

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessments of Individual)
Income Tax, Penalties, and Interest for the)
Taxable Years 1995, 1996, and 1997 by the)
Secretary of Revenue of North Carolina)
vs.)
[Taxpayers])

FINAL DECISION
Docket No. 2000-136

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon an application for a hearing by [Taxpayers, Husband and Wife], wherein they protested the proposed assessments of individual income tax, penalties, and interest for the taxable years 1995, 1996, and 1997. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1. At Taxpayers' request, the hearing was conducted via written communication and is based on all information presented for the record as of October 9, 2002. [An attorney represented the Taxpayers.]

ISSUES

The issues to be decided in this matter are:

1. Did the auditor properly determine Taxpayers' income based on the information available?
2. Is the indirect audit method used by the auditor a reasonable method of income reconstruction?
3. Are the assessments proposed against Taxpayers for the taxable years 1995, 1996, and 1997 lawful and proper?

EVIDENCE

The evidence presented at the hearing by W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division, consisted of the following:

1. Memorandum from E. Norris Tolson, Secretary of Revenue, to Eugene J. Cella, Assistant Secretary for Administrative Tax Hearings, dated May 16, 2001, a copy of which is designated as Exhibit PT-1.

2. Taxpayers' North Carolina individual income tax return for the taxable year 1995, a copy of which is designated as Exhibit PT-2.
3. Taxpayers' North Carolina individual income tax return for the taxable year 1996, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina individual income tax return for the taxable year 1997, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1995 dated October 15, 1999, a copy of which is designated as Exhibit PT-5.
6. Notice of Penalty Assessment for the taxable year 1995 dated December 13, 1999, a copy of which is designated as Exhibit PT-6.
7. Final Notice of Tax Assessment for the taxable year 1995 dated February 19, 2000, a copy of which is designated as Exhibit PT-7.
8. RO Notice of Final Tax Assessment for the taxable year 1995 dated April 21, 2000, a copy of which is designated as Exhibit PT-8.
9. Notice of Individual Income Tax Assessment for the taxable year 1996 dated October 15, 1999, a copy of which is designated as Exhibit PT-9.
10. Final Notice of Tax Assessment for the taxable year 1996 dated February 19, 2000, a copy of which is designated as Exhibit PT-10.
11. RO Notice of Final Tax Assessment for the taxable year 1996 dated April 21, 2000, a copy of which is designated as Exhibit PT-11.
12. Notice of Penalty Assessment for the taxable year 1996 dated December 13, 1999, a copy of which is designated as Exhibit PT-12.
13. Notice of Individual Income Tax Assessment for the taxable year 1997 dated October 15, 1999, a copy of which is designated as Exhibit PT-13.
14. Notice of Penalty Assessment for the taxable year 1997 dated December 13, 1999, a copy of which is designated as Exhibit PT-14.
15. Final Notice of Tax Assessment for the taxable year 1997 dated February 19, 2000, a copy of which is designated as Exhibit PT-15.
16. RO Notice of Final Tax Assessment for the taxable year 1997 dated April 21, 2000, a copy of which is designated as Exhibit PT-16.
17. Field Auditor's Report for the taxable year 1995 dated September 23, 1999, a copy of which is designated as Exhibit PT-17.
18. Field Auditor's Report for the taxable year 1996 dated September 23, 1999, a copy of which is designated as Exhibit PT-18.

19. Field Auditor's Report for the taxable year 1997 dated September 23, 1999, a copy of which is designated as Exhibit PT-19.
20. Letter from Attorney to Muriel K. Offerman, former Secretary of Revenue, dated January 11, 2000, a copy of which is designated as Exhibit PT-20.
21. Letter from Michael A. Hannah, former Assistant Secretary of Revenue, to Attorney dated March 24, 2000, a copy of which is designated as Exhibit PT-21.
22. Letter with related attachments from Attorney to Michael A. Hannah dated June 7, 2000, copies of which are collectively designated as Exhibit PT-22.
23. Letter from Michael A. Hannah to Attorney dated June 12, 2000, a copy of which is designated as Exhibit PT-23.
24. Letter with related attachments from Attorney to Michael A. Hannah dated June 12, 2000, copies of which are collectively designated as Exhibit PT-24.
25. Letter from Michael A. Hannah to Husband dated June 27, 2000, a copy of which is designated as Exhibit PT-25.
26. Letter from Richard C. Stewart, Administrative Officer in Sales and Use Tax Division, to Husband dated January 18, 2002, a copy of which is designated as Exhibit PT-26.
27. Letter from Eugene J. Cella to Husband dated February 18, 2002, a copy of which is designated as Exhibit PT-27.
28. Letter from Husband to Department of Revenue dated February 23, 2002, a copy of which is designated as Exhibit PT-28.
29. Letter from Eugene J. Cella to Husband dated March 1, 2002, a copy of which is designated as Exhibit PT-29.
30. Letter from Husband to Department of Revenue dated March 6, 2002, a copy of which is designated as Exhibit PT-30.
31. Letter from Eugene J. Cella to Husband dated March 13, 2002, a copy of which is designated as Exhibit PT-31.
32. Letter from Eugene J. Cella to Husband dated September 9, 2002, a copy of which is designated as Exhibit PT-32.
33. Letter from Eugene J. Cella to Taxpayer dated September 9, 2002, a copy of which is designated as Exhibit PT-33.

