

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 1996, 1997, and 1998 by the)
Secretary of Revenue of North Carolina)
vs.)
[Taxpayers])

FINAL DECISION
Docket No. 2001-219

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, on February 5, 2002, 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 1996, 1997, and 1998. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayers and W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division. [Taxpayer's employer] is hereinafter referred to as "Employer."

ISSUES

The issues to be decided in this matter are as follows:

1. Are Taxpayers entitled to deductions for nonbusiness itemized deductions in excess of the amounts allowed by the auditor?
2. Is Husband entitled to deductions for employee business expenses?
3. Should the fraud penalty be assessed in lieu of the negligence penalty?
4. Are the individual income tax assessments proposed against Taxpayers for the taxable years 1996, 1997, and 1998 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 1996, a copy of which is designated as Exhibit PT-2.
3. Taxpayers' North Carolina individual income tax return for the taxable year 1997, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina individual income tax return for the taxable year 1998, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1996 dated October 15, 1999, a copy of which is designated as Exhibit PT-5.
6. Notice of Individual Income Tax Assessment for the taxable year 1997 dated October 15, 1999, a copy of which is designated as Exhibit PT-6.
7. Notice of Individual Income Tax Adjustment for the taxable year 1998 dated October 2, 1999, a copy of which is designated as Exhibit PT-7.
8. A paper extract of Taxpayers' federal income tax information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1996, a copy of which is designated as Exhibit PT-8.
9. A paper extract of Taxpayers' federal income tax information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1997, a copy of which is designated as Exhibit PT-9.
10. A paper extract of Taxpayers' federal income tax information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1998, a copy of which is designated as Exhibit PT-10.
11. Auditor's spreadsheet listing itemized deductions claimed by Taxpayers and allowed by the auditor for the taxable year 1996, a copy of which is designated as Exhibit PT-11.
12. Auditor's spreadsheet listing itemized deductions claimed by Taxpayers and allowed by the auditor for the taxable year 1997, a copy of which is designated as Exhibit PT-12.
13. Auditor's spreadsheet listing itemized deductions claimed by Taxpayers and allowed by the auditor for the taxable year 1998, a copy of which is designated as Exhibit PT-13.
14. Cancelled checks written by Taxpayers made payable to [a religious organization], copies of which are designated as Exhibit PT-14.

15. Cancelled checks written by Wife made payable to Cash for donations/gifts, copies of which are designated as Exhibit PT-15.
16. A copy of the North Carolina Employment Security Commission's Wage History File for Husband, a copy of which is designated as Exhibit PT-16.
17. Letter from R. R. Smith, Tax Auditor in the Office Examinations Division, to Taxpayers dated February 16, 1999, a copy of which is designated as Exhibit PT-17.
18. An undated letter from Taxpayers to R. R. Smith, a copy of which is designated as Exhibit PT-18.
19. Letter from [a manager at Employer] dated March 9, 1999, a copy of which is designated as Exhibit PT-19.
20. Letter from R. R. Smith to Taxpayers dated May 12, 1999, a copy of which is designated as Exhibit PT-20.
21. An undated letter from Taxpayers to the Department of Revenue, a copy of which is designated as Exhibit PT-21.
22. Facsimile from Husband to Eugene Davis, Tax Auditor in the Office Examinations Division, dated January 20, 2000, a copy of which is designated as Exhibit PT-22.
23. Facsimile from Husband to Eugene Davis and R. R. Smith dated March 2, 2000, a copy of which is designated as Exhibit PT-23.
24. Letter from Caroline S. Raphun, former Administrative Officer in the Personal Taxes Division, to Taxpayers dated March 16, 2000, a copy of which is designated as Exhibit PT-24.
25. Facsimile from Taxpayers to Caroline S. Raphun dated May 24, 2000, a copy of which is designated as Exhibit PT-25.
26. Letter with related attachments from Caroline S. Raphun to Taxpayers dated December 13, 2000, copies of which are designated as Exhibit PT-26.
27. Letter from Marilyn R. Mudge, former Acting Assistant Secretary for Hearings, to Taxpayers dated February 28, 2001, a copy of which is designated as Exhibit PT-27.
28. Letter from Eugene J. Cella to Taxpayers dated June 6, 2001, a copy of which is designated as Exhibit PT-28.
29. Letter from Taxpayers to Eugene J. Cella dated June 27, 2001, a copy of which is designated as Exhibit PT-29.
30. Letter from W. Edward Finch, Jr., to Taxpayers dated August 2, 2001, a copy of which is designated as Exhibit PT-30.
31. Letter from Eugene J. Cella to Taxpayers dated August 20, 2001, a copy of which is designated as Exhibit PT-31.

