

# STATE OF ARIZONA

Department of Revenue  
Office of the Director  
(602) 716-6090



## CERTIFIED MAIL

The Director's Review of the Decision )  
of the Hearing Officer Regarding: )  
 )  
[Redacted] )  
 )  
TID # [Redacted] )  
\_\_\_\_\_ )

## ORDER

Case No. 201600108-I

On September 26, 2016, the Hearing Officer issued a decision regarding the protest of [Redacted] ("Taxpayers"). Taxpayers 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

Taxpayers timely filed their 2010 Arizona income tax return. The Individual Income Tax Audit Section of the Audit Division ("Division")<sup>1</sup> issued a proposed assessment to Taxpayers disallowing their Schedule C expenses. Taxpayers protested the assessment.

Taxpayers provided some documentation and the Division allowed some of the claimed expenses. The only issue on appeal is whether Taxpayers have substantiated deductible business expenses for \$22,050 Taxpayers state that they paid to their son in cash and \$353 for a printer. Taxpayers assert that they have provided sufficient documentation. The Division argues that the evidence in the record does not support the claimed expenses.

### Findings of Fact

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

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<sup>1</sup>The Department of Revenue reorganized in 2016 and the Division is now the Education and Compliance Division.

1. Taxpayers started a business to sell [redacted]. Taxpayers began making preparations in 2010, but did not make any sales until 2011. Because they had no income, all amounts claimed as a business expenses were deducted as a business loss on Taxpayers' tax return.
2. The largest expense listed on Taxpayers' Schedule C was \$22,050 for "commissions and fees." These were payments to Taxpayers' son, [redacted]. Taxpayers also listed \$4,257 in advertising expenses for their website. Other expenses included insurance, legal and professional services, rent, supplies, utilities, contract labor, office expenses and taxes.
3. The Division issued a notice of proposed assessment disallowing all of Taxpayers' claimed Schedule C expenses.
4. The Division worked with Taxpayers to determine if Taxpayers could provide documentation to substantiate the expenses. Based on the documentation Taxpayers provided, the Division issued a modified proposed assessment dated July 29, 2015. The modification allowed a portion of Taxpayers' Schedule C expenses.
5. After the hearing before the Hearing Office, Taxpayers submitted additional information with their Opening Memorandum. The Division submitted a second modified assessment dated July 27, 2016, with the Response Memorandum. The second modified proposed assessment continued to disallow \$22,050 paid to Taxpayers' son, bank charges of \$56, merchant account of \$82 and printer of \$353 because those amounts were not substantiated.
6. Taxpayers submitted additional documents with their appeal. Based on those documents, the Division agreed in its Response Memorandum to allow the expenses for the bank charges and merchant account.
7. Taxpayers submitted a [redacted] account statement showing a transaction with [redacted] in the amount of \$393.10 for January 30 with a hand written note indicating that \$39.99 was a personal expense and the rest was for an Epson printer. Taxpayers indicate that they do not have an invoice or receipt for the printer.

8. Taxpayers did not have a written agreement with their son. They claim there was an oral agreement. They have never provided details about their son's qualifications or the work he performed. Their son did not appear at the hearing. Instead he submitted an affidavit that states he provided various services including website design, marketing, product design, research and management of operations.
9. Taxpayers claim that they paid their son in cash. They did not issue a 1099 or any other tax form to their son to document the payments. There is no record that their son reported any of the payments on his own tax return for 2010.
10. Taxpayers provided 32 invoices they say are from their son dated between February 24, 2010 and January 1, 2011. These invoices had only a few word description of the services provided. For example, there are a number of charges of \$1,000 for monthly management services. There is no description of what these monthly management services included.
11. The invoices also included charges for monthly mileage reimbursements, always in round numbers and not billed at the time they were incurred. For example, there are three invoices dated August 5, 2010 for April mileage in the amount of \$100, May mileage in the amount of \$200 and June mileage in the amount of \$400. In September there is an invoice for July mileage in the amount of \$120 and August mileage in the amount of \$280. There is no explanation of where their son was driving, who he was meeting with, what he was doing in the other location, or how these activities related to the business. There is also no indication of the actual mileage for the month or how the reimbursement fee was calculated.
12. The invoices also included two charges in May to oversee product printing. The first charge was for \$1,000 and the second charge, five days later, was for \$500. There was also a charge in June to receive and unload a shipment of [redacted] for \$750. Taxpayers provided no evidence of the nature or amount of the [redacted] or actions their son actually undertook.

13. Taxpayers provided a number of documents to support expenses with third-party vendors, including the work to create a website. These included written agreements or documentation as to the services provided, contemporaneous correspondence or emails between Taxpayers and the vendor, and receipts for the amounts paid.

### **Conclusions of Law**

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

1. The taxpayer bears the burden of proving that reported business expenses were actually incurred and were "ordinary and necessary." Internal Revenue Code ("I.R.C") § 162(a).
2. There are even stricter substantiation requirements for expenses such as mileage expenses. I.R.C. § 274(d).
3. 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).
4. In the absence of persuasive corroborating evidence, the Hearing Officer does not have to accept the self-serving testimony of interested parties. *See, Bose Corp. v. Consumers Union of U.S., Inc.*, 466 U.S. 485 (1984); *Day v. Comm'r*, 975 F.2d 534 (8<sup>th</sup> Cir. 1992).
5. Taxpayers must keep and produce sufficient records to enable the taxing authority to determine the correct tax liability. *See INDOPCO v. Commissioner*, 503 U.S. 79, 84 (1992).
6. A close scrutiny is required when amounts are paid to family members to ensure that compensation was negotiated at arm's length and is free from donative intent. *Haeder v. Comm'r*, T.C. Memo, 2001-7.
7. Payments to family members may be disallowed without evidence such as a Form 1099 or a check stub. *Parker v. Comm'r*, T.C. Memo 2016-194 (finding that checks made to "cash" in

round amounts without a 1099 or other documents to link the checks to worker compensation were properly disallowed).

8. An Arizona resident with gross income of \$15,000 or more must file an Arizona income tax return. A.R.S. § 43-301(A).
9. Taxpayers have not provided objective evidence to support their claimed deduction for \$22,050 paid to Taxpayers' son or \$353 for a printer.
10. The Hearing Officer correctly determined that the Department properly disallowed these expenses on Taxpayers' Schedule C.

### **Discussion**

Taxpayers timely filed their tax year 2010 income tax return and claimed Schedule C business losses. As Taxpayers provided documents, the Division reviewed the documentation and allowed some of the expenses. The Division continues to disallow claimed expenses for payments to Taxpayers' son and the alleged cost of a printer. On appeal Taxpayers assert that the evidence they submitted should be enough.

The largest expense at issue is \$22,050 in payments to Taxpayers' son. Taxpayers provide no evidence that the payments were actually made to their son. They claim the payments were in cash. They did not provide a Form 1099. Their son did not provide a bank account showing a deposit of the payments. If Taxpayers' son did receive \$22,050 from the business, he should have reported it on an Arizona return. *See* A.R.S. § 43-301(A). There is no indication in the record, however, that he reported these amounts on an Arizona income tax return for 2010. The lack of records surrounding a payment to a family member, such as a check register or 1099, is cause to disallow the expense. *See Parker v. Comm'r*, T.C. Memo 2016-194.

Taxpayers also fail to document the business purpose for the expenses. Payments to family members must be scrutinized to ensure that compensation was negotiated at arm's length and is free from donative intent. *Haeder v. Comm'r*, T.C. Memo, 2001-7. Taxpayers admit that there was no

written agreement setting forth the work Taxpayers' son was to perform and the compensation he was to receive. Although they claim there was an oral agreement, they have not clearly enunciated the terms of the agreement. The invoices Taxpayers produced were for large, round amounts without much detail as to the actual work performed. The record does not establish that payments to Taxpayers' son were negotiated at arm's length and were free from an intent to gift their son some money.

Some of the amounts were for mileage reimbursements without any detail of how the amounts were calculated or what travel was performed. Mileage expenses, especially when it appears in such round numbers as in this case, must be disallowed when there is not substantial supporting documentation. I.R.C. § 274(d). Taxpayers failed to present any documents to meet the standard for a mileage deduction.

Finally, Taxpayers assert that the charge on their account statement for [redacted] was, in part, for a printer for the business. Taxpayers admit that they do not have any documentation to tie that charge to the printer. They also used a personal account to make the purchase and included personal items in the purchase. The document provided does not support the claimed deduction for the printer.

The facts and circumstances of this case support the Hearing Officer's conclusion that the Division properly disallowed the claimed expenses for payments to Taxpayers' son and for the printer. Based on the foregoing, the Hearing Officer's Decision is affirmed with the exception of the expenses for the bank charges and merchant account as set forth in the third modified proposed assessment attached to the Division's Response to the Director.

### **ORDER**

The Hearing Officer's decision is affirmed as modified by the Division.

This decision is the final order of the Department of Revenue. Taxpayers may contest this order by filing an appeal to the State Board of Tax Appeals, 100 North 15<sup>th</sup> 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.

Your current tax due under the assessment is \$602.87. In addition, interest has accrued and continues to accrue on the assessment. The interest amount changes daily. Taxpayers may contact the Arizona Department of Revenue for a current payoff amount.

Dated this \_\_\_\_ day of March, 2017.

ARIZONA DEPARTMENT OF REVENUE

David Briant  
Director

Certified original of the foregoing  
mailed to:

[Redacted]

cc: Individual Income Tax Appeals Section  
Individual Income Tax Audit Section  
Education and Compliance Division