BEFORE THE IOWA DEPARTMENT OF REVENUE
HOOVER STATE OFFICE BUILDING
DES MOINES, IOWA

IN THE MATTER OF	)	
	)	**DIRECTOR'S FINAL ORDER**
RANDOLPH POHL	)	**ON APPEAL**
CAMELLIA POHL	)	
1216 N. Concord St.	)	DOCKET NO.
Davenport, IA 52804	)	2015-200-1-0084 AND
	)	2015-200-1-0160
	)	
v.	)	DIA NO.
	)	18IDR0050 AND
IOWA DEPARTMENT OF REVENUE	)	18IDR0051
	)	
Individual Income Tax	)	

PROCEDURAL SUMMARY

An Administrative Law Judge issued a Proposed Decision (Findings of Fact, Conclusions of Law, and Order) in the above-captioned matter on April 30, 2019. Mr. and Mrs. Pohl ("taxpayers") appealed the Proposed Decision to the Director of the Department of Revenue ("Director") on May 29, 2019. The Director's Review was scheduled for July 18, 2019.

A Notice of Time and Place of Hearing was issued to the parties on June 17, 2019. The Director's hearing was held on July 18, 2019. Assistant Attorney General Paxton Williams appeared in person on behalf of the Iowa Department of Revenue ("Department"). The taxpayers appeared in person and were represented by attorney James R. Monroe. Also present for the hearing were Michael Mertens, attorney for the Director; Hollie Welch, Executive Secretary to the Director; Staci Nelson, Technical Tax Specialist for the Department; Assistant Attorney General Kate Penland (observing only), Department Attorneys J.D. Hernandez (observing only) and Zach Waldmeier (observing only), and Department intern Nick Bushelle (observing only).

The ALJ found that the Department's refund denial for individual income tax year 2012 and Notice of Assessment for individual income tax year 2013 should be AFFIRMED.

The Director, having examined the record developed by the parties, issues this Order.

FINDINGS OF FACT

The Director hereby adopts and incorporates into this decision the Findings of Fact made by the Administrative Law Judge, except to the extent modified or expanded below.

The Director disagrees with the Administrative Law Judge's proposed finding of fact that Mrs. Pohl was credible[1] in her testimony that she subjectively intended to run her Lia Sophia business for profit. Mrs. Pohl's testimony that she learned about Lia Sophia at a career fair was cited as support for this conclusion. This may be true, but it is not particularly relevant to this issue. Most relevant is whether Mrs. Pohl intended to actually run the business for profit once she began operations. A significant portion of Mrs. Pohl's testimony in this area rested on her efforts to advance her Lia Sophia business or the expenses she incurred in those efforts. For example, Mrs. Pohl testified about her out-of-town business trips and monthly meetings, her home office, her various sales and marketing endeavors, the length of her work days and time spent engaged in Lia Sophia, and her advertising attempts, among other things. Tr1 at pp. 79-80, 83-85, 89, 99. This testimony overlapped in many places with her testimony about business expenses, which was determined not credible elsewhere in the Proposed Decision's Findings of Fact incorporated into this Final Order. It is difficult to divide her entire testimony into separate categories for the purpose of assessing credibility. All of it was essentially offered for the same reason: to persuade the tribunal that she was entitled to the tax benefits she claimed. As a result, her credibility here suffers for the same reasons as her credibility did on the issue of business expenses.

The Administrative Law Judge cited Mrs. Pohl's demeanor as a reason to find her credible on this issue, including the emotions she displayed while describing the marital conflict and personal stress that resulted from the endeavor. The loss of her retirement funds seemed to play an important role in this. Mrs. Pohl testified that she cashed out her retirement plan over several years ($6,000 in 2012 and $6,400 in 2013) in order to finance her Lia Sophia business and described the marital discord and personal stress that resulted from that loss of retirement income. Tr1 at pp. 75, 90-92, 103, 107-108. But the record also suggests that Mrs. Pohl claimed on her federal income tax return that her $6,000 retirement distribution in 2012 was made for higher education purposes.[2] This claim made her eligible for an exception to the additional federal tax on early retirement distributions.[3] There is no exception to that additional

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[1] Page six, paragraph three, sentence one of the Proposed Decision appears to erroneously omit the word "credible" (...Tribunal finds Camellia Pohl's testimony she subjectively intended to run her Lia Sophia business for profit [*credible*] based not only on...). Reading that sentence to include the word "credible" is proper and supported by the context and plain language of the surrounding text.

[2] See Exhibit X, at p. 335. Mrs. Pohl claimed this exception on her 2012 federal form 5329 by listing exception number 8 on line 2 of that form. The 2012 instructions for federal form 5329 indicate that exception number 8 is used for "IRA distributions made for higher education purposes."

[3] Early distributions from qualified retirement accounts are required to be reported on federal form 5329 and generally incur an additional 10% federal tax unless an exception applies. One such exception is for IRA distributions made for higher education purposes.

federal tax for early retirement distributions that are used for general business purposes. It is difficult to reconcile these conflicting claims.

The value that could be gained from considering Mrs. Pohl's demeanor in this case must be heavily discounted by the content of her self-serving testimony which contained numerous inconsistencies, generalizations, excuses, and exaggerations. Therefore, while it is true that the Director was not present to observe and assess the demeanor of Mrs. Pohl, her testimony and the record in this case provide adequate evidence to make a credibility determination without considering demeanor.

A preponderance of the evidence supports a determination that Mrs. Pohl's testimony relating to her intent run her Lia Sophia business for profit was not credible. To the extent the Proposed Decision's Findings of Fact incorporated into this decision reference Mrs. Pohl's credibility on this issue, it is noted that the Director finds to the contrary.

CONCLUSIONS OF LAW

The taxpayers raised several issues in this case. These issues were described in the Findings of Fact and largely restated in the taxpayer's appeal petition to the Director. Each issue is addressed in turn below.

1. *Burden of proof*

Both parties agree that the taxpayers bear the burden of proof on the issue of whether the Lia Sophia activities were engaged in for profit. The parties disagree on who bears the burden of proof on the issue of whether the taxpayers' 2012 and 2013 business expenses were substantiated.

In general, the burden of proof in a contested case is on the taxpayer challenging the tax assessment or denial of refund. *See* Iowa Code § 421.60(6)(c); Iannone v. Iowa Dep't of Revenue & Fin., 641 N.W.2d 735, 738-39 (Iowa 2002); Camacho v. Iowa Dep't of Revenue & Fin., 666 N.W.2d 537, 542 (Iowa 2003). But this burden can shift to the Department under certain circumstances, as in the case of a "new matter". Iowa Code § 421.60(6)(c); Iowa Admin. Code r. 701-7.17(11). The taxpayers argue that because the Department's refund denial and notice of assessment cite the hobby loss limitation as a reason for denial of the Schedule C deductions for the Lia Sophia activities, the Department's subsequent assertion that the taxpayers have not substantiated those expenses is a "new matter" that would shift the burden of proof to the Department to prove the lack of substantiation. The Director disagrees.

"New matter" is defined in Iowa Code § 421.60(6)(c) as "an adjustment not set forth in the computation of the tax in the assessment or refund denial as distinguished from a new reason for the assessment or refund denial." In this case, the Department's assertion that the taxpayers' have not substantiated their business expenses is simply an additional reason to

uphold the original adjustment which denied the business expenses. This is not an adjustment not set forth in the computation of tax. As such, there is no new matter that would shift the burden of proof.

The taxpayers also argue that the Department should bear the burden of proof in this case under Iowa Code § 421.60(6)(b) because, according to them, the Department is "challenging the final resolution between the IRS and the taxpayer." Here, the taxpayers misinterpret § 421.60(6)(b). That Code section only concerns the burden of proof in cases where an assessment was not made within six years after the return became due, which is not applicable here. Also, that Code section does not operate to place the burden of proof on the Department when there has been an IRS resolution. Therefore, Iowa Code § 421.60(6)(b) is not applicable. As such, taxpayers bear the burden of proof on the issue of whether the 2012 and 2013 business expenses were substantiated.

2. *Whether the Department is bound by the Internal Revenue Service (IRS) audit results*

The record in this case indicates that the IRS audited taxpayers' 2012 federal income tax return and issued an examination report that had small or immaterial changes to federal tax liability related to the Schedule C deductions for the Lia Sophia activities. The examination report categorized the income changes by relevant tax return schedule and general deduction category, and included the dollar increase or decrease for each category, but did not describe the issues considered or resolved, if any, during the federal audit.

The taxpayers have argued that the Department is bound by the results of that 2012 IRS audit and cannot independently analyze the taxpayers' 2012 Schedule C activities. Their argument rests primarily on Iowa's adoption of certain parts of the Internal Revenue Code. The Department contends the opposite, that it is not bound by that IRS audit in this case and that it has the power to engage in its own analysis of taxpayers' 2012 Schedule C activities.

It is true that Iowa's income tax regime incorporates substantial elements of the Internal Revenue Code. The starting point for calculating Iowa taxable income is a taxpayer's "adjusted gross income...as properly computed for federal income tax purposes under the Internal Revenue Code." *See* Iowa Code § 422.7. However, a plain reading of that provision does not support the interpretation that it *requires* the Department to defer to the audit findings of the IRS, nor does any other provision of Iowa law explicitly or implicitly support such an interpretation. In fact, under the Iowa Code the Director and the Department have the exclusive power and duty to administer the Iowa income tax, including the examination of returns and the determination of tax. *See generally* Iowa Code §§ 421.17(1), 422.25, 422.67, 422.70. In the course of making these Iowa tax determinations the Department will, when appropriate, use rulings and regulations duly promulgated by the commissioner of internal revenue. *See* Iowa Admin. Code r. 701-41.2. But an IRS examination report with no explanation for the action is not a ruling or regulation promulgated by the IRS commissioner. Even if it was, that fact alone would not necessarily bind the Department to its conclusions.

The taxpayers also appear to be indirectly arguing for the application of issue preclusion as a form of collateral estoppel against the Department in this case. That doctrine "means simply that when an issue of ultimate fact has once been determined by a valid and final judgment, that issue cannot again be litigated between the same parties in any future lawsuit. City of Johnston v. Christenson, 718 N.W.2d 290, 297 (Iowa 2006); *see also* Comes v. Microsoft Corp., 709 N.W.2d 114, 117 (Iowa 2006) ("collateral estoppel prevents parties to a prior action in which judgment has been entered from relitigating in a subsequent action issues raised and resolved in the previous action"). It serves several purposes, including "to protect litigants from the vexation of relitigating identical issues with identical parties or those persons with a significant connected interest to the prior litigation. Winnebago Indus., Inc. v. Haverly, 727 N.W.2d 567, 571-72 (Iowa 2006). Collateral estoppel may be applied against an eligible party when certain requirements are satisfied. But these requirements do not need to be evaluated here because the Department was not a party to or in any way connected to the prior IRS audit, and as such is not a party against whom collateral estoppel can be applied.[4]

The Supreme Court of Minnesota came to the same conclusion in a very similar situation. *See* Busch v. Commissioner of Revenue, 713 N.W.2d 337 (Minn. 2006). In *Busch*, a Minnesota taxpayer claimed gambling expenses as a Schedule C business loss on both the federal and Minnesota income tax returns. The federal income tax return was audited by the IRS but was not adjusted or corrected. The Minnesota Revenue Department, however, audited the taxpayer's state return and disallowed the gambling losses after determining they were hobby losses and not engaged in for profit. The Court held that "when the IRS has failed to adjust or correct a taxpayer's federal return, collateral estoppel does not apply because there was no prior adjudication and the [Minnesota] commissioner was neither a party nor privy and therefore has no opportunity to be heard." *Id.* at 342. The court added that "even if the IRS had made a determination of a taxpayer's federal taxable income, the [Minnesota] commissioner was not foreclosed from adjusting the taxpayer's state taxable income" because "[e]ven when Minnesota tax law incorporates the federal law, the commissioner is not necessarily bound by the IRS's determinations. *Id.*

The Director concludes that the Department is not bound by the IRS audit results in this case.