32. Letter from Eugene J. Cella to Taxpayers dated October 29, 2001, a copy of which is designated as Exhibit PT-32.
33. Letter from Eugene J. Cella to Taxpayers dated November 6, 2001, a copy of which is designated as Exhibit PT-33.
34. Statement from R. R. Smith dated February 4, 2002, a copy of which is designated as Exhibit PT-34.

The evidence presented by Taxpayers at the hearing consisted of the following:

1. A list entitled 1996 Tax Preparation Information summarizing various deductions allowed and disallowed by the Department for the taxable year 1996, a copy of which is designated as Exhibit TP-1.
2. Taxpayers' contribution record for [a religious organization] for the tax year 1997 dated February 4, 1998, a copy of which is designated as Exhibit TP-2.
3. A list entitled 1997 Tax Preparation Information summarizing various deductions allowed and disallowed by the Department for the taxable year 1997, a copy of which is designated as Exhibit TP-3.
4. Taxpayers' contribution record for [a religious organization] for the tax year 1998 dated March 12, 1999, a copy of which is designated as Exhibit TP-4.
5. A list entitled 1998 Tax Preparation Information summarizing various deductions allowed and disallowed by the Department for the taxable year 1997, a copy of which is designated as Exhibit TP-5.

Taxpayers stated at the hearing that the tax preparation software they used to prepare their 1996 income tax return erroneously doubled the deduction for real estate taxes and mortgage interest. Taxpayers conceded that some of the medical expenses claimed in tax year 1998 were not paid during that year and are not deductible on the 1998 return. Husband also conceded that from July 1997 through tax year 1998 he was an employee and that he was eligible for reimbursement from Employer for ordinary and necessary expenses incurred but that he did not request reimbursement. Husband stated that he was a contractor rather than an employee during all of the tax year 1996 and through June of 1997. Taxpayers admitted at the hearing that they altered some cancelled checks in an effort to substantiate some charitable contributions that they contend they made but were unable to prove otherwise.

At the conclusion of the hearing, the Assistant Secretary allowed the Personal Taxes Division and Taxpayers thirty days to submit additional information for the record in support of their respective positions. Subsequent to the hearing, Taxpayers submitted an undated letter to the Assistant Secretary with related attachments, copies of which are collectively designated as Exhibit TP-6. The Personal Taxes Division submitted a print out of the North Carolina Division of Motor Vehicles' title history of Husband's 1985 [automobile], a copy of which is designated as Exhibit PT-35.

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 timely filed their North Carolina individual income tax returns for the taxable years 1996, 1997, and 1998 reflecting overpayments of \$5,475.00, \$3,977.00, and \$4,014.00, respectively. The overpayments for the tax years 1996 and 1997 were refunded to Taxpayers.
3. Husband reported wages on his federal income tax returns for the taxable years 1996, 1997, and 1998 of \$92,794.36, \$81,292.94, and \$72,142.61, respectively. Wife received wages of \$3,187.26 and a retirement distribution of \$363.22 during the taxable year 1996. Wife reported no income in tax years 1997 or 1998.
4. Taxpayers claimed itemized deductions on their federal income tax returns as follows:

	<u>1996</u>	<u>1997</u>	<u>1998</u>
Medical expenses	\$ 0.00	\$ 0.00	\$ 8,331.00
Taxes	10,200.00	7,155.00	6,809.00
Interest	13,692.00	13,056.00	16,311.00
Contributions	30,348.00	25,441.00	16,536.00
Employee business expenses	<u>32,293.00</u>	<u>17,692.00</u>	<u>12,341.00</u>
TOTAL	<u>\$86,533.00</u>	<u>\$63,344.00</u>	<u>\$60,328.00</u>

5. Taxpayers furnished a voluminous amount of receipts, cancelled checks, and other documents to the auditor reflecting both deductible and nondeductible expenditures during the tax years at issue.
6. Husband contends that he worked as a consultant and that the nature of his relationship with his employers was similar to that of an independent contractor rather than an employee. Husband received wage and tax statements (Form W-2) from his employers reflecting wages paid during the tax years at issue. On his federal returns, he identified his work-related expenses as "employee" expenses. Husband furnished a copy of an e-mail message from Employer stating that during the tax year 1998 Husband did not receive reimbursement related to certain customary expenses necessary to his position and responsibility. Employer subsequently informed the auditor by telephone that it would reimburse Husband for ordinary and necessary business expenses incurred. Employer further stated that Husband was not required to travel much and was not required to recruit personnel. Husband contends that some meal and entertainment involved recruitment of personnel. Employer reported Husband's wages to the Employment Security Commission further supporting that he was an employee. Most of the business meal receipts furnished by Taxpayers reflected restaurants located in the general area of Husband's tax home. Further, most of the receipts and cancelled checks for meals and lodging furnished by Taxpayers were in Wife's name.

