayer [REDACTED] acted as landlord for the rental properties and performed the functions of finding tenants, collecting rents, arranging for repairs and maintenance, Taxpayers have not presented any documentation showing the extent of her participation in both the real estate activity and other business or employment activities.

Internal Revenue Service regulations provide that material participation may be established by contemporaneous daily time reports, logs, or similar documents or other reasonable means, such as appointment books, calendars, or narrative summaries that identify the services performed and the approximate number of hours spent performing such services. Treas. Reg. § 1.469-5T(f)(4). Taxpayers did not provide a contemporaneous log or appointment calendar or other contemporaneous documentation showing that Taxpayer [REDACTED] met the requirements of I.R.C. § 469(c)(7)(B)(i) and (ii) to be considered a real estate professional.

Based on the record here, Taxpayers have not carried their burden of proving that Taxpayer [REDACTED] "materially participated" in any real estate activity or that she devoted at least 750 hours to the properties in total. Taxpayers have not shown that they qualify for the I.R.C. § 469(c)(7) exception for real estate professionals.

Exception for $25,000 loss.

I.R.C. § 469(i) includes an exception to the passive activity loss disallowance rule which allows taxpayers who "actively participate" in a rental real estate activity to deduct up to $25,000 of passive activity losses annually. However, this exception begins to phase out when a taxpayer's adjusted gross income (AGI) (without regard to Taxpayers' passive activity loss), exceeds $100,000 and phases out entirely when AGI reaches $150,000. I.R.C. § 469(i)(3)(A).

Taxpayers' AGI without regard to their claimed passive activity loss was over $[REDACTED]. We do not have to determine whether Taxpayer actively participated in the rental activity because Taxpayers' AGI exceeded $150,000 and the up to $25,000 exception is not applicable.[3] The Section verified expenses of $[REDACTED]. However, because Taxpayers' real estate activity was a passive activity not subject to an exception, the deduction of the expenses was limited to Taxpayers' passive activity income of $[REDACTED].[4]

The modified proposed assessment included interest and a penalty for failure to file when due. 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. Interest was properly included in the modified proposed assessment.

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[3] In any event, Taxpayers have not presented documentation from which a level of participation in the activity could be determined.

[4] Some of the expenditures disallowed by the Section were considered capital expenditures that are required to be added to the basis of the property and cannot be deducted as a current expense or were double deductions. Because Taxpayers' deduction is limited to the $[REDACTED] income, whether some of the disallowed expenses in excess of $[REDACTED] were properly disallowed is not an issue for the 2006 tax year.

A.R.S. § 42-1125(A) imposes a late filing penalty if a taxpayer fails to file a return on or before the due date of the return. Taxpayers failed to timely file a return for tax year 2006. The penalty was properly imposed. The penalty may be abated if the failure to file was due to reasonable cause and not due to wilful neglect. "Reasonable cause" is generally defined to mean the exercise of "ordinary business care and prudence." *Daley v. United States,* 480 F. Supp. 808 (D.N.D. 1979). Reasonable cause has not been established. Therefore, the imposition of the failure to file when due penalty is upheld.

Based on the foregoing, the Section's third modified proposed assessment dated October 27, 2014 is upheld.

DATED this 9th day of December, 2014.

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 (for disclosure purposes only):

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Individual Income Tax Audit Section