3. *Whether the Department is bound by certain statements made by the Department's employee at the hearing*

During questioning of one of the Department's employees at the hearing, the taxpayers' counsel asked the employee to recite or verify the federal adjusted gross income amounts that

[4] Although not determinative to the Director's conclusion that collateral estoppel cannot apply against the Department in this case, the taxpayers' counsel appeared to concede as much at the Director's hearing on July 18, 2019, when he stated "Judge Gallagher in [sic] that [sic] Department argued there is no collateral stuff or issue preclusion, which I agree. I mean, I am not trying to say that those doctrines apply." *See* transcript of Director's hearing at p. 8.

were listed on the taxpayers' IRS tax return transcripts for 2012 and 2013. Following the first recitation from the federal transcript, counsel asked "[s]o that was the correct adjusted gross income for federal purposes; right?", to which the Department's employee replied, "[i]t appears that's what they arrived at, yes." Following the second recitation from the federal transcript taxpayers' counsel asked "And that -- that's the correct adjusted gross income for the federal; correct?" to which the Department employee replied, "That's what the IRS arrived at, yes."

The taxpayers contend that these answers by the Department's employee amount to admissions that should bind the Department and require it to recognize those adjusted gross income amounts as correct for Iowa tax purposes. The Director disagrees that these answers rise to the level of an admission. The most plausible interpretation of that exchange is that the Department's employee was simply being asked to verify amounts listed on those federal transcripts, and the employee did just that. It would be illogical to interpret these answers as an admission that the federal tax return transcript's adjusted gross income amounts are the correct amounts for Iowa tax purposes. Because these answers are not admissions, it is not necessary to determine whether they could act to bind the Department in this case.

4. *Whether taxpayers have substantiated their claimed expenses and deductions related to their Schedule C Lia Sophia Activities in 2012 and 2013.*

Iowa law imposes an income tax "upon every resident and nonresident of the state which tax shall be levied, collected, and paid annually upon and with respect to the entire taxable income." Iowa Code § 422.5(1). The starting point for calculating Iowa tax is an individual's "adjusted gross income before the net operating loss as properly calculated for federal income tax purposes under the Internal Revenue Code." Iowa Code § 422.7.

As a general rule under the IRC, taxpayers are allowed to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. 26 U.S.C. § 162(a). An expense is "ordinary" if it is normal, usual, or customary in the trade, business, or industry. Dasent v. Comm'r of Internal Revenue, 116 T.C.M. (CCH) 551 (T.C. 2018). An expense is "necessary" if it is appropriate and helpful for the business. *Id.* An expense may be "ordinary and necessary" while at the same time unreasonable in amount and in such case only a portion which is reasonable will qualify for a deduction. U.S. v. Haskel Engineering Supply Co., 380 F.2d 786, 788 (9th Cir. 1967). No deduction is allowed for personal, living, or family expenses. 26 U.S.C. § 262.

Iowa law requires taxpayers to retain records supporting the statements made on tax returns and any deductions therein. *See* Iowa Admin. Code r. 701-38.3 (incorporating by reference the record retention requirements of 26 U.S.C § 6001 and Treas. Reg. 1.6001-1(e)). A taxpayer's self-serving declaration is generally not a sufficient substitute for records. *Id.* Fine v. Comm'r, *106 T.C.M. (CCH) 482 (T.C. 2013)* (citing Weiss v. Commissioner, T.C. Memo.1999–17). Courts do refuse to rely on non credible testimony to substantiate claimed

expenses. *See* Buck v. Comm'r, 86 T.C.M. (CCH) 591 (T.C. 2003); Alacan v. Comm'r, T.C.M. (RIA) 2005-063 (T.C. 2005).

In this case, the taxpayers produced a handwritten log for 2012 which in some instances provides a date and short description or category of the claimed expenses. Taxpayers did not provide a handwritten or similar log for 2013. Taxpayers produced spreadsheets for 2012 and 2013 that categorize expenses by date and amount, but do not otherwise identify or describe the claimed expenses. It is not clear whether these spreadsheets were made contemporaneously with the claimed expenses or were constructed at a later date, perhaps at the time the tax returns were prepared. The amounts claimed on the tax returns, handwritten ledgers, and spreadsheets are inconsistent and conflicting in numerous places.

The taxpayers produced incomplete records or receipts to support their claimed expenses, but made several excuses for the lack of documentation, including that the IRS lost or failed to return documents, that the Department did not properly request the documents, that certain documents were "in my file in the car", and that their computer crashed. This all suggests general neglect on the part of the taxpayers with accounting and tax matters, which is further supported by taxpayers' failure to timely file their 2012 Iowa tax return for over two years until it was requested by the Department. Moreover, the records that were produced were generally lacking in detail, were inconsistent, and often appeared to be personal in nature. A close look at the provided receipts indicates Mrs. Pohl's personal and professional life were mixed considerably. The high amount of expenses relative to income casts a shadow over her accounting. Mrs. Pohl spent time testifying at the hearing about these expenses, but her testimony only served to exacerbate the problems with her records and returns. For reasons already discussed, her testimony was not credible and cannot be relied upon here to prove or corroborate the claimed expenses. As such, almost all the deductions and receipts appear suspect, and the Director is unable to determine whether or not they are proper.

a. Advertising Expenses

Taxpayers' 2012 Schedule C claims $1,659 in advertising expenses. Ex. X, at p. 336. Taxpayer's post-hearing brief alleges that $908.31 of advertising expenses were substantiated with records or testimony and should be allowed. The records cited by taxpayers include vague department store and restaurant receipts, as well as a nondescript receipt with a handwritten note "movie passes for prize". They also include handwritten receipts labeled as "advertising" and "ad". The nature of these handwritten receipts makes it impossible to independently verify the payee and the services or property received. Other than a business card and an invitation to one party, there does not appear to be any documentary evidence in the record, such as copies of flyers or advertisements, that would suggest the taxpayers incurred advertising expenses of this magnitude. Ex. 48, at p. 675; Ex. 8, at p. 237. Many of the receipts and records that were provided appear personal in nature.

There are two receipts, each for $250, which appear to be from "MVF Fairground", but they are difficult to read. Mrs. Pohl testified they were payment for a booth at the Mississippi

Valley Fair where she sold or marketed Lia Sophia products. The amount, structure, and payee on these two receipts makes it at least plausible they are an ordinary and necessary business expense, but Mrs. Pohl's lack of credibility means her testimony cannot be relied on, and without more it is impossible to determine that they are proper.

Taxpayers' 2013 Schedule C claims $957 in advertising expenses. Ex. Y, at p. 345. Taxpayers' post-hearing brief claims that $25.71 of advertising expenses were substantiated with records or testimony and should be allowed. The Office Max receipts provided by the taxpayers to prove the $25.17 expense are inadequate to substantiate the claimed advertising expenses. *See* Ex. T, at p. 271.

For these reasons, the taxpayers have not met their burden to prove any 2012 or 2013 advertising expenses.

b. Office Expenses

Taxpayers' 2012 Schedule C claims $2,559 in office expenses. Ex. X, at p. 336. Taxpayers' handwritten ledger for 2012 has no general category for office expenses, but does have a category labeled "expense" that sums to $4,028.34. Ex. S, at pp. 115-124. But that handwritten ledger also contains a notation that end-of-year expenses total $3,113.28. Ex. S, at p. 124. Taxpayers' 2012 spreadsheet has a category for expenses which sums to $2,579, but the year-end amount on that spreadsheet is nonetheless listed at $2,559. Ex. S., at pp. 199-203. Taxpayers' post-hearing brief alleges that $2,395.96 of office expenses were substantiated with records or testimony and should be allowed. The Director concludes that the expenses listed below are substantiated by taxpayers upon production of the applicable receipts and are hereby allowed. The other receipts appear personal in nature. Taxpayers have not met their burden to prove any other 2012 office expenses.

Lia Sophia "new start kit" invoice (Ex. S, at p. 132):	$136.48
Lia Sophia sample invoice (Ex. S, at p. 138):	$136.69
Lia Sophia sample invoice (Ex. S, at p. 141):	$76.67
Lia Sophia sample invoice (Ex. S, at p. 142):	$41.68
Lia Sophia sample invoice (Ex. S, at p. 145):	$51.31
2012 Office Expenses Total:	**$442.83**

Taxpayers' 2013 Schedule C claims claims $1,883 in office expenses. Ex. Y, at p. 345. Taxpayers' 2013 spreadsheet has a category for expenses which sums to $1,928.70. Ex. T, at pp. 287-292. Taxpayers' post-hearing brief alleges that $1,643.92 of office expenses were substantiated with records or testimony and should be allowed. The Director concludes that the expenses listed below are substantiated by taxpayers upon production of the applicable receipts and are hereby allowed. The other receipts appear personal in nature. Taxpayers have not met their burden to prove any other 2013 office expenses.

Lia Sophia sample invoice (Ex. T, at p. 245):	$87.26

Lia Sophia sample invoice (Ex. T, at p. 250):	$234.92
2013 Office Expenses Total:	**$322.18**

c. Supplies

Taxpayers' 2012 Schedule C claims $2,413 of supplies. Ex. X, at p. 336. Taxpayers' handwritten ledger for 2012 contains a category labeled "supplies" that appears to sum $2,060.28, but that also contains a notation that end-of-year supplies total $1,967.22. Ex. S, at pp. 115-124. Taxpayer's post-hearing brief alleges that $2,467.03 of supplies were substantiated with records or testimony and should be allowed. The Director concludes that the expenses listed below are substantiated by taxpayers upon production of the applicable receipts and are hereby allowed. The other receipts appear personal in nature. Taxpayers have not met their burden to prove any other 2012 deductions for supplies.

Lia Sophia supply invoice (Ex. S, at p. 134):	$90.74
Lia Sophia supply invoice (Ex. S, at p. 135):	$80.84
Lia Sophia supply invoice (Ex. S, at p. 137):	$41.25
Lia Sophia supply invoice (Ex. S, at p. 140):	$49.28
Lia Sophia supply invoice (Ex. S, at p. 146):	$62.92
2012 Supplies Total:	**$325.03**

Taxpayers' 2013 Schedule C claims $2,278 of supplies. Ex. Y, at p. 345. Taxpayers' 2013 spreadsheet has a category for supplies which sums to $2,284.69. Ex. T, at pp. 287-292. Taxpayers' post-hearing brief alleges that $1,096.18 of supplies were substantiated with records or testimony and should be allowed. The Director concludes that the expenses listed below are substantiated by taxpayers upon production of the applicable receipts and are hereby allowed. The other receipts appear personal in nature. Taxpayers have not met their burden to prove any other 2013 deductions for supplies.

Lia Sophia supply invoice (Ex. T., at p. 246):	$11.83
Lia Sophia supply invoice (Ex. T., at p. 247):	$11.83
Lia Sophia supply invoice (Ex. T., at p. 249):	$11.83
Lia Sophia supply invoice (Ex. T., at p. 253):	$139.69
2013 Supplies Total:	**$175.18**

d. Travel Expenses

Travel and entertainment expenses are subject to heightened levels of scrutiny, and are generally not deductible unless the taxpayer substantiates with "adequate records" the amount, time and place, business purpose and business relationship of the expense. 26 U.S.C. § 274(a), (d). In this case, taxpayers' 2012 Schedule C claims $1,895 in travel expenses. Ex. X, at p. 336. Taxpayers' handwritten ledger for 2012 does not include a specific category for travel, but does appear to include over $600 in hotel costs in various cities. Ex. S, at pp. 115-124. Taxpayers' 2012 spreadsheet includes a category for travel/meals and has $1,612.48 labeled as (T), presumably for travel, but the year-end amount is nonetheless listed as $1,895. Ex. S, at

pp. 199-203. Taxpayers' post-hearing brief alleges that $816.13 of travel expenses were substantiated with records or testimony and should be allowed. These cited expenses include hotel receipts for stays in Milwaukee, Wisconsin, Des Moines, Iowa, and Lakeville, Minnesota. Taxpayers have not provided adequate evidence to substantiate the business purpose or relationship for the hotel stays. The expenses appear personal in nature. In fact, the taxpayer conceded that the Lakeville hotel stay was personal in nature during the hearing. Tr1 at p. 143. As such, taxpayers have not met their burden to prove any 2012 travel expenses.

e. Meals

Meal expenses are subject to the same heightened levels of scrutiny and are only deductible if the taxpayer can prove, among other things, that the meal was directly related to the active conduct of the taxpayer's business, or for an expenditure directly preceding or following a substantial and bona fide business discussion, was associated with the active conduct of the taxpayer's business. 26 U.S.C. § 274(a), (d). In most cases, only 50% of an otherwise valid business meal expense is deductible. 26 U.S.C. § 274(n). Taxpayers' 2012 Schedule C claims $920 in deductible meal and entertainment expenses. Ex. X, at p. 336. Taxpayers' 2012 handwritten ledger has a category for meals which sums to $1,177.78, but also includes a notation that the total meals expenses is $1,197.54. Ex. S, at pp. 115-124. Taxpayers' 2012 spreadsheet includes a category for travel/meals and has $1,311.83 labeled as (m&e), presumably for meals and entertainment, but the year-end amount is nonetheless listed as $920.00. Ex. S, at pp. 199-203. There is no indication that the amount claimed on the return ($920) was properly reduced by 50%. Taxpayers' post-hearing brief alleges that $1,923.83 of meal expenses were substantiated with records or testimony, 50% of which should be allowed. Taxpayers have not provided adequate records or reliable testimony to substantiate the business purpose or relationship for any meal. The expenses appear personal in nature. As such, taxpayers have not met their burden to prove any 2012 meal expenses.

Taxpayers' 2013 Schedule C claims $337 in deductible meal and entertainment expenses. Taxpayers' 2013 spreadsheet has a category for travel/meals that sums to $570.30. Ex. T, at pp. 287-292. There is no indication that the amount claimed on the return ($337) was properly reduced by 50%. Taxpayers' post-hearing brief appears to allege in one place that taxpayers have substantiated $442 in meal expenses, but in another place offers no support or citation that meal expenses were substantiated by taxpayers with records or testimony. *See* taxpayers' post-hearing brief, 2013 Exhibit "B". The Director could find no records, and the taxpayers have provided no reliable testimony, to substantiate the amount or business purpose or relationship for any meal expenses for 2013. As such, taxpayers have not met their burden to prove any 2013 meal expenses.

f. Utilities (Internet/Phone)

Taxpayers' 2012 Schedule C claims $1,680 in deductible utilities. Ex. X, at p. 336. Taxpayers' post-hearing brief alleges that $2,035 of utility expenses were substantiated with records or testimony and should be allowed.

In support of this, taxpayers cite to various 2012 AT&T wireless bills in the record that are in the name of Camellia Pohl. These bills do not match the amount alleged to be deductible. The taxpayers' post-hearing brief has these expenses labeled as "business phone." Taxpayers also cite to various 2012 Centurylink bills in the record that are in the name of Randoph Pohl. These do not match the amount alleged to be deductible. The taxpayers' brief has these expenses labeled as "internet & security", but handwritten marks on the face of the bills label them in various places as "home phone and security" and "internet and phone." The records only indicate amounts billed, not paid.

Taxpayers have not provided adequate records to substantiate the amount or business purpose for these expenses. The expenses appear personal in nature. As such, taxpayers have not met their burden to prove any 2012 utility expenses.

Taxpayers' 2013 Schedule C claims $1,560 in deductible utilities. Ex. Y, at p. 345. Taxpayers' 2013 spreadsheet has a category for utilities that sums to $1,680. Ex. T, at pp. 287-292. Taxpayers' post-hearing brief alleges that $4,165.20 of utility expenses were substantiated with records or testimony and should be allowed. The taxpayers cite to various 2013 AT&T, CenturyLink, and Sprint bills in the record in the name of Camellia Pohl or Randolph Pohl. Again, the amounts on the bills do not equal the amounts claimed as substantiated by the taxpayer, and most of the records only indicate amounts billed, not paid. Taxpayers have not provided adequate records to substantiate the amount or business purpose for these expenses. The expenses appear personal in nature. As such, taxpayers have not met their burden to prove any 2013 utility expenses.

g. Vehicle Expenses

Business expenses related to passenger vehicles are subject to the same heightened levels of scrutiny as are meal and travel expenses, and are generally not deductible unless the taxpayer substantiates with "adequate records" the amount, time and place, business purpose and business relationship of the expense. 26 U.S.C. §§ 274(a), (d); 280F(d)(4) . Taxpayers' 2012 Schedule C claims $9,203 in vehicle expenses. Ex. X, at p. 336. Neither the 2012 handwritten ledger nor the 2012 spreadsheet provided by taxpayers appear to contain any vehicle expenses. Ex. S, at pp. 115-124, 199-203. Taxpayers' post-hearing brief alleges that $1,883.54 of vehicle expenses were substantiated with records or testimony and should be allowed. In support, the taxpayers cite to various receipts in the record related to car registration and oil changes for a 2003 Lincoln Aviator. They also cite to various bills from Progressive automobile insurance, but those records only indicate amounts billed, not paid, and do not indicate which vehicle or vehicles are covered by the policy. The amounts claimed substantiated for that insurance policy also differs from the amounts listed on the bills. The record also includes various receipts that may or may not be vehicle related, but there is no indication about the vehicle to which they relate. No credible evidence is available regarding the portion of a vehicle's use that is personal in nature or for business purposes, if any. No travel or mileage log has been provided. Taxpayers' federal form 4562 lists 15,390 business miles driven in 2012. Ex. X, at p. 338. This figure seems suspect when compared to the number and type of

activities listed on taxpayers' 2012 activity calendar. *See* Ex. S, at pp. 106-110. The expenses appear personal in nature. As such, taxpayers have not met their burden to prove any 2012 vehicle expenses.

Taxpayers' 2013 Schedule C claims $166 in deductible car and truck expenses. Ex. Y, at p. 345. Taxpayers 2013 spreadsheet does not appear to contain any vehicle expenses. Ex. T, at pp. 287-292. Taxpayers' post-hearing brief alleges that $4,330.55 of vehicle expenses were substantiated with records or testimony and should be allowed. Again, taxpayers cite to various items in the record such as repair receipts, as well as Progressive automobile insurance bills that only indicate amounts billed, not paid, and that do not indicate which vehicle or vehicles are covered by the policy. The amounts claimed substantiated for the insurance policy differs from the amounts listed on the bills. No credible evidence is available regarding the portion of a vehicle's use that is personal in nature or for business purposes, if any. No travel or mileage log has been provided. The expenses appear personal in nature. Taxpayers have not met their burden to prove any 2013 vehicle expenses.

h. Home Office

Generally, no business deduction for the use of a taxpayer's residence is allowed, unless the taxpayer proves that the expense is allocable to a portion of the residence that is exclusively used on a regular basis as the taxpayer's principal place of business. 26 U.S.C. § 280A. For both 2012 and 2013, taxpayers claimed that 260 square feet of their home was used exclusively for business. Ex. X, at p. 339; Ex. Y, at p. 346. According to taxpayers, this represents almost 28% percent of the total area of their home (936 square feet). Assessor records and testimony introduced by the Department suggests the total living area includes 556 square feet of finished basement bringing the total to roughly 1,492 square feet. Ex. A5, p. 365; Tr2 at pp. 93-95; Tr3 at pp. 27-30. This would lower the business use percentage available in calculating the deduction to roughly 17%. Not only that, it does not appear Mrs. Pohl discounted the business use of her home for the period in 2012 before she began her Lia Sohphia activities or the period in 2013 after she ceased. Regardless, the taxpayers have failed to provide credible or convincing evidence that any portion of the home was exclusively used on a regular basis for business.

Mrs. Pohl testified that her basement is unfinished and not considered livable space, and that she used two rooms, which were locked and inaccessible by other family members, exclusively for business as storage and an office. Tr1 at pp. 82-84. This is rather difficult to believe on its face, given the nature of her Lia Sophia activities, including her lack of inventory, and the fact that she and her husband still had one daughter living at home, and two daughters who attended colleges in Iowa but who presumably visited home periodically. *Id.* It's even more difficult to believe considering Mrs. Pohl's pervasive credibility issues. *See e.g.,* Johnson v. C.I.R., 105 T.C.M (CCH) 1548 (T.C. 2013) (taxpayer's testimony, without more, was insufficient to establish he used any portion of his residence exclusively for business). As such, taxpayers have not met their burden to prove any amounts are deductible in 2012 or 2013 as home office expenses.

However, 26 U.S.C. § 280A only operates to limit expenses that are not otherwise deductible as a personal expense, such as home mortgage interest and residential real estate taxes. 26 U.S.C. §§ 280A(b), 163(h)(2), 164(a). The record in this case includes a federal form 1098 mortgage interest statement showing $3,771.21 of mortgage interest paid by taxpayers in 2012, as well as a property tax statement showing $1,861 of real estate taxes paid in 2012. Ex. S, at pp. 204-205. A portion of this mortgage interest and real estate tax was included in taxpayers' now disallowed home office expenses. The record suggests that the remaining balance of $2,723 in mortgage interest and $1,344 in real estate taxes was claimed as an itemized deduction on taxpayers' 2012 IA 1040 Schedule A.[5] In this case, taxpayers are entitled to a full deduction for their 2012 home mortgage interest and property taxes. To the extent the itemized deduction for mortgage interest on the 2012 IA 1040 Schedule A is less than $3,771.21, that deduction is hereby increased to $3,771.21. To the extent the itemized deduction for real estate taxes on the 2012 IA 1040 Schedule A is less than $1,861, that deduction is hereby increased to $1,861.[6]

i. Other Expenses

Taxpayers' Schedule C for 2012 and 2013 contains various other deductions for commissions and fees, depreciation/section 179 expense, insurance, legal and professional services, and repairs and maintenance. These expenses have not been substantiated and are denied. In some cases, the deductions appear improper on their face. For example, taxpayers' 2013 Schedule C includes a $2,744 deduction for what appears to be an I.R.C. section 179 deduction expense on a Lincoln Aviator (see Ex. Y, at pp. 345, 348), despite testimony and other evidence that the taxpayer obtained and used that vehicle prior to 2013.[7] Also, taxpayers' 2013 Schedule C, line 16a, includes a $3,747 mortgage deduction. This appears to be for mortgage interest on their personal residence, which is only proper as a deduction in calculating the business use of their home or as an itemized deduction on Schedule A. Taxpayers did in fact also use this entire $3,747 of interest to calculate their home office deduction and schedule A itemized deductions, resulting in an attempted triple deduction of mortgage interest. Ex. Y, at p. 346; Ex. 14, at p. 371.