In lieu of appearing at the hearing, Husband requested that the matter be resolved via written communication. The Assistant Secretary granted the request and allowed Taxpayers until October 9, 2002, to furnish information in support of their objections to the assessments. Husband submitted a letter dated October 5, 2002, summarizing his position, a copy of which is designated as Exhibit TP-1.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. Taxpayers are and at all material times were natural persons, sui juris, and citizens and residents of North Carolina.
2. Taxpayers filed their joint North Carolina individual income tax returns for the tax years 1995, 1996, and 1997, under approved extensions of time for filing.
3. During the tax years at issue, Husband operated a proprietorship engaged in the business of muffler repair and used auto sales. Although requested by the auditor, Husband did not provide business records pertaining to sales, income, and expenses. Husband claims that the business records for the period January 1, 1996 through August 28, 1997 were destroyed by fire. Husband also claims that the business records for the period after the fire, August 1997 through September 1998, were lost when the truck in which the records were stored was involved in a traffic accident.
4. In conjunction with an examination of Taxpayers' withholding tax and sales and use tax liabilities, the auditor increased Taxpayers' gross income for the tax years 1995, 1996, and 1997 by \$50,361.00, \$44,329.00, and \$68,267.00, respectively, because the auditor determined that Taxpayers had understated their gross income by these amounts. In determining the amounts of understated income, the auditor used the Cash Transactions/"T" Account auditing method. This method compares income from known sources to expenditures. The auditor compared the amount of income and expenditures reported on Taxpayers' federal income tax returns for the tax years at issue and estimated their personal living expenses based on national standards from the federal Bureau of Labor Statistics to determine the understatement of income.
5. The auditor asserted the 25 percent negligence penalty for all tax years at issue and the penalty for underpayment of estimated income tax for the tax years 1996 and 1997.
6. Notices of Individual Income Tax Assessment reflecting the auditor's adjustments were mailed to Taxpayers on October 15, 1999, for the tax years 1995, 1996, and 1997. Taxpayers filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.
7. Subsequent to receiving Taxpayers' hearing request, the penalties for underpayment of estimated income tax for the tax years 1996 and 1997 were abated because it was determined that the penalties had been asserted in error.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. Gross income means all income from whatever source derived, including compensation for services and gross income derived from business.

2. A taxpayer is required to compute his net income using a method of accounting that is consistent with respect to both income and deductions. Where the method does not clearly reflect the taxpayer's income, the computation is required to be made by a method which in the opinion of the Secretary of Revenue does clearly reflect his income, following as nearly as practical the federal practice unless contrary to the context and intent of State law. The method used must be reasonable.
3. Section 6001 of the Internal Revenue Code requires a taxpayer to maintain such permanent books of account or records as are necessary to establish the amount of gross income, deductions, credits, or other matters required to be shown on his income tax return. Similar State law requires a taxpayer to furnish records, books of account, and any other information necessary to verify the correctness of his or her income tax return when requested to do so by the Secretary of Revenue.
4. In cases where the taxpayer does not provide adequate and reliable information upon which his tax liability may be determined, an assessment may be made upon the basis of the best information available and in the absence of information to the contrary, such assessment is deemed to be correct.
5. A penalty of 25 percent of the additional tax is required for negligent failure to comply with the income tax laws if a taxpayer understates gross income by 25 percent or more.

DECISION

The Secretary must base a proposed assessment on the best information available. In the absence of business records and other documentation, the auditor properly determined Taxpayers' income for each year by relying on Taxpayers' federal income tax returns and estimates of personal living expenses using national standards. This is a reasonable method of income reconstruction. Husband takes issue with the audit methodology contending that most of his income was from nontaxable sources, such as insurance proceeds and loans. However, Husband has furnished absolutely no factual evidence to support his claims or to otherwise establish that the amounts of understated income determined in the audit are in error.

Based on the foregoing findings of fact and conclusions of law, the proposed individual income tax assessments for the taxable years 1995, 1996, and 1997 are lawful and proper and are declared to be finally determined and immediately due and collectible together with interest as allowed by law.

Made and entered this 6th day of January, 2003.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue