

STATE OF NORTH CAROLINA

**BEFORE THE
SECRETARY OF REVENUE**

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessments of Individual)
Income Tax, Penalties, and Interest for the)
Taxable Years 1993 through 1996 by the)
Secretary of Revenue of North Carolina)
vs.)
[Taxpayer 1] & [Taxpayer 2], Taxpayers)

FINAL DECISION

Docket No. 2002-689

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, on December 18, 2002, upon an application for a hearing by [Taxpayer 1] and [Taxpayer 2], hereinafter referred to collectively as "Taxpayers," wherein they protested the proposed assessments of individual income tax, penalties, and interest for the taxable years 1993 through 1996. Taxpayer 1 is hereinafter referred to as "Husband." The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Husband and W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division. Husband's employer, [Name] University, 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 Department?
2. Is Husband entitled to deductions for employee business expenses and self-employment related expenses in excess of the amounts allowed by the Department?
3. Are the individual income tax assessments proposed against Taxpayers for the taxable years 1993 through 1996 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 1993, a copy of which is designated as Exhibit PT-2.
3. Taxpayers' amended North Carolina individual income tax return for the taxable year 1993, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina individual income tax return for the taxable year 1994, a copy of which is designated as Exhibit PT-4.
5. Taxpayers' amended North Carolina individual income tax return for the taxable year 1994, a copy of which is designated as Exhibit PT-5.
6. Taxpayers' North Carolina individual income tax return for the taxable year 1995, a copy of which is designated as Exhibit PT-6.
7. Taxpayers' amended North Carolina individual income tax return for the taxable year 1995, a copy of which is designated as Exhibit PT-7.
8. Taxpayers' North Carolina individual income tax return for the taxable year 1996, a copy of which is designated as Exhibit PT-8.
9. Notice of Individual Income Tax Assessment for the taxable year 1993 dated April 19, 1998, a copy of which is designated as Exhibit PT-9.
10. Notice of Amended Individual Income Tax Assessment for the taxable year 1993 dated August 1, 2000, a copy of which is designated as Exhibit PT-10.
11. Notice of Individual Income Tax Assessment for the taxable year 1994 dated April 19, 1998, a copy of which is designated as Exhibit PT-11.
12. Notice of Amended Individual Income Tax Assessment for the taxable year 1994 dated March 28, 1999, a copy of which is designated as Exhibit PT-12.
13. Notice of Amended Individual Income Tax Assessment for the taxable year 1994 dated August 1, 2000, a copy of which is designated as Exhibit PT-13.

14. Notice of Individual Income Tax Assessment for the taxable year 1995 dated April 19, 1998, a copy of which is designated as Exhibit PT-14.
15. Notice of Amended Individual Income Tax Assessment for the taxable year 1995 dated August 1, 2000, a copy of which is designated as Exhibit PT-15.
16. Notice of Individual Income Tax Assessment for the taxable year 1996 dated April 19, 1998, a copy of which is designated as Exhibit PT-16.
17. Notice of Amended Individual Income Tax Assessment for the taxable year 1996 dated March 28, 1999, a copy of which is designated as Exhibit PT-17.
18. Notice of Amended Individual Income Tax Assessment for the taxable year 1996 dated August 1, 2000, a copy of which is designated as Exhibit PT-18.
19. Taxpayers' federal individual income tax return for the taxable year 1993, a copy of which is designated as Exhibit PT-19.
20. Taxpayers' federal individual income tax return for the taxable year 1994, a copy of which is designated as Exhibit PT-20.
21. Taxpayers' federal individual income tax return for the taxable year 1995, a copy of which is designated as Exhibit PT-21.
22. Taxpayers' federal individual income tax return for the taxable year 1996, a copy of which is designated as Exhibit PT-22.
23. The auditor's schedule of itemized nonbusiness deductions allowed for tax years 1993, 1994, 1995, and 1996, a copy of which is designated as Exhibit PT-23.
24. A copy of excerpts from Employer's Faculty Handbook, a copy of which is designated as Exhibit PT-24.
25. Letter from Husband to the Department of Revenue dated April 8, 1997, a copy of which is designated as Exhibit PT-25.
26. Letter from K. J. Caviness, former Tax Auditor with the Department of Revenue, to the Taxpayers dated April 10, 1997, a copy of which is designated as Exhibit PT-26.
27. Letter from K. J. Caviness to Employer's Payroll Supervisor dated April 17, 1997, a copy of which is designated as Exhibit PT-27.
28. Letter from K. J. Caviness to Taxpayers dated May 29, 1997, a copy of which is designated as Exhibit PT-28.

29. Letter from Husband to the Department of Revenue dated June 3, 1997, a copy of which is designated as Exhibit PT-29.
30. Letter from K. J. Caviness to Taxpayers dated June 9, 1997, a copy of which is designated as Exhibit PT-30.
31. Letter from Dorothy L. Wiggins, Assistant Director of the Office Examination Division, to Taxpayers dated September 2, 1997, a copy of which is designated as Exhibit PT-31.
32. Letter, with attachments, from Husband to K. J. Caviness dated September 5, 1997, copies of which are designated as Exhibit PT-32.
33. Letter from Husband to the Department of Revenue dated May 14, 1998, a copy of which is designated as Exhibit PT-33.
34. Letter from Husband to the Department of Revenue dated May 14, 1998, a copy of which is designated as Exhibit PT-34.
35. Letter from Husband to the Department of Revenue dated May 14, 1998, a copy of which is designated as Exhibit PT-35.
36. Letter from Husband to the Department of Revenue dated May 14, 1998, a copy of which is designated as Exhibit PT-36.
37. Letter from Husband to the Department of Revenue dated August 18, 1998, a copy of which is designated as Exhibit PT-37.
38. Letter from W. Edward Finch, Jr., to Taxpayers dated April 30, 1999, a copy of which is designated as Exhibit PT-38.
39. Letter from Husband to W. Edward Finch, Jr., dated May 19, 1999, a copy of which is designated as Exhibit PT-39.
40. Letter from W. Edward Finch, Jr., to Taxpayers dated May 25, 1999, a copy of which is designated as Exhibit PT-40.
41. Letter from Taxpayers' former attorney, to W. Edward Finch, Jr., dated September 8, 1999, a copy of which is designated as Exhibit PT-41.
42. Letter, with attachments, from Taxpayers' former attorney, to W. Edward Finch, Jr., dated October 28, 1999, copies of which are designated as Exhibit PT-42.
43. Letter, with attachments, from Taxpayers' former attorney, to W. Edward Finch, Jr., dated December 13, 1999, copies of which are designated as Exhibit PT-43.

44. Letter from W. Edward Finch, Jr., to Taxpayers' former attorney, dated February 2, 2000, a copy of which is designated as Exhibit PT-44.
45. Letter from Taxpayers' former attorney, to W. Edward Finch, Jr., dated February 14, 2000, a copy of which is designated as Exhibit PT-45.
46. Letter from W. Edward Finch, Jr., to Taxpayers' former attorney, dated March 17, 2000, a copy of which is designated as Exhibit PT-46.
47. Letter from W. Edward Finch, Jr., to Taxpayers, dated August 7, 2000, a copy of which is designated as Exhibit PT-47.
48. Letter, with attachment, from W. Edward Finch, Jr., to Taxpayers' former attorney, dated August 23, 2001, copies of which are designated as Exhibit PT-48.
49. Letter from W. Edward Finch, Jr., to Taxpayers' former attorney, dated January 11, 2002, a copy of which is designated as Exhibit PT-49.
50. Letter, with attachments, from Taxpayers' former attorney, to W. Edward Finch, Jr., dated January 25, 2002, copies of which are designated as Exhibit PT-50.
51. Letter, with attachments, from Taxpayers' former attorney, to W. Edward Finch, Jr., dated March 26, 2002, copies of which are designated as Exhibit PT-51.
52. Letter from W. Edward Finch, Jr., to Taxpayers' former attorney, dated July 29, 2002, a copy of which is designated as Exhibit PT-52.
53. Letter from Taxpayers' former attorney, to W. Edward Finch, Jr., dated August 16, 2002, a copy of which is designated as Exhibit PT-53.
54. Letter from Taxpayers' former attorney, to W. Edward Finch, Jr., dated September 3, 2002, a copy of which is designated as Exhibit PT-54.
55. Letter from W. Edward Finch, Jr., to Taxpayers' former attorney, dated September 16, 2002, a copy of which is designated as Exhibit PT-55.
56. Letter from Eugene J. Cella to Taxpayers' former attorney, dated October 29, 2002, a copy of which is designated as Exhibit PT-56.
57. Letter from Taxpayers' former attorney, to Eugene J. Cella dated November 1, 2002, a copy of which is designated as Exhibit PT-57.
58. Letter from Eugene J. Cella to Taxpayers dated November 8, 2002, a copy of which is designated as Exhibit PT-58.