To the extent any claimed deduction is not substantiated, taxpayers argue alternatively that the Cohan rule should apply and that their expenses should be estimated. *See* Cohan v. Comm'r, 39 F.2d 540, 544 (2d Cir. 1930). That rule provides that under certain circumstances a court "may estimate the amount of expense if taxpayer is able to demonstrate that he has paid or incurred a deductible expense but cannot substantiate the precise amount, as long as he

[5] The taxpayers' 2012 federal 1040 Schedule A includes these amounts, which suggests that amount was also deducted for Iowa tax purposes, but it is difficult to know for certain because the record does not include a copy of the Iowa Schedule A.

[6] Mortgage interest and real estate taxes were also included in taxpayers' now disallowed 2013 home office expenses. The same treatment cannot be extended to these deductions because the full amounts for 2013 were already included on the taxpayers' Schedule A.

[7] A deduction under 26 U.S.C. § 179 is generally only available during the tax year that property is placed in service.

produces credible evidence providing a basis for the Court to do so." Fiedziuszko v. Comm'r of Internal Revenue, 115 T.C.M. (CCH) 1419 (T.C. 2018). Many of taxpayers' expenses are subject to heightened scrutiny to which the Cohan rule has been superseded by federal statute. *Id.* Also, there is no credible evidence in this case to prove deductible expenses were incurred or to provide a basis to make an estimate. Therefore, it is unnecessary to determine whether the Cohan rule could apply here.

To find otherwise would be to condone the taxpayers' systematic sloppy record-keeping and intermingling of personal expenses. This is especially true given the taxpayers' low revenues (as compared to income) and lack of physical evidence that parties or events occurred and that profits were pursued. The Department is compelled to take a minimalist approach and apply a high level of scrutiny to this case.

In summary, the amount of 2012 business expenses substantiated by the taxpayers equals $767.86 ($442.83 office expenses + $325.03 expenses), which is less than the $1,721 of deductions that were already allowed by the Department when it gave taxpayers the maximum hobby loss deduction in its prior refund denial. So taxpayers cannot secure a more favorable result for their 2012 Schedule C than they have already received. However, taxpayers are entitled to an itemized deduction for mortgage interest of $3,771, and for real estate taxes of $1,861, and to the extent the corresponding deductions on their 2012 IA 1040 Schedule A were less than those amounts, those deductions shall be increased by the appropriate amount and the taxpayer's 2012 income tax refund shall be adjusted by the Department accordingly.

The amount of 2013 business expenses substantiated by the taxpayers equals $497.36 ($322.18 office expenses + $175.18 supplies), which does exceed the $462 of deductions that were already allowed by the Department when it gave taxpayers the maximum hobby loss deduction in its prior assessment. Taxpayers would be entitled to an adjustment of their assessment to account for the $35.36 in additional deductions, but for the fact that they were not engaged in their Lia Sophia activities for profit and are limited by 26 U.S.C. § 183, as described below.

5. *Whether taxpayers' Lia Sophia Activities were engaged in for profit*

Deductions are limited when a taxpayer does not engage in an activity for profit. 26 U.S.C. § 183(a). In such cases, a taxpayer cannot deduct business expenses in excess of the hobby income produced. *Id.* The test for whether an activity is engaged in for profit is whether the activity is undertaken with a profit motive. Kovarik v. Iowa Dep't of Revenue, No. 18-0001, 2018 WL 6422889 (Iowa Ct. App. Dec. 5, 2018) (unpublished). "An activity is engaged in for profit if the taxpayer has an actual, honest profit objective, even if it is unreasonable or unrealistic." Keating v. C.I.R., 544 F.3d 900, 904 (8th Cir. 2008) (citing Treas. Reg. § 1.183-2(a)). "When deciding if the taxpayer was operating with a 'genuine profit motive,' the factfinder is not bound by the taxpayer's stated intention." Kovarik at 5 (quoting Meinhardt v. Comm'r, 766 F.3d 917, 919 (8th Cir. 2014). The determination is to be made by reference to

objective standards, and greater weight is given to objective facts than to the taxpayer's mere statement of intent. Treas. Reg. § 1.183-2(b).

The IRS uses a list of nine factors in determining whether an activity is engaged in for profit: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or her advisors; (3) the time and effort expended by 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 in respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) any elements of personal pleasure or recreation. *Id.*

No factor or group of factors is controlling, nor is it necessary that a majority of factors point to one outcome. Pouemi v. C.I.R., 110 T.C.M. (CCH) 213 (T.C. 2015) (citing Keating v. C.I.R. at 904). Certain factors may be accorded more weight in a particular case because they have greater salience or persuasive value as applied to its facts. *Id.* Each factor will be addressed in turn.

(1) Manner in which the taxpayer carries on the activity.

This first factor weighs heavily against the taxpayer. Three common inquiries considered in this context are (1) whether the taxpayer maintained complete and accurate books and records for the activity; (2) whether the taxpayer conducted the activity in a manner substantially similar to those of other comparable activities that were profitable; and (3) whether the taxpayer changed operating procedures, adopted new techniques, or abandoned unprofitable methods consistent with an intent to improve profitability. Rundlett v. Comm'r, 102 T.C.M. (CCH) 307 (T.C. 2011) (quoting Giles v. Commissioner, T.C. Memo. 2005–28). *See also* Treas. Reg. § 1.183–2(b)(1).

Mrs. Pohl failed to keep adequate and accurate books and records. She had no separate bank account for her Lia Sophia activities and substantially mixed her personal and business life, as evidenced by the manner in which she kept receipts and claimed expenses. Mrs. Pohl's recordkeeping was incomplete, inconsistent, and conflicting. Her handwritten expense log for 2012 provided some information regarding the date and amount of expense, but often only included vague descriptions such as the store where an expense was incurred, or the expense category. No expense log was provided for 2013. Expense spreadsheets were provided for 2012 and 2013, but these only included categories and amounts and did not identify the place of purchase, the item, or the purpose for an expense. There is no indication that these spreadsheets were prepared contemporaneously with the expenditures. Importantly, the handwritten log, spreadsheets, and tax returns conflicted in numerous places. It appears Mrs. Pohl's record keeping was an attempt to memorialize her transactions for tax purposes. To indicate a profit motive, records generally should assist in cutting expenses, increasing profits, making financial projections, and evaluating the overall performance of the business. Keating v. C.I.R at 904 (citing Filios v. Comm'r, 224 F.3d 16, 23 (1st Cir. 2000)). *See also* Burger v.

Comm'r, 50 T.C.M. (CCH) 1266 (T.C. 1985) (The purpose of maintaining books and records is more than to memorialize for tax purposes the existence of the subject transactions; it is to facilitate a means of periodically determining profitability and analyzing expenses such that proper cost saving measures might be implemented in a timely and efficient manner). There is no evidence in the record to suggest that Mrs. Pohl tracked her sales or customers or analyzed her profitability and success. Mrs. Pohl also failed to fulfill her Lia Sophia tax filing obligations in a business-like manner, as demonstrated by her late-filed and incorrect Iowa tax returns.

Mrs. Pohl did not have much in the way of a formal business plan, written or not. She testified about receiving business materials upon joining Lia Sophia, about aspiring to hold a certain number of parties and earning certain monthly revenues, and about trying various techniques to make sales. But there is no evidence that she developed a plan that included her capital needs and projected expenses, nor did she appear to manage spending to control losses after her sales did not meet her original expectations.

(2) The expertise of the taxpayer and her advisors.

Certain aspects of this factor weigh for and against the taxpayer, but it ends up neutral. Mrs. Pohl's background was in the travel business and she did not have any expertise with jewelry sales. She did not appear to do extensive study of multi-level marketing entities or jewelry sales prior to beginning, though she did testify that she spent time learning about Lia Sophia with her advisor and at sales seminars. But it is also true that Lia Sophia was a simple and ready-made business structure that would not require much training to learn. What Mrs. Pohl did not appear to do is consult with any financial or independent business experts about the economics of running a business. The taxpayers did not even consult a tax accountant, choosing instead to prepare and file their own returns. *See* Keating v. C.I.R. at 904 (mechanics and economics of activity are separate areas of expertise, and failure to obtain expertise in economics of activity may indicate a lack of profit objective) (citing Burger v. Comm'r, 809 F.2d 355, 359 (7th Cir. 1987)).

(3) The time and effort expended by the taxpayer in carrying on the activity.

This factor weighs against the taxpayer. Mrs. Pohl made statements to the Department and testified at the hearing that she dedicated an average of seven hours a day, 136 hours per month, and 1,800 hours per year to Lia Sophia activities, which would essentially make Lia Sophia equivalent to a full-time job. Ex. J, at p. 51; Tr1, at p. 89. But that is difficult to believe based on the type and amount of activities listed on her 2012 calendar, the number of parties and the type and amount of activities to which she testified, and the amount of income she produced. If this level of activity is to be believed, it would amount to a rough return on time invested of slightly less than one dollar per hour for 2012 and $0.25 per hour for 2013. Also, many of the activities she cited were unsupported by documentary evidence, or the receipts or records that were provided were contradictory, often suggesting a personal element to the activity. There is little doubt that Mrs. Pohl expended some time and energy in her Lia Sophia activities, but the evidence does support a finding of a profit motive.

(4) The expectation that assets used in the activity may appreciate in value.

Both parties appear to agree that this factor is not relevant in this case, and the Director agrees.

(5) The success of the taxpayer in carrying on other similar or dissimilar activities.

Both parties appear to agree that this factor weighs against the taxpayer, and the Director agrees. Mrs. Pohl was self-employed in various aspects of the travel business before and after her Lia Sophia endeavor. The record shows that Mrs. Pohl does not have success in making other activities profitable. She has consistently recorded large Schedule C losses in other endeavors that report little revenue but significant amounts of expenses. The seven-year period of Mrs. Pohl's Schedule Cs reviewed by the Department that includes the years at issue revealed a cumulative net loss of well over $100,000. This pattern of losses cuts against a finding of a profit motive.

(6) The taxpayer's history of income or losses in respect to the activity; and

(7) The amount of occasional profits, if any, which are earned.

Certain aspects of these factors weigh for and against the taxpayer, but both factors ultimately end up against the taxpayer. Mrs. Pohl's Lia Sophia activities were never profitable, and in fact produced significant losses relative to income. *See e.g.,* Kuberski v. C.I.R., 84 T.C.M., 5 (CCH) 178 (T.C. 2002) ("The magnitude of the activity's losses in comparison with its revenues is an indication that the taxpayer did not have a profit motive."). And the size of these losses is even more pronounced considering the relatively small initial investment needed by Mrs. Pohl to begin her Lia Sophia operations. *See* Treas. Reg. § 1.183–2(b)(7) (amount of profits considered "in relation to the amount of taxpayer's investment and the value of the assets used in the activity").

It is possible that these losses do not indicate a lack of profit motive if Mrs. Pohl was in a start-up stage and Lia Sophia may have eventually produced a profit. *See* Treas. Reg. § 1.183–2(b)(6) (A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity was not engaged in for profit.) Mrs. Pohl argued as much, and claimed that she left Lia Sophia after less than two years in part because she was convinced she wouldn't be able to turn a profit. This may be true, but it also seems likely from the testimony that her primary reason for leaving was her dissatisfaction with Lia Sophia's business practices and because of the class action lawsuit against it. Also, losses incurred during a start-up phase often, but not always, occur because of initial capital outlays, product development, or inefficiencies and mistakes made in running a business for the first time. This does not seem relevant to Lia Sophia because it was not a capital-intensive endeavour. It also does not seem relevant to Mrs. Pohl because she has experience with other business endeavours that were not capital-intensive, and all suffered from the same problem of low income and high expense.

(8) The financial status of the taxpayer.

This factor weighs against the taxpayer. The taxpayers are not wealthy, but appear to be financially secure. Mr. Pohl does experience periodic unemployment because of the nature of his profession, but he receives consistent wage income each year, among some other income to the couple. It is clear that the taxpayers were not reliant on income from Lia Sophia. The losses created from Lia Sophia did produce a material tax benefit to the taxpayers in 2012 by offsetting a significant portion (28%) of their total wages and other income. *See* Treas. Reg. § 1.183-2(b)(8) ("Substantial 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 especially if there are personal or recreational elements involved.") .

For 2013, taxpayers filed separately, which means the Lia Sophia losses were not available to offset Mr. Pohl's significant wage income. But a material tax benefit was still received by Mrs. Pohl because the loss offset her retirement income withdrawals. Taxpayers have argued that their decision to file separately was to their detriment and shows that they were not seeking tax benefits. But considering the taxpayers' issues with recordkeeping and preparing accurate and correct tax returns, it also seems possible that decision was inadvertent.

(9) Any elements of personal pleasure or recreation.

This factor weighs slightly against the taxpayer. It is not necessary that an activity be engaged in exclusively to derive a profit. Treas. Reg. § 1.183-2(b)(9). Suffering has never been a prerequisite to deductibility. Jackson v. Commission, 59 T.C. 312, 317 (1972) (finding taxpayer was engaged in boat chartering business despite fact he enjoyed sailing). But the record in this case and the sales model of Lia Sophia suggest a certain element of personal pleasure or social recreation associated with being involved. This sales model relies heavily on social outings and in-home parties aimed at selling the product. Mrs. Pohl testified about calling on friends and family to have parties and produce sales, and a good portion of her sales were made to family members. The Director believes this is analogous to *Elliot v. Commissioner*, which involved an Amway distributorship. In that case the Tax Court found that, although the taxpayers occasionally attended seminars, "most of their activity involved giving parties and taking people out to restaurants" and noted that "[w]hile there is no requirement that profit oriented work be onerous and unpleasant, the evidence presented by petitioners does not indicate activity motivated by a profit objective." Elliot v. C.I.R., 90 T.C. 960, 973 (1988).

After applying the the nine-factor test and considering the evidence in its totality, the Director concludes that Mrs. Pohl did not engage in her Lia Sophia activities in 2012 and 2013 with the intent to make a profit. As a result, the so-called "hobby loss" rules apply to limit her deductions attributable to Lia Sophia to the gross income derived from that activity. *See* 26. U.S.C. § 183; Kovarik v. Iowa Dep't of Revenue, No. 18-0001, 2018 WL 6422889 (Iowa Ct. App. Dec. 5, 2018) (unpublished).

ORDER

IT IS THEREFORE ORDERED that the taxpayers' allowable 2012 itemized deductions for mortgage interest is $3,771, and for real estate taxes is $1,861. To the extent the corresponding deductions on taxpayers' 2012 IA 1040 Schedule A were less than those amounts, those deductions are hereby increased by the appropriate amounts to equal $3,771 and $1,861, respectively. The taxpayers' 2012 income tax assessment and refund shall be adjusted by the Department accordingly. In all other respects, the Department's 2012 income tax assessment is AFFIRMED.

IT IS THEREFORE ORDERED that the Department's 2013 income tax assessment is AFFIRMED.

The Department shall take all necessary action to implement this decision.

Issued at Des Moines, Iowa, this 13th day of September, 2019.

IOWA DEPARTMENT OF REVENUE

BY: _____
Kraig Paulsen
Director

CERTIFICATE OF SERVICE

I certify that on this 13th day of September, 2019, I caused a true and correct copy of the Director's Final Order on Appeal to be forwarded by U.S. mail or delivered to the following persons:

Paxton J. Williams
Assistant Attorney General
Hoover State Office Building
2nd Floor
LOCAL

James R. Monroe
James R. Monroe Law Firm
P.O. Box 41355
Des Moines, Iowa 50311

Hollie Welch
Executive Secretary
Iowa Department of Revenue

NOTICE

An aggrieved taxpayer has thirty days from the date of the Director's Final Order to file an appeal to the Iowa District Court. The appeal must be made in writing.

The appeal can be filed in either the Polk County district court or in the district court for the county in which the petitioner resides or has its principal place of business. Information regarding the clerk of court for each county can be found at: http//www.iowacourts.gov/Administration/Directories.

Iowa Department of Inspections and Appeals
Administrative Hearings Division
Wallace State Office Building, Third Floor
Des Moines, Iowa 50319

RANDOLPH POHL CAMELLIA POHL, 1216 N. Concord St. Davenport, IA 52804, Appellant, v. IOWA DEPARTMENT OF REVENUE, Respondent. Individual Income Tax.	**PROPOSED DECISION** Case Nos. 18IDR0050 18IDR0051 Rev. Docket Nos. 2015-200-1-0084 2015-200-1-0160

The hearing in these cases commenced on October 22, 2018 with the last day being December 17, 2018. Randolph Pohl and Camellia Pohl (collectively "Pohls") appeared and were represented by James Monroe. Paxton Williams appeared on behalf of the Iowa Department of Revenue ("IDR"). Both parties presented witnesses and exhibits, and the final submission by the parties occurred on April 9, 2019. The matter is now fully submitted.

FINDINGS OF FACT

A.

This case revolves around Camellia Pohl's efforts to operate a Lia Sophia business in 2012 and 2013. Lia Sophia is a classic a multi-level marking entity that sells jewelry.[1] See e.g., Tr2., at p. 5. Like many who deeply involve themselves in such pyramid like businesses, she had no profits and ultimately ended her business after only 22 months. Tr., at pp. 67, 169. The issues in this case are whether she intended to operate her Lia Sophia business for profit and, if so, were the business losses claimed on the Pohl's 2012 and 2013 state returns justified. The amount at issue here is around $2,500.00. Exs. E, at p. 1; I, at p. 1.

By way of background, the Pohls are married. Randolph Pohl for all relevant time periods has been a licensed electrician and a nuclear instrumentation technician. Tr2., at p. 54. He is a union member, and his employer changes frequently, as he services different nuclear plants during times when the plants are down for maintenance. Id. He has periods of unemployment between jobs, but he has reported wage and unemployment income for all relevant years. Tr2., at p. 87. By contrast, Camellia Pohl has had more variety in her career.

[1]"Multi-level marketing is a way of retailing in which consumer products are sold by independent distributors, whose compensation includes a percentage of sales of an entire sales group, as well as earnings on one's own sales." State ex rel. Ieyoub v. Phipps, 634 So. 2d 51, 53 (La. Ct. App. 1994).

Prior to her involvement in Lia Sophia, Camellia Pohl, who is a high school graduate and has some college, had some accounting and bookkeeping work for "an airlines reporting corporation type thing." Tr., at p. 72; Tr2., at p. 15. She also had bookkeeping experience with sales receipts for a travel agency. Tr2., at p. 15. She further had a home-based travel agency, and she transition to Lia Sophia after attending a career fair where she was given information about the company. Id., at p. 73.

Camellia Pohl's formal involvement with Lia Sophia began on March 1, 2012, when she signed an "Advisor Agreement." Exs. 1; 9, at p. 278. She was recruited by Kay Pethound and another person with Lia Sophia. Tr. at p. 73. While Camellia Pohl described Kay Pethound as her supervisor, this is somewhat of a misnomer because of the lack of any employer/employee relationship between the two. Id.; Ex. 10, at p. 1 (advisory agreement terms including the status of an independent contractor). Camellia Pohl's stated goal was to "make a profit by the end of the year." Tr. at p. 74. This would be accomplished by having four to eight parties a month with approximately several thousand dollars in earnings. Id. There was at least an initial requirement for the number of parties to remain "active" and avoid becoming "nonactive," which would involve paying another fee. Id., at p. 78.

By all accounts, Camellia Pohl's goal went unrealized. For 2012, the Pohls reported they had $1,721.00 in gross income from the Lia Sophia business with $23,507.00 in expenses. Ex. N, at p. 1 (summary); Ex. X (tax return). For 2013, the Pohls reported they had $462.00 in gross income from the business and $19,793.00 in expenses. Ex. N, at p. 1 (summary); Ex. Y (tax return). Of note, the tax returns show early retirement distributions of $6,000.00 for 2012, and $8,385.00 for 2013. Ex. X, at p. 1; Ex. Y, at p. 1. Further, the 2012 tax return, which was not filed until 2015 and had a filing status of married filing a joint return, shows approximately $76,979.00 in earnings, which is total income before the business loss is considered to reach a final gross income. Ex. X, at p. 1. Likewise, the 2013 tax return, which had a filing status of married filing separately on a combined return, shows earnings for the Pohls of $107,908.00, which again is total income before the business loss is considered to reach a final gross income. Ex. Y, at p. 1.

As a result of this, Camellia Pohl ended her relationship with Lia Sophia and engaged in another career, which eventually lead her to starting her own business again. Tr., at p. 79. Of note, none of her business endeavors appear to have proven successful to date, as she also reported losses from her various other businesses for years 2009-2011 and 2015-2017. Tr., at p. 78.

B.

The Pohls activities concerning the Lia Sophia business came to the attention of both the IRS and IDR. On May 15, 2013, the IRS sent the Pohls' a letter requesting information concerning the La Sophia business and the business losses. Ex. 20. This eventually lead to an IRS agent coming to the Pohls' home to review the claimed space for the business as well as looking over other business documents. Tr., at pp. 95-96. The end result of the audit was the imposition of no material additional tax liability. Id., at pp. 101-02; Exs. 21, 22. Importantly, the Pohls claim the IRS failed to return or even internally retain some of the documentation sent to it. Tr., at p. 100.

The interaction with IDR did not resolve itself and gives rise to these cases. IDR's interest in this matter began when it realized the Pohls failed to timely file any return for 2012, and IDR then issued a letter to them on December 1, 2014, stating it had no record of their 2012 tax return and requesting a response. Ex. B. Apparently, IDR's attention for 2012 also caused them to consider the Pohls' 2013 tax returns, and a few days earlier on November 24, 2014, IDR sent a letter requesting information about the

Lia Sophia activities. Ex. A. In response, the Pohls filed a 2012 tax return in early 2015 that requested a $1,940.00 refund. Ex. X, at p. 2. Of note, the tax return erroneously stated it was signed on April 2, 2012. Id. As for 2013, the Pohls completed the business questionnaire for the tax return they had already timely filed and that requested a refund of $669.00. Ex. Y, at p. 2.

IDR did not accept the claimed refunds and adjusted both years. For 2012, IDR found Lia Sophia was a hobby and not a true business and disallowed any the claimed expenses above the maximum allowed for hobby losses. Tr3., at p. 33 ("The Department did not go through this calculation. It simply allowed expenses up to the amount of income reported, which just basically nets out the Schedule C. It allowed the maximum amount of expenses for a hobby loss."); Ex. N, at p. 1; Ex. F, at p. 2. This reduced the amount of the refund to $291.00. Ex F., at p. 4. IDR made a similar determination for 2013 and ultimately found the Pohls owed money, prompting IDR to issue a Notice of Assessment on February 12, 2015, for $187.20. Exs. C, D. Interest continues to accrue, and the reason IDR made this determination was based at that time solely on finding the Pohls had not engaged in the Lia Sophia for profit.

The Pohls appealed. At the hearing, IDR presented a January 22, 2018, letter it sent to the Pohls, which outlines most the reasons it found their Lia Sophia business was a hobby and not engaged for profit. Ex. N. The letter considered and applied the nine factors listed in federal regulations to discerning between when an enterprise is a hobby versus run for profit. Id. With respect to the first factor of the manner in which the taxpayer carries on the activity, the letter found the Lia Sophia enterprise was not being run like a business because, as everyone acknowledges, the Pohls did not have a separate bank account or have fixed hours for the operation and because there was a general lack of documentation on all the expenses or how the expenses related to the business. Ex. N, at pp. 2-3. IDR, for example, took issue with the fact there was only a log for 2012 and not 2013, the spreadsheet for those years did not "identify the place of the purchase or item you are including in each category of business expense," and the 2012 log did not match the 2012 spreadsheet or 2012 federal Schedule C. Id. IDR also noted the expenses listed on the 2013 spreadsheet do not match the amounts reported on federal Schedule C. Id., at p. 3. IDR further critiqued the lack of profits and lack of use of a website and LinkedIn. Id.

With respect to the second factor that is the expertise of the taxpayer or advisors, IDR focused on the lack of a business plan, lack of proof Kay Pethound was an expert in the field, the difference between the Lia Sophia business and the travel industry to which Camellia Pohl had experience, and a nominal number of shows. Id., at pp. 4-5. With respect to the third factor of the time and effort expended by the taxpayer in carrying on the activity, IDR found the documentation was sparse and did not find the record of six shows that were provided were sufficient to justify the claim of 7 hours per day, 136 hours per month, and 1800 per year. Id., at p. 4. It further questioned the time given how little in sales were reported. Id., at p. 5. With respect to the fourth factor that assets used in the activity may appreciate, IDR found this was irrelevant. Id.

With respect to the fifth factor of the success the taxpayer in carrying on other similar or dissimilar activities, IDR noted Camellia Pohl has claimed losses in her business ventures for virtually all of 2009 to 2016. Id. With respect to the sixth and seventh favors of history of income or losses with respect to the activity and the amount of occasional profits, IDR focused on the small amount of earnings compared to the large losses claimed, the overall losses from all the businesses, the limited investment required to start and maintain active status in Lia Sophia, and the limited sales of $5,736.67, in 2012 and $1,806.00 in 2013. Id., at pp. 5-6. With respect to the eighth factor of the financial status of the taxpayer, IDR concluded the Pohls had enough income to live "comfortably by most standards," which reveals the lack of need for the Lia Sophia business and it being a hobby. Id., at pp. 6-7. With respect to the ninth and last factor of

elements of personal pleasure, IDR found there was one show that Camellia Pohl hosted on March 12, 2012 that she did not receive commission, which IDR viewed as a lack of interest in profit. Id., at p. 7. IDR further took issue with the lack of recruiting others into the business and her "apparent" personal pleasure from the activity. Id.

At the hearing, IDR also challenged whether the claimed expenses were proven and, if so, whether such were ordinary and necessary expenses. Besides focusing on the incomplete and inconsistent documentation given to it as discussed in the letter, IDR also noted that many of the documents were too vague and incomplete to prove any expenses. For example, some receipts appear to show decorative items, but they lack descriptions of the item or other documentation showing it related to the Lia Sophia business. See, e.g., Tr3, at p. 8-22. Another example would be a Walmart receipt showing a purchase for "ST unlimited" and "911 fee," which showed no connection to the Lia Sophia business. Ex. T, at p. 270; Tr3., at pp. 9-10. There were other receipts that showed the purchase of two desks, which IDR found odd given the business. Tr3., at p. 11. Further, while some of the receipts show purchases of what would appear to be common groceries for a household and not for parties, such as the fruit bought at Sam's club on July 29, 2013. Ex. T, at p. 267. Likewise, there was also receipts for common household items, such as a mattress. Ex. T, at p. 273; Tr3., at pp. 17-18. There were also medical purchases, including for a marijuana test kit which IDR found not related to the business. See, e.g., Tr2,. at p. 103.

In response, Camellia Pohl provided testimony she attended various training seminars and other monthly meetings as well as receipts purportedly related to such. See, e.g., Tr., at p. 79, 80; Ex. S, at p. DOR-154. She also testified she recruited at least one other person into the endeavor. Tr., at p. 81. She further outlined her marketing strategies, including going to a fair, and testified she attempted to reassess her marketing every quarter to no avail as "none of it seem to work." Id., at pp. 85, 89. Likewise, Camellia Pohl testified she did operate her business in a business like matter, as evidence in part by her using two rooms in her home and purchasing various necessary items like a desk, computer, internet, and phone. See, e.g., id. at p. 84. She further testified that her hours varied due to the nature of the work, and she did various things to keep her customer's happy such as a purchase replacement jewelry when Lia Sophia refused to honor its return or warranty policy. Id., at p. 89, 113. For tax year 2013, Camellia Pohl testified she bought a program to do her taxes, and she created and ledger and inputted her expenses in accord with what the program requested. Id., at p. 104.

In addition, Camellia Pohl specifically testified as to her expenses. For example, she testified as to the vehicle costs, including insurance, repairs, and maintenance. See, e.g., Tr., at pp. 116, 122-23; Exs. 16-19, 37. She also testified to the meals she had as part of her business as well as party favors. Tr., at p. 117-18; Ex. 44, S, at p. 167. She further testified concerning other party supplies and gave copies of receipts. Tr. at p. 118; Ex. 35. She further testified as to the costs of her operations such as her phone. Tr., at p. 127; Ex. S, at p. 178; Ex. 45. There was also testimony concerning advertising cost and at least some receipts. Tr. at p. 118, 151-52; Ex. S, at p. 162. There were claims of certain expenses such as a desk. Further, there was testimony and receipts from Lia Sophia for items, including display items. Tr., at p. 133; Ex. S, at p. 133. This also included testimony and receipt for a night stay in Des Moines related to a conference. Tr., at p. 143, Ex. S, at p. 155. Camellia Pohl further testified she found the money to afford these expenses by cashing out her retirement accounts and other financial products in 2012 and 2013, which is the aforementioned distribution on those tax returns. Tr3., at p. 92.

Camellia Pohl also tried to account for the various discrepancies IDR found. As an initial matter, she did admit or at least appear to contest some portions of the submitted tax returns were improper, including an adjustment to line 35 for office expense or reporting more mortgage interest than they paid.

Tr., at p. 108; see also Tr3., at p. 22-26. Further, Camellia Pohl attempted to explain away the lack of receipts to verify all the claimed expenses on the ground that the IRS had lost some document and failed to return all the documents she submitted, IDR did not timely request full documentation (which is not true), and she did not understand IDR wanted all of her information versus just a sample, such as a report of all of her Lia Sophia parties as opposed to the provided accounting of a few. See, e.g., Tr., at p. 9, 144; Tr3., at p. 90-91. Likewise, she claimed some of the missing documents were "in my file in the car" at one point in the hearing, and just dismissed certain discrepancies, such as when the receipt she stated was for installing a thicker door in her home office was for a front door repair. Compare Tr., at p. 125 with Ex. S, at p. 129. She further explained away the discrepancy in the receipts for materials that could have no relation to her business, like the mattress and marijuana test kit, stating either such was excluded or the receipt was inadvertently included. Tr3., at pp. 94-95. She also claimed her computer containing her Lia Sophia materials "crashed." Ex. M. Some of the items, however, like the purchase of two desks or more than one computer, she defended on the ground such was necessary. See, e.g., Tr3., at p. 84.

C.

Following the hearing, the Pohls submitted a closing brief raising six distinct issues. The issues are: (1) whether IDR had the burden of proof on whether the business was for profit, the amount of the deductions with respect to the activities, and the Taxpayers resolution with the IRS of the 2012 audit; (2) whether IDR is bound by its own admission regarding Taxpayer's net income for 2012 and 2013 and/or the IRS's audit for 2012; (3) whether Camellia Pohl entered into and/or carried on her Lia Sophia activity for profit; (4) whether the Pohls substantiated their business expenses for 2012; (5) whether the Pohls substantiated their business for 2013; and (6) whether the IDR's calculations are accurate for 2013. Pohls Cl. Br., at p. 1. As part of this the Pohls' make 80 separate general proposed finds of fact in addition to seven ultimate findings of fact. Id., at pp. 2-15.

Taking the issues in turn, the Pohls first claim that, while they have the burden of proof on the issue giving rise to the assessment and denial of refund—namely the issue of whether they operated their business for profit, IDR carries the burden on the remaining issues such as the propriety of the actual expenses claimed because it did not raise this issue until years after the assessment. Id., at p. 16. The Pohls then claim that IDR is bound by the results of the IRS audit seemingly because the underlying law at issue is federal and IRS determined the federal tax in the prior audit. Id., at pp. 17-18. With respect to the third issue of running the business for profit, the Pohls maintain that all of the factors in federal regulation either support or are not material when considering Camellia Pohl's numerous activities from training and marketing to purchasing. Id., at pp. 19-24. With respect to the substantiation of the expenses in 2012, the Pohls provided charts summarizing what they believed the testimony and documents showed, which they totaled at $20,430.00 for 2012 and which shows they are entitled to a refund of $1,940.00. Id., at p. 25-26. For 2013, the taxpayers stated expenses exceeded income, which results in her owning nothing and Randolph Pohl owing $40.00. Id., at pp. 26-27.

In response, IDR makes several arguments. First, IDR argues the Pohls have the burden of proof on all issues in this case because the additional reason for the assessment, namely the lack of substantiating the business expenses, is not a "new matter" but part of the original assessment. IDR Br. at p. 2. IDR then asserts that the law is also crystal clear it does not have defer to results of an IRS audit because IDR is given the authority to enforce Iowa tax law and not the federal government. Id., at pp. 7-10. IDR then argues Camellia Pohl did not run her Lia Sophia business for profit under the factors in federal law because of the lack of formality, documentation, results, and resources expended among other things as discussed in its aforementioned letter. Id., at pp. 12-20. IDR then, alternatively, argues the Pohls did not prove their

2012 and 2013 claimed losses because their testimony was not credible and the documentation was insufficient or generally lacking, focusing at one point on the at most $800.00 advertising expenses in 2012 and $25.00 in 2013 but noting the receipts were too vague to understand context. Id., at pp. 22. IDR takes issue with all of the receipts on similar grounds. Id., at p. 23-33. Finally, IDR challenges numerous findings of fact on the grounds of relevance or being supported by the record, including all of the ultimate findings of facts, and proposes 15 alternative findings of fact. Id., at pp. 4-7.

The Pohls then filed a Reply brief, focusing on the dispute over the proposed findings of fact and claiming those that were specifically objected are deemed admitted. Reply Br, at pp. 10-12. There was also spent time spent re-arguing the weight of the federal factors on for prohibit or hobby loss in this case. Id., at pp. 11-23. Of note, the Pohls specifically argue that "if the expenses have not been substantiated, the Tribunal should estimate such in accord with federal practice called the Cohan rule. Id., at p. 30 (citing Cohan v. Commissioner, 39 F.2d 540, 543-44 (2d Cir. 1930). The Pohls then set out new amount either due or refunded based or additional charts, which total a refund of $1,801 for 2012 and Randolph Pohl only owing $14 in 2013. Id., at pp. 31-32.

For clarity, and as discussed below, the Tribunal finds Camellia Pohl's testimony she subjectively intended to run her Lia Sophia business for profit based not only her demeanor at the hearing, including the stress and emotional discomfort she emoted concerning her reasons for the business and the marital conflict that arose related to it, but also on the surrounding circumstances. This includes, but is not limited to, her pattern of behavior moving between businesses attempting to find a successful one so she could contribute to the family. This also includes the fact her involvement began after being recruited at a career fair by an entity that was a business and had her sign an independent salesperson/distributor agreement.

While the Tribunal finds her testimony about wanting to run the business profitably credible, the Tribunal does not find her testimony about the Lia Sophia expenses credible. This is because many of the records supporting the claimed expenses are not present under the questionable reasons of the IRS not returning them, a broken hard drive, Camellia Pohl refusing to get them from her vehicle, or her claiming to believe she only needed to send the IDR some of her records and not all. Further, the records that are present are not internally consistent, as evidenced in part by comparing the 2012 ledger, the 2012 and 2013 spreadsheet, and the tax returns with each other, and appear to show an intermingling of business and non-business activities, such as the attempt to claim the marijuana test kit or the mattress. Further, her claims about such things as the door replacement, which was contradicted by the door repair receipt, are hard on their face to accept, and based on her demeanor at the hearing including her lack of detail on her prior employment and other matters, it appears Camellia Pohl did not really remember many of the expenses of her defunct Lia Sophia business. In fact, the tax returns by all accounts have errors in them, and the fact the 2012 return filed in 2015 was signed with a date in 2012 reveals the general lack accuracy in the Pohls' records and statements. Even the purposes of the withdrawal of the retirement funds seems like there may have been purposes other than the business, such as simply living beyond her means, and the claimed expenses compared to the claimed gross profits from the business are so disproportionate it does cast a shadow on the Pohls' accounting. At most, the Tribunal does believe Camellia Pohl spent time and resources in the Lia Sophia business, but as for any specific expense or amount, the Tribunal is very skeptical because the Pohls have no credibility on the details of their expenses. There is a reason why IDR simply gave them the maximum hobby loss deduction, which is simply that not much sense made of the records and statements of the Pohls. There constantly shifting position through this process is telling.

In reaching this specific conclusion concerning Camellia Pohl's testimony and the expenses as well as the other factual findings in this decision, the Tribunal has incorporated some but not all of the proposed

findings of fact of the parties. The remaining findings of fact are rejected as either being immaterial to the matters to be decided or not supported. The claim that one party's lack of a specific objection to the other party's proposed findings deems that finding admitted and material is rejected, as nothing in rule requires this and the parties cannot force the Tribunal to make any finding of fact it believes is not supported or relevant. See generally, 701 Iowa Administrative Code § 7.17(8)(a).

CONCLUSIONS OF LAW

A.

Iowa law imposes an income tax "upon every resident and nonresident of the state which tax shall be levied, collected, and paid annually upon and with respect to the entire taxable income as defined" in law. Iowa Code § 422.5(1). The starting point for the calculation of net taxable net income is the adjusted gross income as properly calculated under the federal Internal Revenue Code ("I.R.C."). Iowa Code § 422.7.

As a general rule under the I.R.C., a taxpayer may deduct ordinary and necessary expenses incurred while engaging in a trade or business. See 26 U.S.C. §§ 162, 183(a). Normal and necessary means "normal, usual, or customary in the taxpayer's trade or business [and] appropriate and helpful to the taxpayer's business [even if it is not] absolutely essential." Dasent v. Comm'r of Internal Revenue, 116 T.C.M. (CCH) 551 (T.C. 2018) (internal quotation marks omitted). "To qualify for a deduction under § 162(a), a taxpayer must show that the expense was (1) paid or incurred during the taxable year, (2) for carrying on any trade or business, and (3) an ordinary and necessary expense." Zavadil v. Comm'r of Internal Revenue, 793 F.3d 866, 871 (8th Cir. 2015) (citing Comm'r of Internal Revenue v. Lincoln Savings & Loan Ass'n., 403 U.S. 345, 352 (1971)).

The test for whether an activity is related to a trade or business is whether the activity is undertaken with a profit motive. Kovarik v. Iowa Dep't of Revenue, No. 18-0001, 2018 WL 6422889, at *5 (Iowa Ct. App. Dec. 5, 2018) (unpublished). "An activity is engaged in for profit if the taxpayer has an actual, honest profit objective, even if it is unreasonable or unrealistic." Keating v. Comm'r of Internal Revenue, 544 F.3d 900, 904 (8th Cir. 2008), citing, 26 C.F.R. § 1.183-2(a)). While the "determination 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 test is at its heart "is purely subjective." Wells Fargo & Co. v. United States, 143 F. Supp. 3d 827, 846 (D. Minn. 2015) (citing Keating, 544 F.3d at 904); 26 C.F.R. § 1.183-2(a). Relevant factors in trying to discretion whether a subjective profit motive exists generally include, but are not limited to the following:

> **(1) Manner in which the taxpayer carries on the activity.** The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.
>
> **(2) The expertise of the taxpayer or his advisors.** Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where

the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) The time and effort expended by the taxpayer in carrying on the activity. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) Expectation that assets used in activity may appreciate in value. The term profit encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of § 1.183–1 for definition of an activity in this connection.

(5) The success of the taxpayer in carrying on other similar or dissimilar activities. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) The taxpayer's history of income or losses with respect to the activity. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) The amount of occasional profits, if any, which are earned. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is

engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial 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 especially if there are personal or recreational elements involved.

(9) Elements of personal pleasure or recreation. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

26 C.F.R. § 1.183-2(b)(emphasis in the original). Importantly, "[n]o one factor is determinative in making th[e]determination," and determination is not to be made simply "on the basis that the number of factors (whether or not listed [ ]) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa." Id. "[G]reater weight is given to objective facts than to the taxpayer's mere statement of his intent." Id. § 1.183-2(a).

Deduction of expenses related to an activity not engaged in for profit is limited to gross income derived from the activity. 26 U.S.C. § 183(b); see also Faulconer v. Comm'r, 748 F.2d 890, 893 (4th Cir. 1984). Thus the extent, if any, of "[d]eductibility depends on whether the activity was carried on for income or profit." Meinhardt v. Comm'r of Internal Revenue, 766 F.3d 917, 919 (8th Cir. 2014) (citing Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23, 35 (1987)). By statute, the "burden of proof with respect to assessments or denial of refunds in contested case proceedings shall be . . . upon the taxpayer who challenges the assessment or refund denial, except that, with respect to any new matter or affirmative defense, the burden of proof shall be upon the department." Iowa Code § 421.60(6)(c). The term "new matter" is defined to mean "an adjustment not set forth in the computation of the tax in the assessment or refund denial as distinguished from a new reason for the assessment or refund denial." Id. The term "affirmative defense" means "one resting on facts not necessary to support the taxpayer's case." Id.

B.

In this case, DHS's assessment and denial of refund must stand based *solely* on the record made in this case. As discussed below, the Pohls have the burden of proof due to the existence of the assessment

and denial of refund, and the IRS audit does not control because the IRS is a separate entity from the IDR. Further, while the Tribunal does believe the Pohls subjectively intended to operate the Lia Sophia business in good faith despite the business being objectively irrational from an economic standpoint, the Pohls' poor accounting, missing and contradictory records, and general lack of credibility on their expenses reveal the Tribunal cannot meaningfully discern if any specific claimed business loss is warranted. Because of this, the Tribunal finds the Pohls cannot secure a more favorable outcome than the one already given to it by IDR crediting the maximum hobby loss deduction, and as such, its actions are proper.

Core to the Tribunal's analysis is the issue of which party bears the burden of proof. Both parties agree the Pohls beard the burden on the issue of whether the Lia Sophia business was operated for profit, but they disagree on whether the specific claimed business expenses would still not be deductible due to a lack of corroboration. This dispute arises from the fact IDR did not advance this reason until after it issued the notice of assessment and denial of refund at issue in this case. Fortunately, the law is clear on this issue. When there is an assessment or denial of refund, the taxpayers bear the burden of proof absent the matter being a "new matter" or an affirmative defense. No claim exists that IDR belated reason for its position is an affirmative defense, and as for a new matter, the governing law states it is "an adjustment not set forth in the computation of the tax in the assessment or refund denial as distinguished from a new reason for the assessment or refund denial." Iowa Code § 421.60(6)(c). Here, the denial of the business expenses due to lack of corroboration is a new reason for the same adjustments of not allowing the business expenses because either the lack of a profit motive or corroboration would lead to the same result. As such, the Pohls bear the burden of proof on all relevant issues. See Iannone v. Iowa Dep't of Revenue & Fin., 641 N.W.2d 735, 738–39 (Iowa 2002).

Also central to the Tribunal's analysis is the significance of the IRS audit that found no additional or at least materially more tax liability for the Pohls' Lia Sophia business. As an initial matter, the United States and the State of Iowa are separate sovereigns, and as such, the actions of one cannot generally be attributed to or binding on the other. See United States v. Wheeler, 435 U.S. 313, 320 (1978) (stating "the basic structure of our federal system [is] States and the National Government are separate political communities" and each "derive power from different sources"), superseded by statute on other grounds as recognized in United Stated v. Lara, 541 U.S. 193 (2004). There is no applicable exception to this general rule for these two cases. First, no constitutional, statutory, or regulatory provision in either federal or state law requires IDR to defer to the audit findings of the IRS in a case like this where the state revenue law has incorporated some of federal taxation law. Second, there is no equitable doctrine in case law enabling such. The two most applicable equitable doctrines, namely issue preclusion as a form of collateral estoppel and general equitable estoppel can apply to bind the IDR to the findings of the IRS audit because those two doctrines require, among other things, the party against whom the doctrine is to be used to be the same that either previously litigated and lost the issue or took a bad action. See, e.g., City of Johnston v. Christenson, 718 N.W.2d 290, 297 (Iowa 2006) ("Issue preclusion, or direct or collateral estoppel, means simply that when an issue has once been determined by a valid and final judgment, that issue cannot again be litigated between the same parties in any future lawsuit."); Fennelly v. A-1 Mach. & Tool Co., 728 N.W.2d 163, 180 (Iowa 2006) ("The exceptional circumstances under which equitable estoppel will lie against the government include instances when, in addition to the traditional elements of estoppel, the party raising the estoppel proves affirmative misconduct or wrongful conduct by the government or a government agent."). To the best of the Tribunal's knowledge, no court or administrative tribunal has ever come to a contrary conclusion on similar facts. See, e.g., Busch v. Comm'r of Revenue, 713 N.W.2d 337, 342 (Minn. 2006).("We have said that when the IRS has failed to adjust or correct a taxpayer's federal return, collateral estoppel does not apply because there was no prior adjudication and the commissioner was neither a party nor privy and therefore has no opportunity to be heard.").

Finding the Pohls have the burden of proof and the IRS action have no significant, the next issue is whether the Pohls operated the Lia Sophia business for profit. While little doubt exists on this record that the Pohls did not have an objectively reasonable basis to believe the Lia Sophia business would be a profitable activity, little doubt also exists that the Pohls, specifically Camellia Pohl whose essentially ran the entire business, had an "actual, honest profit objective." Indeed, viewing the entirely of the record before delving into the specific, non-exclusive factors in federal law, the Tribunal had a great deal of time to assess the demeanor of Camellia Pohl given the length of her testimony, and based in part on the stress and other discomfort she exhibits while testifying as to the impact of the business of her family and life goals, it firmly believes she intended to make the business profitable.

The circumstances of her involvement strongly corroborate this, as she learned of the business at a career fair she attended due to her prior business struggling, and as she only lasted in the business nearly 22 months before attempting to do something else that could make money. This transiency points to a sincere effort to find a business that makes money and separates this case from many where there is a clear, personal fixation on an unprofitable business for years. See, e.g., Kovarik, 2018 WL 6422889, at *6 (holding that a side business was a hobby in part because the individual "acknowledged he had not realized a profit from consulting for any of the seventeen years he had been conducting the activity"). The life-cycle of the business is also common of those that are routinely, but unsuccessfully, run for profit. The Lia Sophia business is a pyramid-type sales model not too different from financial advisor or insurance salesperson. It is common for such individuals who are starting off in the field to have initial sales based on their existing relationships and then have sales fall off and the business ultimately fail as the existing relationships no longer can produce income and as the individual is unable to find new source of income. Thus, the initial sales followed by a decline of sales is typical. Further, the relatively small amount of money at issue in this case cuts against this being a scheme to lower tax rates or otherwise subvert the tax laws. If nothing else, the failure of the Pohls to even timely file a 2012 tax returns indicates that the participation in the business was unrelated to secure a tax advantage through a hobby business.

The non-exhaustive and not controlling factors in federal law do nothing to change this because they more or less cancel themselves out. With respect to the manner in which the taxpayer carries on the activity; this is more neutral than clearly favoring any party. On one hand, Camellia Pohl did not have a separate bank account and her records are at best incomplete and contain items not pertaining to the business including, but not limited to, the mattress and marijuana test kit. Further, her testimony as to the expenses was not complete, clear, or compelling. Some of it was just hard to accept on its face, and other portions, such as the door replacement, were hard to accept in light of the contrary receipt that was submitted. On the other hand, Lia Sophia had a basic business model based on direct communication and sales mostly through discrete events, and it does not seem reasonable to expect much in terms of a bureaucratic business structure, at least in its early stages. Further, the fact the business was started only after the last business failed and shuttered within 22 months is compelling, as if the business was not being run for profit, then why would she have entered it at the point in her life and then existed after a seemingly reasonable trial period. Such goes to the overall business manner in which she operated the activity, as ending an enterprise that is unprofitable after a trial period appears to be the essence of a profit motive. As such, and while there is additional material that cuts both ways such, it is a fair summary of the record to find this factor is not particularly helpful.

The second factor is again mostly neutral. At its core, the Lia Sophia business is a sale occupation, and while it is true she does not appear to have had prior experience in multi-level marketing of jewelry, it is true she did have experience is sales. Likewise, while it appears Camellia Pohl did not do extensive study of multi-level marketing entities or the jewelry business prior to stumbling onto a Lia Sophia representative

at a career fair and joining, it is equally true that home-based direct sales position do not have a particularly intensive training requirements, like becoming a physician and providing consultant services. It is also true Pohl did have at least some parties and marketing which is consistent with how this business is operated. While her testimony was generally lacking is detail and credibility concerning her business expenses, Lia Sophia did issue tax statements to her of her income, which indicates some activity.

The third factor concerning the time and effort expended on the activity fairs a little better for the Pohls but is again mostly neutral. In the Pohl's favor is the fact Camellia Pohl withdrew from her other travel business and shifted her attention to this business, without another job or employment. She also ended her participation in Lia Sophia fully at a specific time and shifted her attention elsewhere. This all cuts in favor of her operating the business for profit and not being a side, hobby business simply done for personal enrichment or tax advantage. On the other hand, though, Camellia Pohl's testimony about her hours and activities are not fully persuasive due to her lack of credibility on the details of her business. She had a tendency towards overstating, and since it is her burden of proof, this cuts against her and all but offsets this factor.

The next several factor do not have much in the way of salience given the specific facts of this case. The fourth factor that the assets used in the activity may appreciate in value has little significance because of the nature of the business. This was a multi-level marketing business based on personal sales and not a business like a farm, where there is the acquisition of assets like land that tend to appreciate. The fifth factor of success in carrying on similar or dissimilar activities is also unremarkable because, while Pohl did have a history of losses prior to joining Lia Sophia, she moved onto to a different business which cuts against this factor having much in the way of weight. This situation is not that of an individual who started their fourth unsuccessful iteration of the same failed business. It is true is was a sales position and she had unsuccessfully been in sales, but this is not enough to make the factor mean much. The sixth factor of income and losses with respect to Lia Sophia has little salience because of the relatively small amount of time Camellia Pohl was operating the business. This is a short amount of time and not on the same order as the "series of years" that the governing rule references when considering this factor. It is true she had limited earnings, as evidenced by the Lia Sophia tax records, and she claimed great losses. However, her overall losses were not substantiated as discussed below, and again, it appears this business never survived its trial period.

The final few factors also provide limited insight. The seventh factor concerning the amount of occasional profits does tend to favor IDR as there were never any profits at any point in time. That said, the force of the factor is limited because, again, the business was only operating for less than 2 years. The eighth factor concerning the financial status of the taxpayer does favor IDR because the Pohls' income was significant, but this factor is again limited because the rule speaks of tax advantages from claiming the loss of the business in dispute and because the amount at issue here is relatively small. The ninth factor concerning the elements of personal pleasure or recreation is not very helpful because, while it is true Camellia Pohl has the longing to be a successful business owner and support her family and this drove her into and out of the Lia Sophia business, being a successful business owner and contributing at its core does require profitability even if the broader goal is to have some prestige from attaining that status. Because of the limited value of the nine factors under the specific facts of this case and the totality of the record broadly supporting Camellia Pohl's testimony concerning her subjective intent, the Tribunal must find she intended to operate her business for profit.

While the Pohls may have intended to operate the Lia Sophia business for profit, they nonetheless failed to meet their burden of proof to show each and every claimed business expense was proper. Simply

put, the Tribunal does not find their testimony about any specific expense particularly credible and, without such, even the most straightforward receipts, such as for advertising, are suspect. The reasons for this conclusion are several. First, by all accounts, the Pohls do not have documentation to support all of the claimed expenses, and the reason they do not is somewhat suspect, as it is a combination of the IRS kept and lost records, they did not think the IDR wanted everything when it requested such, and such have are now no longer available for a variety of reasons. Second, the records the Pohls have contain numerous inaccuracies and are inconsistent. For example, by the Pohls own admission at hearing, the tax returns the Pohls submitted have inaccurate information, and the receipts they submitted included things that could not have been related to the business, including the mattress and marijuana test kit the parties focused on at the hearing. Further, the spreadsheets, ledger, and tax returns are not consistent, and many of the receipt are intrinsically questionable. For example, the July 16, 2012, Menards receipt for a hosebib, what appears to be a washing machine part, and a lawn patch, play sand, and 42 pound "SQ pattern" does not appear particularly related to the business. Ex. S, at p. 127. This is compounded by the general lack of detail to show that any specific receipt, such as the non-descript restaurant receipts, were actually related to the Lia Sophia business. Third, Camellia Pohls testimony trying to explain away these difficulties with broad statements she appropriate sorted the expenses is vague and not persuasive, particularly since a close look at the receipts indicates Camellia Pohl was mixing her business and personal life. This would be consistent with her general lack of care about details including the detail of timely filing a 2012 tax return, and this fact just undercuts the claims that the generic receipts for a cellphone, vehicle repair, household items, and the like were appropriate. Likewise, the testimony about the retirement account distributions being used for the business as opposed to personal items has no residence on this record. As such, while the Tribunal does believe the Pohls devoted time and resources to the Lia Sophia business, it is uncertain as to whether the specific claimed expenses are appropriate.

Perhaps anticipating this difficulty, the Pohls argue the Tribunal should estimate the expenses in the event it unable to simply credit all the claimed expenses. For support, the Pohls rely on the Cohen rule, and summarizing this rule, the United States Tax Court recently stated: "Under the Cohan rule, the Court may estimate the amount of the expense if the taxpayer is able to demonstrate that he has paid or incurred a deductible expense but cannot substantiate the precise amount, as long as he produces credible evidence providing a basis for the Court to do so." Fiedziuszko v. Comm'r of Internal Revenue, 115 T.C.M. (CCH) 1419 (T.C. 2018). A part from the problems later enacted administrative rules cut back the Cohan rule and there does not appear to be any Iowa authority adopting the doctrine, the rule itself requires there must "be sufficient evidence in the record to provide a basis upon which an estimate may be made and to permit us to conclude that a deductible expense was incurred in at least the amount allowed." Xuncax v. Comm'r, 82 T.C.M. (CCH) 455 (T.C. 2001). This is where the Pohls' claim fails because virtually everything from the individual cellphone, restaurant, and vehicle receipts to the inconsistent ledger and spreadsheets require the Pohls' testimony on the matter to find the expenses occurred in some amount and were "ordinary and necessary." At most, it is a slightly closer case on a few documents related to advertising and other actions with limited dual use purposes, but given the lack of credibility of the Pohls on the expenses generally, the Tribunal will find they could not secure a result more favorable than where the IDR gave them the maximum hobby loss deduction. As a result, IDR's action must be AFFIRMED.

III.

For the reasons stated above, the amount in the assessment is AFFIRMED. IDR shall take all necessary action to implement this decision.

IT IS SO ORDERED.

Dated this the 30th day of April, 2019.

Jonathan M. Gallagher
Administrative Law Judge
Wallace State Office Building – 3rd Floor
502 East 9th Street
Des Moines, IA 50319
Telephone: (515) 242-0009
Fax: (515) 281-4477
Jonathan.Gallagher@dia.iowa.gov

Cc: Paxton Williams, Assistant Attorney General (By email)
James Monroe, Attorney for Taxpayers (By email and mail)

NOTICE

Any aggrieved party has 30 days, including Saturdays, Sundays and legal holidays, of the date of this Proposed Decision to file an appeal to the Director of the Department of Revenue. 701 I.A.C. § 7.17(8)(d). The appeal must be made in writing. The appeal shall be directed to:

Office of the Director
Iowa Department of Revenue
Hoover State Office Building
Des Moines, Iowa 50319