7. For the tax year 1996, Taxpayers furnished a receipt verifying real estate tax paid of \$1,929.00. Taxpayers deducted real estate taxes of \$3,858.00.
8. For the tax year 1996, Taxpayers furnished a mortgage company statement verifying mortgage interest paid of \$6,010.00. However, Taxpayers deducted mortgage interest of twice that amount on the return.
9. The auditor allowed charitable cash deductions as substantiated by cancelled checks furnished by Taxpayers for the tax years at issue and non-cash contributions of \$500.00 for the tax year 1998.
10. Taxpayers altered three cancelled checks they provided as verification for charitable contributions for tax year 1998. For example, check number 1976 dated January 25, 1998 (see Exhibit PT-14) was written for \$5.00 and was cashed by the bank for that amount. Taxpayers concede that they later altered the check from \$5.00 to \$5,000.00 and added the word "thousand" after the word "five" on the legal line of the check. The bank cashed a fourth check made payable to the same charitable organization in tax year 1996 in the amount of \$500.00 for only \$5.00. Taxpayers contend the check was not altered and was cashed for the wrong amount because of a bank encoding error.
11. Upon examination, the auditor disallowed itemized deductions of \$73,980.00, \$56,444.00, and \$31,402.00 for the tax years 1996, 1997, and 1998, respectively. The deductions were disallowed because Taxpayers did not furnish records to adequately substantiate the amounts claimed.
12. Notices of Individual Income Tax Assessment reflecting the adjustments for the tax years 1996 and 1997 were mailed to Taxpayers on October 15, 1999.
13. A Notice of Individual Income Tax Adjustment reflecting the auditor's adjustments for the tax year 1998 was mailed to Taxpayers on October 2, 1999. The adjustments decreased Taxpayers' overpayment for the tax year 1998 to \$1,965.00, which was applied to the 1996 liability.
14. The auditor assessed the twenty-five percent negligence penalty for the tax years 1996 and 1997.
15. Taxpayers filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.
16. Based on information furnished by Taxpayers subsequent to their request for a hearing, the auditor adjusted the 1996 and 1997 proposed assessments to allow itemized deductions as follows:

	<u>1996</u>	<u>1997</u>
Taxes	\$ 7,595.00	\$ 7,005.00
Interest	7,682.00	13,001.00
Contributions	6,752.00	6,476.00
TOTAL	<u>\$22,029.00</u>	<u>\$26,482.00</u>

17. Taxpayers furnished information at the hearing and subsequent to the hearing verifying charitable cash contributions in excess of amounts previously allowed. This increases the contribution deductions by \$663.00, \$5,508.00, and \$2,432.00 for taxable years 1996, 1997, and 1998 respectively.

CONCLUSIONS OF LAW

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

1. A taxpayer is allowed deductions for amounts paid during the taxable year for certain nonbusiness expenses. The deductions include but are not limited to qualifying medical expenses, taxes, interest paid, and charitable contributions. Taxpayers' nonbusiness itemized deductions for State income tax purposes are the same as for federal purposes except that state, local, and foreign income taxes deducted on the federal return must be added to federal taxable income in computing North Carolina taxable income.
2. For cash contributions of less than \$250.00, taxpayers are required to keep a cancelled check, a receipt, or other reliable written records from the charitable organization. For contributions of \$250.00 or more, taxpayers must have an acknowledgement of the contribution from the qualified organization. For non-cash contributions, taxpayers must keep records showing the name of the charitable organization, the date and location of the contribution, and a detailed description of the property. For non-cash contributions of \$250.00 or more, the records must generally also include the fair market value of the property; the cost or other basis of the property; the terms and conditions attached to the gift; and whether the organization gave the taxpayer any goods or services as a result of the gift. For expenses related to the use of a taxpayer's car in giving services to a qualified organization, the taxpayer must keep records regularly at or near the time the expense was incurred showing the name of the organization and the miles driven for charitable purposes.
3. A taxpayer is allowed to deduct the ordinary and necessary expenses paid during the income year in carrying on a trade or business or for the production or collection of income. In order to claim any deduction, a taxpayer must be able to prove that the expenses were in fact paid or incurred. In cases where a taxpayer is away from his tax home, a deduction for travel expenses, including meals and lodging, is not permitted unless the taxpayer substantiates each expenditure by adequate records or by sufficient corroborating evidence. The taxpayer must maintain a timely record in an account book or diary showing the amount of each expenditure, the time and place of travel, and the business purpose. In order to be considered "adequate records," account books, diaries, logs, statements of expenses, and other similar records must be prepared or maintained in such a manner that each recording of an expense is made at or near the time of the expense and the documentary evidence is sufficient to establish each element of the expense. A taxpayer claiming a deduction must satisfy the specific statutory provisions authorizing the deduction and must also bear the burden of proving entitlement to it.
4. A taxpayer's "tax home" is the place away from which traveling expenses must be incurred to be deductible and is, as a general rule, the place at which the taxpayer conducts the trade or business. It includes the entire city or general area in which the

taxpayer's business or work is located. If the taxpayer is engaged in business at two or more separate locations, the tax home is located at the principal place of business during the taxable year.