Subsequent to the hearing, the Assistant Secretary allowed both the Personal Taxes Division and Taxpayers 30 days to submit additional information for the record in support of their respective positions. At Husband's request, the Assistant Secretary allowed an additional 30 days. Subsequent to the hearing, the following evidence was entered into the record:

1. Electronic mail message from Husband to Eugene J. Cella dated January 16, 2003, a copy of which is designated as Exhibit TP-1.
2. Letter from Eugene J. Cella to Husband dated January 16, 2003, a copy of which is designated as Exhibit TP-2.
3. Electronic mail message with related attachments from Husband to Eugene J. Cella dated February 18, 2003, a copy of which is designated as Exhibit TP-3.

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 North Carolina individual income tax returns for the tax years 1993 and 1994 on October 9, 1996. The returns reflected overpayments of \$164.32 and \$1,021.70, respectively. Refund checks for the overpayments were issued to Taxpayers on October 21, 1996 and November 14, 1996, for the tax years 1993 and 1994, respectively.
3. Taxpayers filed an amended 1993 return on September 3, 1997, to correct errors entering federal taxable income on the original return and to increase the credit for tax paid to another state on income also taxed by North Carolina. The amended return reflected an overpayment of \$583.00, which was not refunded.
4. Taxpayers filed an amended 1994 return on May 15, 1997, to correct errors entering federal taxable income on the original return; to reduce North Carolina income tax withheld for Alabama withholding erroneously claimed on the State return; and to claim a credit for income tax paid to another state on income also taxed by North Carolina. The amended return reflected an overpayment of \$305.00, which was not refunded.
5. Taxpayers timely filed their North Carolina individual income tax returns for the tax years 1995 and 1996. The return for the tax year 1995 reflected additional tax due of \$134.27; however, Taxpayers did not include payment with the return. Taxpayers

subsequently paid \$187.00 on July 2, 1997. Taxpayers' return for the tax year 1996 reflected an overpayment of \$1,642.00, which was not refunded.

6. Taxpayers filed an amended North Carolina individual income tax return for the tax year 1995 on April 7, 1997, to correct errors entering federal taxable income and computing additions to federal taxable income; to claim a credit for income tax paid to another state on income also taxed by North Carolina; and to claim the credit for a child. The amended 1995 return reflected an overpayment of \$1,403.00, which was not refunded.
7. At the auditor's request, Husband furnished receipts, canceled checks, and spreadsheets listing various personal and business related expenses. Upon examination of the returns and Taxpayer's records, the auditor adjusted the 1993, 1994, and 1996 returns to disallow all employee business expenses, other miscellaneous deductions, and to reduce the nonbusiness itemized deductions claimed for taxes paid, home mortgage interest, and charitable contributions. The 1996 return was also adjusted to disallow the credit of \$162.00 for investing in business property.
8. The auditor adjusted the 1995 return to increase the nonbusiness itemized deduction for taxes, to reduce the deduction for charitable contributions, and to disallow deductions for casualty losses and employee business expenses.
9. The auditor adjusted the returns for the tax years 1995 and 1996 to also disallow all business expenses deducted on federal Schedule C. Taxpayers did not report any income or expenses on federal Schedule C for the taxable years 1993 and 1994.
10. The miscellaneous deductions for employee business expenses claimed by Taxpayers for the tax years 1993 through 1996 are in connection with Husband's employment as a university professor. The business expenses claimed by Taxpayers on federal Schedule C for the tax years 1995 and 1996 are in connection with Husband's consulting business that he began in 1995. Taxpayers furnished voluminous amounts of receipts, canceled checks, and spreadsheets listing various personal and business related expenses; however, the information does not meet the tests to establish that the expenses were bona fide business expenses such as, time, place, description, business purpose, and business relationship. Taxpayers' information also did not distinguish which records related to Husband's employment and which were in connection with his consulting business.
11. The auditor adjusted the returns for the tax years 1993 and 1996 to disallow the credit for tax paid to another state because copies of Taxpayers' returns filed with Alabama showed that Taxpayers were refunded all tax withheld resulting in no net tax paid.
12. The auditor adjusted the return for the tax year 1995 to reduce the credit for tax paid to Alabama to correct Taxpayers' error in computing the allowable credit. In error, when computing the credit, Taxpayers did not adjust tax paid to Alabama for the amount of the tax refunded to them.

13. The auditor asserted the ten percent negligence penalty for the tax year 1993 and the twenty-five percent negligence penalty for the tax years 1994, 1995, and 1996. The auditor also asserted the twenty-five percent late filing penalty for the tax years 1993 and 1994.
14. Notices of Individual Income Tax Adjustment reflecting the auditor's adjustments for the tax years 1993 through 1996 were mailed to taxpayers on April 19, 1998.
15. Based on additional information subsequently furnished by Husband, the auditor adjusted the proposed assessments for the taxable years 1994 and 1996 to allow the deduction for home mortgage interest of \$7,602.00 and \$9,599.00, respectively.
16. Notices of Amended Individual Income Tax Assessment reflecting the adjustments for the tax years 1994 and 1996 were mailed to Taxpayers on March 28, 1999. In error, the auditor did not adjust the 1994 return to disallow the credit of \$2,114.64 incorrectly claimed as North Carolina income tax withheld from Husband's wages by Employer. The state tax withheld by Employer was paid to Alabama and is not allowable on the North Carolina return.
17. In an effort to resolve this matter prior to the hearing, Taxpayers proposed that the Department allow the following additional deductions relating to both the Husband's employment and to his consulting business:

<u>Year</u>	<u>Amount</u>
1993	\$10,314.38
1994	\$12,236.65
1995	\$15,500.11
1996	\$12,394.82

18. The Department allowed deductions for one half of the amounts proposed by Taxpayers. The return for the tax year 1994 was also adjusted to disallow the erroneous credit of \$2,114.64 for Alabama tax withheld claimed on the North Carolina return. The withholding adjustment increased the 1994 tax in excess of the amount previously assessed on March 28, 1999; however, the three-year statute limitations for assessments prevented the Department from assessing tax in excess of the total tax and penalty of \$2,378.68 reflected on the amended assessment of March 28, 1999. Notices of Amended Individual Income Tax Assessment for the tax years 1993 through 1996 were mailed to Taxpayers on August 1, 2000.
19. Taxpayers filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.

CONCLUSIONS OF LAW

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

1. Pursuant to sections 162 and 212 of the Internal Revenue Code, 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 expense was in fact paid or incurred in a trade or business carried on by the taxpayer; the expense was ordinary and necessary; and the taxpayer has proof of the expenditure.
2. A proposed assessment must be based on the best information available and, in the absence of information to the contrary, such assessment is presumed to be correct.
3. In cases where a taxpayer is away from his tax home, Internal Revenue Service Regulation 1.274-5 precludes a deduction for travel expenses, including meals and lodging, 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 documentary evidence which, in combination, are 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. Generally, a taxpayer’s tax home is his or her regular place of business or post of duty, regardless of where the family home is maintained. 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. Commuting expenses incurred for travel between a taxpayer’s personal residence and his or her tax home and personal living expenses are not deductible.
5. Pursuant to section 1938 of the Energy Policy Act of 1992 (Pub. L. No. 102486), enacted on October 24, 1992, which amended Section 162(a) of the Internal Revenue Code, if a taxpayer’s period of employment away from home in a single location lasts for more than one year, no deduction is allowed for travel expenses paid or incurred. (Revenue Ruling 93-86)

6. 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.
7. Except as provided in section 183 of the Code and Treasury Regulation 1.183.1, no deductions are allowable for expenses incurred in connection with activities that are not engaged in for profit. Section 183 of the Code provides rules relating to the allowance of deductions in the case of activities not engaged in for profit. If an activity shows a profit for any three or more years in a period of five consecutive years, it is presumed to be engaged in for profit, unless the Internal Revenue Service establishes to the contrary.
8. A tax credit is allowed to an individual who is a resident of North Carolina for income tax imposed by and paid to another state or country on income that is also taxed by North Carolina. In determining the amount of tax paid to another state when income tax withholding is involved, the amount withheld must be reduced by the amount of any refunds the taxpayer received.
9. A tax credit is allowed (G.S. 105-129.16) equal to 4.5 percent of the cost of certain business property placed in service in North Carolina. The burden of proving entitlement for the credit and the amount of the credit rests upon the taxpayer, and no credit may be allowed to a taxpayer that fails to maintain adequate records or to make them available for inspection.
10. A penalty is required for negligent failure to comply with the income tax laws. The penalty is ten percent of the deficiency due to the negligence unless the deficiency is large, in which case the penalty is twenty-five percent. A deficiency is large where the taxpayer understates gross income, overstates deductions, makes erroneous adjustments to federal taxable income, or does any combination of these and the combined errors equal or exceed twenty five percent of gross income.
11. A penalty is required of five percent of the tax for each month or part of a month (maximum twenty five percent) the return is late.

DECISION

The miscellaneous deductions for employee business expenses claimed by Taxpayers for the tax years 1993 through 1996 are in connection with Husband's employment as a university professor. The business expenses claimed by Taxpayers on

federal schedule C for the tax years 1995 and 1996 are in connection with Husband's consulting business that he began in 1995. These expenses were the primary issue at the hearing. The record shows that Husband furnished large amounts of receipts, canceled checks, and spreadsheets listing various expenses incurred during the tax years at issue. However, the information does not adequately meet the tests to establish that the expenses were bona fide business expenses such as time, place, description, business purpose, and business relationship. Some of the employee business expenses listed appear to be personal rather than business related or were items which employers customarily furnish to employees such as computer equipment, office supplies, etc. Husband's information does not adequately distinguish which records relate to his employment and which were in connection with his consulting business for the taxable years 1995 and 1996. Husband furnished information (Exhibit PT- 42) indicating that Employer reimbursed him for some of his employee business expenses; however it is unclear which expenses were reimbursed or in what amounts. According to Employer's faculty handbook (Exhibit PT-24), expenses for travel on official business or for professional development, which has been approved in advance, may be reimbursed. Employee business expenses for which Taxpayer was eligible for reimbursement but failed to make a proper claim for reimbursement with employer are not deductible (*Dixon v. Commissioner T.C. Memo, 1999-310*).

Husband contends that his employment with Employer "was temporary employment prior to a positive tenure decision" by Employer and that his "untenured appointment would qualify as temporary" for purposes of deducting employee business expenses relating to a temporary job assignment (see Exhibit TP-3). Notwithstanding

that Employer's policy for new faculty may not provide a "permanent" position until the faculty member is tenured, Husband's employment does not qualify as temporary for purposes of deducting away from home expenses pursuant to Code section 162 because his period of employment exceeded one year. In fact, as of the day of the hearing, Husband was still employed by Employer.

Husband argues that the losses claimed on the 1995 and 1996 returns are in connection with an activity engaged in for profit as described in Section 183 of the Code and consequently should be allowed. The Department did not disallow Husband's losses from his consulting business on the basis that he engaged in the endeavor without the requisite profit motive. Rather, the Department disallowed the expenses claimed by Taxpayers in determining the losses on the basis of inadequate substantiation and because Husband's expenditures relating to the business were difficult to distinguish from employee business expenses. Subsequent to the hearing, Husband submitted a list of various expenditures incurred in tax year 1993 (Exhibit TP-3). The list classified some of the expenditures as relating to employee business expenses (Federal Form 2106), some as relating to federal Schedule C, while others remained unclassified. The record shows that Taxpayers did not file federal Schedule C with their federal income tax returns for the taxable years 1993 or 1994 nor did Husband begin his consulting business until 1995 (see Exhibits PT-50 and PT-41); consequently there is no indication that Husband is entitled to deduct any of the expenses classified as Schedule C related on the 1993 list.

The record shows that although Taxpayers' records did not adequately substantiate all of the deductions at issue, the Department did allow Taxpayers to deduct a portion of the expenditures previously disallowed (see finding of fact number 18). The

Assistant Secretary finds that Taxpayers have not carried their burden of proof that they are entitled to deductions in excess of the amounts allowed by the Department for employee business expenses; other miscellaneous deductions; nonbusiness itemized deductions; Schedule C business expenses; tax credits for tax paid to other states; and tax credits for investing in business property.

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessments for the taxable years 1993 through 1996 to be 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 15th day of May, 2003.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue