



7. Taxpayer has a degree in mechanical engineering and has over [REDACTED] years of experience in the [REDACTED] industry.
8. Taxpayer has focused his activity on drag reduction modifications to [REDACTED] and [REDACTED].
9. Engine performance improvements have focused on [REDACTED] to improve power and efficiency.
10. Target [REDACTED] has been the [REDACTED] and the [REDACTED].
11. Taxpayer's goal is to produce performance improvement products that can be purchased by the [REDACTED] owner.
12. Taxpayer selected a small market because larger manufacturers of [REDACTED] aftermarket products do not make products for the small market. The proposed products are intended to fill a demand not otherwise met.
13. Taxpayer submitted projections that once the product is brought to market, a net profit between \$[REDACTED] and \$[REDACTED] may be achieved.
14. Taxpayer had other full-time employment during [REDACTED] and received wages from that employment.
15. Taxpayer reported wages earned of \$[REDACTED] for tax year [REDACTED].
16. Taxpayer's Schedule C for tax year [REDACTED] showed [REDACTED] gross receipts and claimed the following expenses:

Car and Truck	[REDACTED]
Depreciation	[REDACTED]
Interest	[REDACTED]
Legal and professional	[REDACTED]
Rent-business property	[REDACTED]
Taxes and Licenses	[REDACTED]
Travel	[REDACTED]
Meals and Entertainment	[REDACTED]
Utilities	[REDACTED]
Other expenses:	
Development Costs	<u>[REDACTED]</u>
Total expenses	[REDACTED]

17. Taxpayer had total mortgage interest of \$[REDACTED]. Of that, Taxpayer claimed \$[REDACTED] on Schedule A and \$[REDACTED] on Schedule C.
18. In a submission dated May 7, 2013 Taxpayer proposed allocating mortgage interest of \$[REDACTED] to Schedule C and the remainder to Schedule A.
19. Taxpayer submitted a listing of travel, entertainment and restaurant expenses that showed the date, payee, city and the amount. Two entries had a hand written notation "hotel."
20. The Section reviewed the information submitted by Taxpayer and agreed that the following expenses were substantiated:

Car and Truck	[REDACTED]
Depreciation	[REDACTED]
Interest	[REDACTED]
Legal and professional	[REDACTED]
Rent-business property	[REDACTED]
Taxes and Licenses	[REDACTED]
Travel	[REDACTED]
Meals and Entertainment	[REDACTED]
Utilities	[REDACTED]
Other expenses:	
Development Costs	<u>[REDACTED]</u>
Total expenses	[REDACTED]

21. The Section stated in its response memorandum:
  - a. Taxpayer's Schedule C activity was not conducted with the intent to make a profit.
  - b. Taxpayer's Schedule Cs for years 2004 through 2010 showed \$[REDACTED] gross receipts and losses of \$[REDACTED].
  - c. Taxpayer's Schedule C loss offset his other income.
  - d. The Section disallowed \$[REDACTED] of Taxpayer's revised car and truck expense of \$[REDACTED] contending it was comprised of normal commuting expense from Taxpayer's office to [REDACTED] to his home.

22. Some of the trips claimed by Taxpayer included mileage between Taxpayer's home and his place of employment.
23. Taxpayer contends in his reply that mileage between places of work is deductible.
24. The Schedule C indicated Taxpayer was on a cash basis of accounting.
25. Taxpayer's reply included an accounting from [REDACTED] showing payment of \$[REDACTED] by Taxpayer on [REDACTED] and \$[REDACTED] on [REDACTED].
26. Taxpayer did not provide any additional information or substantiation regarding the disallowed Schedule C expenses.
27. Taxpayer reported the following gross receipts and losses for tax years 2004 through 2010:

<u>Year</u>	<u>Receipts</u>	<u>(Loss)</u>
2004	[REDACTED]	[REDACTED]
2005	[REDACTED]	[REDACTED]
2006	[REDACTED]	[REDACTED]
2007	[REDACTED]	[REDACTED]
2008	[REDACTED]	[REDACTED]
2009	[REDACTED]	[REDACTED]
2010	[REDACTED]	[REDACTED]
	[REDACTED]	[REDACTED]

#### 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. Research and experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with his trade or business may be deducted as expenses. IRC § 174(a)(1).
4. Research and experimental expenses include costs incident to the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1).
5. The research and experimental expenses are required to be paid in connection with a taxpayer's trade or business. IRC § 174(a)(1).
6. The test for research and experimental expenses in connection with a trade or business under IRC § 174 is broader than the test for deducting ordinary and necessary expenses of carrying on a trade or business under IRC § 162. *Snow v. Commissioner of Internal Revenue*, 416 U.S. 500, 94 S.Ct. 1876 (1974).
7. A taxpayer does not have to actively carry on a trade or business during the tax year for purposes of IRC § 174. *Snow v. Commissioner of Internal Revenue*, *supra*.
8. The nine factors normally considered for purposes of IRC § 183 to determine whether a person is carrying on a business for profit during the tax year are not relevant for a determination under IRC § 174.
9. A taxpayer must still be engaged in a trade or business at some time, and the facts of each case must be examined to determine whether the taxpayer's activities in connection with a product are sufficiently substantial and regular to constitute a trade or business for purposes of IRC § 174. *Green v. Commissioner of Internal Revenue*, 83 T.C. 667 (1984).
10. For tax year [REDACTED] Taxpayer's activities in connection with the development of his [REDACTED] related products was sufficiently substantial and regular under IRC § 174.

11. The terms “paid or incurred” and “paid or accrued” are construed according to the method of accounting upon the basis of which the taxable income is computed. IRC § 7701(a)(25).
12. Taxpayer was on a cash basis.
13. A cash basis taxpayer deducts expenses for the taxable year in which actually paid. Treas. Reg. § 1.446-1(c)(1)(i).
14. Taxpayer did not show that the payments to [REDACTED] were made in tax year [REDACTED].
15. Travel expenses 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).
16. 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.
17. 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.
18. A taxpayer's costs of commuting to his place of employment are personal expenses and do not qualify as deductible expenses. Treas. Reg. § 1.262-1(b)(5).
19. Taxpayer's commuting expenses between his home and place of employment are not deductible.
20. The Section properly disallowed Taxpayer's commuting expense.
21. Taxpayer did not show that the Section's calculation of the amount of commuting expenses disallowed was not correct.

22. The limitation on deducting home office expenses does not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business or with his income-producing activity. IRC § 280A(b).
23. Taxpayer is entitled to a deduction for the full amount of mortgage interest paid on his residence for tax year [REDACTED].
24. Taxpayer is entitled to an additional deduction of mortgage interest on his Schedule A of \$[REDACTED], the difference in mortgage interest between the \$[REDACTED] taken on the Schedule C and the amount agreed to by the Section of \$[REDACTED].
25. Based on the record here, the Section properly calculated Taxpayer's Schedule C expenses for tax year [REDACTED] at \$[REDACTED].
26. 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.
27. The Section's proposed assessment dated March 21, 2012 for tax year [REDACTED] is upheld in part. The Section shall allow Taxpayer Schedule C expenses of \$[REDACTED] and an additional Schedule A mortgage interest deduction of \$[REDACTED].

#### DISCUSSION

Taxpayer timely filed his [REDACTED] tax year personal income tax return. The Section reviewed Taxpayer's return and issued a proposed assessment disallowing Taxpayer's Schedule C business loss. Taxpayer protested the assessment. The Section contends that Taxpayer's activity was not engaged in with an intent to make a profit and Taxpayer has not substantiated all of his Schedule C expenses.

Taxpayer was not actively engaged in a business of marketing a product. Taxpayer's activity involved the development of a product to be sold once the product had been developed. While ordinary and necessary business expenses are deductible

under IRC § 162, IRC § 174 provides for a deduction of research and experimental expenses incident to the development or improvement of a product. Taxpayer has demonstrated that for tax year [REDACTED] his substantiated expenses were deductible under IRC § 174.

The Section agreed that Taxpayer substantiated expenses of \$[REDACTED]. Taxpayer agreed that he did not have substantiation for all of his claimed expenses. The parties continue to disagree regarding the following three areas:

- Payment of \$[REDACTED] to [REDACTED],
- The disallowance of \$[REDACTED] of mileage, and
- The disallowance of travel expenses.

**Payment to [REDACTED].**

As a part of his reply, Taxpayer submitted a statement from [REDACTED] substantiating the payment of \$[REDACTED] (\$[REDACTED] on [REDACTED] and \$[REDACTED] on [REDACTED]). Taxpayer is on a cash basis of accounting. In order to be deductible, Taxpayer has to show that the payments to [REDACTED] were made in [REDACTED]. The statement submitted by Taxpayer does not show that either payment was made in [REDACTED]. Taxpayer has thus not shown he is entitled to a deduction of the \$[REDACTED] made to [REDACTED].

**Disallowance of \$[REDACTED] Mileage.**

Taxpayer had other full-time employment during [REDACTED] and reported wages earned of \$[REDACTED]. Taxpayer's mileage log showed some trips that included mileage between Taxpayer's home and his place of employment. The cost of travel between Taxpayer's home and his regular place of employment is a non-deductible personal expense. The Section properly disallowed Taxpayer's commuting expense.

**Travel Expenses.**



The Section disallowed Taxpayer's claimed travel expenses of \$[REDACTED] and meals and entertainment of \$[REDACTED]. While Taxpayer submitted some information relating to travel and meals, the information did not show how the deducted amounts were calculated and did not include enough documentation to substantiate the claimed travel and meal expenses. The Section's disallowance of the travel and meal expenses was proper.

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 [REDACTED] dated March 21, 2012 is upheld in part. The Section shall allow Taxpayer Schedule C expenses of \$[REDACTED] and an additional Schedule A mortgage interest deduction of \$[REDACTED].

DATED this 10th day of September, 2013.

ARIZONA DEPARTMENT OF REVENUE  
HEARING OFFICE

[REDACTED]  
Hearing Officer

Original of the foregoing mailed to:  
[REDACTED]

Copy of the foregoing mailed to:  
[REDACTED]

Copy of the foregoing delivered to:  
Arizona Department of Revenue  
Individual Income Tax Audit Section