BEFORE THE STATE BOARD OF TAX APPEALS
STATE OF ARIZONA
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GILBERT R. and JULIE D. SOMMER, Appellant, vs. ARIZONA DEPARTMENT OF REVENUE, Appellee.	Docket No. 2015-12-I NOTICE OF DECISION FINDINGS OF FACT AND CONCLUSIONS OF LAW

The State Board of Tax Appeals, having considered all evidence and arguments presented, and having taken the matter under advisement, finds and concludes as follows:

FINDINGS OF FACT

During the pertinent time period, Gilbert R. and Julie D. Sommer ("Appellants") were members of H.I.R. Hidden Inlet Resort L.L.C. ("LLC"), which operated a fishing resort in Alaska. Based on information obtained through an exchange of information agreement with the Internal Revenue Service ("IRS"), the Arizona Department of Revenue ("Department") learned that for tax year 2006, Appellants had reported Schedule C business expenses of $52,591 and zero income. The Department disallowed the Schedule C expenses and issued an assessment against Appellants of additional income tax, plus interest, for tax year 2006.

Appellants protested the assessment but failed to do so in a timely manner. Subsequently, the Department issued a Closing Agreement allowing Appellants 16.67% of the verified expenses they originally claimed on their Schedule C for 2006. Appellants paid the tax due under the Closing Agreement under protest then filed a timely claim for refund, which was denied. Appellants protested the denial to the Department's Hearing Officer who upheld the denial. Appellants now timely appeal to this Board.

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DISCUSSION

The issue before the Board is whether Appellants are entitled to a refund of tax assessed by the Department. The presumption is that an assessment of additional income tax is correct, and the burden is on the taxpayer to overcome this presumption. See *Ariz. State Comm'n v. Keickhefer*, 67 Ariz. 102, 191 P.2d 729 (1948).

A taxpayer computes Arizona taxable income by starting with federal adjusted gross income. Appellant can then make certain additions and subtractions pursuant to A.R.S. §§ 43-1021 and 43-1022. Finally, Appellant is allowed certain exemptions and itemized deductions calculated under the Internal Revenue Code ("IRC"). A.R.S. §§ 43-1001 and 43-1042. However, 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).

Appellants reported a loss of $52,591 on a Schedule C filed with their federal return. A Schedule C is used to report the profit or loss from a sole proprietorship. If an LLC has only one member, it is taxed as a sole proprietorship, and the net income of the business is reported on a Schedule C. If, however, an LLC has two or more members, it files its tax returns as a partnership. Each partner's or member's share of the profit or loss of the partnership or LLC is recorded on a Schedule K-1. The K-1 information is reported on Line 17 of the partner's or member's federal Form 1040.

Appellants' LLC had two classes of membership – Class A, of which Appellants had a 16.67% interest and Class B, of which Appellants were the only members and had a100% interest. Appellants' K-1 Schedule identified the amount of Appellants' share of profit, loss and capital as 16.666667%.

The LLC reported a loss of $110,437. Appellants reported $18,404 (i.e.,16.666667 % of $110,437) on Line 17 of their federal return as their share of the loss from the LLC. The Department

allowed the full amount of this loss.[1] However, in addition to this loss. Appellants claimed the additional Schedule C business expenses at issue, claiming that these were expenses that they paid on behalf of the LLC.

Partnership expenses are deductible only by the partnership and not by the partners. See *Wilson v. United States* 376 F.2d 280, 297 (Ct. Cl. 1967); *Cropland Chem. Corp. v. Comm'r*, 75 T.C. 288, 295 (1980), aff'd. without published opinion 665 F.2d 1050 (7th Cir. 1981 ("The general rule is well established that a partner cannot directly deduct on his income tax return the expenses of the partnership.") The exception to this rule is when there is an agreement among the partners that such partnership expenses will be borne by particular partners out of their own funds.

The 2006 instructions for federal Schedule E, which is to be used to report, among other items, income or loss from partnerships, confirms that a taxpayer may deduct unreimbursed ordinary and necessary partnership expenses that the taxpayer paid on behalf of the partnership on the Schedule E form ***if*** the taxpayer is required to pay those expenses under the partnership agreement. While the LLC's operating agreement provides that any operating **loss** not exceeding $50,000 in one fiscal year was required to be paid in full by the holder of the Class B membership interest (i.e., Appellants) and that the LLC manager could request Class A members to contribute to the LLC cash necessary to reimburse the LLC for **losses** over $50,000, Appellants were not required to pay LLC **expenses**. A loss and an expense are two different concepts.

For the reasons set forth above, the Board finds that Appellants are not entitled to the refund claimed. Further, because 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." Appellants are liable for the interest assessed.

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[1] Many of the expenses claimed by Appellants on Schedule C fall into the same categories of expenses reported by the LLC, and the Department has since determined that it allowed the full amount of this loss in error.

CONCLUSIONS OF LAW

1) Appellants have not met the burden of proving that they are entitled to the loss and deductions claimed; therefore, they are liable for the tax assessed. See *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P. 2d 719, 724 (1969). See *Ariz. State Tax Comm'n v. Kieckhefer*, 67 Ariz. 102, 105, 191 P. 2d 729 (1948); see, also *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969); A.R.S. § 42-1105(D).

2) Appellant is liable for the interest assessed. See A.R.S. § 42-1123(C).

ORDER

THEREFORE, IT IS HEREBY ORDERED that the appeal is denied, and the final order of the Department is affirmed.

This decision becomes final upon the expiration of thirty (30) days from receipt by the taxpayer, unless either the State or taxpayer brings an action in superior court as provided in A.R.S. § 42-1254.

DATED this 3rd day of June, 2014.

STATE BOARD OF TAX APPEALS

Karen J. Brogdon,
Chairperson

KJB:ALW

CERTIFIED

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