5. Employees are allowed to deduct certain expenses for the business use of a part of their home if that part is used regularly and exclusively as their principal place of business or a place to meet or deal with patients, clients, or customers in the normal course of their trade or business. The regular and exclusive business use must be for the convenience of their employer.
6. A ten percent penalty is required for negligent failure to comply with the income tax laws without intent to defraud. A twenty-five percent negligence penalty is imposed pursuant to G.S. 105-236(5)b for a large individual income tax deficiency. A large income tax deficiency exists when a taxpayer understates taxable income by an amount equal to twenty-five percent or more of gross income.
7. If there is a deficiency or delinquency in payment of any tax because of fraud with intent to evade the tax, a penalty of fifty percent of the total deficiency is required.
8. The proposed assessments of additional income tax for the taxable years 1996, 1997, and 1998 were properly issued and are, under the facts, lawful and proper except to the extent hereinafter modified.

DECISION

During the hearing, Taxpayers conceded that deductions for real estate taxes and mortgage interest were erroneously doubled on the 1996 return and that the majority of medical expenses for 1998 were not paid during that year. Consequently, the remaining issues address the extent to which deductions for charitable contributions, employee business expenses, and personal property tax are allowable.

Husband contends that for the tax year 1996 through June of 1997 he was an independent contractor rather than an employee. Husband stated at the hearing that he worked for Employer as an employee from July 1997 through 1998 but that he did not request reimbursement from Employer for business expenses.

The facts indicate that Husband was paid wages during the entire period at issue and that he claimed deductions for "employee" business expenses. Notwithstanding that the evidence indicates that Husband was an employee, the primary issue before the Assistant Secretary is whether Husband has in fact carried his burden of proof that he is entitled to the

deductions for employee business expenses. In order to claim deductions for business expenses, a taxpayer must satisfy the specific statutory provisions authorizing the deduction and substantiate his eligibility for it. The Assistant Secretary finds that Husband has not carried his burden of proving entitlement to the deductions for employee business expenses. Further, employee business expenses for which Husband was eligible for reimbursement but failed to make a proper claim for reimbursement with Employer are not deductible (*Dixon v. Commissioner* 1999 RIA TC Memo ¶ 99,310).

The Assistant Secretary further finds that Taxpayers have not met their burden of proof that they are entitled to deductions for personal taxes in excess of the amounts allowed by the Department.

Taxpayers admit to altering various cancelled checks sent to the Department as verification of charitable contributions for the tax year 1998. Notwithstanding Taxpayers' purported reasons for altering the checks, such behavior was clearly a deliberate attempt to deceive the Department and, therefore, fraudulent. However, there is no additional tax due for the tax year 1998 against which the fraud penalty may be applied. The twenty-five percent negligence penalty was properly assessed for the taxable years 1996 and 1997.

Subsequent to the hearing, Taxpayers furnished additional information substantiating charitable cash contributions in excess of amounts previously allowed thereby increasing the contributions deductions by \$663.00, \$5,508.00, and \$2,432.00 for the taxable years 1996, 1997, and 1998 respectively. The recalculation of Taxpayer's income tax liability is as follows:

	<u>1996</u>	<u>1997</u>	<u>1998</u>
North Carolina taxable income			
previously determined	\$69,665.00	\$49,792.00	\$37,501.00
Less: Additional contributions	<u>663.00</u>	<u>5,508.00</u>	<u>2,432.00</u>
Corrected NC taxable income	\$69,002.00	\$44,284.00	\$35,069.00
Corrected tax	4,617.64	2,887.00	2,243.00
Less: Net tax paid as withholding	<u>311.00</u>	<u>1,121.00</u>	<u>2,414.00</u>
Tax due/overpayment	\$ 4,306.64	\$ 1,766.00	(\$ 171.00)
Negligence penalty	1,076.66	441.50	
Interest to June 24, 2002	<u>1,767.41</u>	<u>571.31</u>	<u>39.62</u>
Total	\$ 7,150.71	\$ 2,778.81	(\$ 210.62)
Less: Payment	<u>1,965.00</u>		
TOTAL DUE	<u>\$ 5,185.71</u>	<u>\$ 2,778.81</u>	<u>(\$ 210.62)</u>

The proposed assessments for the taxable years 1996, 1997, and 1998 as herein modified are declared to be finally determined and immediately due and collectible together with interest as allowed by law.

Made and entered this 24th day of May, 2002.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue