

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessments of Additional)
Income Tax for the Taxable Years 1999,)
2000, and 2001 by the Secretary of Revenue)
of North Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 2003-555

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on February 24, 2004, upon an application for hearing by [Taxpayer], wherein she protested the proposed assessments of additional income tax for the taxable years 1999, 2000, and 2001. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by [Taxpayer's representative, hereinafter referred to as "Accountant;"] W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division; and Patrick G. Penny, Administrative Officer in the Personal Taxes Division.

Pursuant to G.S. 105-241.1, assessments proposing additional tax, penalties, and interest for the tax years 1999, 2000, and 2001 were mailed to Taxpayer on September 1, 2003. Taxpayer filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.

ISSUE

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

1. Is Taxpayer entitled to business expenses in excess of the amounts allowed by the Department?
2. Are the assessments for additional income tax proposed against Taxpayer for the taxable years 1999, 2000, and 2001 lawful and proper?

EVIDENCE

The evidence presented 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. Taxpayer's North Carolina individual income tax return for the taxable year 2000, a copy of which is designated as Exhibit PT-2.
3. Taxpayer's North Carolina individual income tax return for the taxable year 2001, a copy of which is designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 1999 dated September 1, 2003, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 2000 dated September 1, 2003, a copy of which is designated as Exhibit PT-5.
6. Notice of Individual Income Tax Assessment for the taxable year 2001 dated September 1, 2003, a copy of which is designated as Exhibit PT-6.
7. Taxpayer's "corrected" federal individual income tax return for the taxable year 1999, a copy of which is designated as Exhibit PT-7.
8. Taxpayer's "corrected" federal individual income tax return for the taxable year 2000, a copy of which is designated as Exhibit PT-8.
9. Taxpayer's "corrected" federal individual income tax return for the taxable year 2001, a copy of which is designated as Exhibit PT-9.
10. A facsimile message from Microsoft Corporation including several Forms NC-4, Employee's Withholding Allowance Certificate submitted by Taxpayer, copies of which are collectively designated as Exhibit PT-10.
11. Letter from Accountant to the Department of Revenue dated September 26, 2003, a copy of which is designated as Exhibit PT-11.
12. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Accountant dated October 28, 2003, a copy of which is designated as Exhibit PT-12.
13. Letter from Accountant to Patrick G. Penny dated November 25, 2003, a copy of which is designated as Exhibit PT-13.
14. Letter from Eugene J. Cella to Accountant dated December 15, 2003, a copy of which is designated as Exhibit PT-14.

Accountant presented the following evidence at the hearing:

1. [A Document], a copy of which is designated as Exhibit TP-Presentation.
2. Taxpayer's "corrected" North Carolina individual income tax return for the taxable year 1999, a copy of which is designated as Exhibit TP-1.
3. Taxpayer's "corrected" North Carolina individual income tax return for the taxable year 2000, a copy of which is designated as Exhibit TP-2.
4. Taxpayer's "corrected" North Carolina individual income tax return for the taxable year 2001, a copy of which is designated as Exhibit TP-3.
5. Document entitled 2000 Mileage Log, a copy of which is designated as TP-4.
6. Taxpayer's signed statement, a copy of which is designated as TP-5.
7. Signed statements from two of Taxpayer's clients, copies of which are collectively designated as Exhibit TP-6.

At the hearing, Accountant stated that he no longer contested the audit adjustments related to the Schedules A because the auditor had allowed the job-related education expenses on Schedules A.

FINDINGS OF FACT

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

1. Taxpayer at all material times was a natural person, sui juris, and a citizen and resident of North Carolina.
2. Taxpayer timely filed her 2001 North Carolina individual income tax return in April 2002. Taxpayer filed her 2000 North Carolina individual income tax return late in January 2002. Taxpayer submitted a 1999 North Carolina individual income tax return to the auditor in July 2003 during the audit of Taxpayer's 1999, 2000, and 2001 tax years.
3. Upon examination, Taxpayer submitted "corrected" federal returns for the taxable years 1999, 2000, and 2001 to the auditor. While the amounts reflected on Schedules A and C of the "corrected" federal returns differed from the amounts reflected on the originally filed federal returns, the auditor used the "corrected" federal returns as the basis of the audit.
4. Taxpayer's "corrected" federal returns reflected the following deductions and expenses on Schedules A and C:

Schedule A Itemized Deductions:

<u>Deduction Claimed</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Medical Expenses	\$ 0.00	\$ 0.00	\$ 699.00
Taxes	720.00	0.00	3,012.00
Gifts to Charity	11,000.00	11,000.00	11,150.00
Other Miscellaneous	6,175.00	5,000.00	6,000.00
Totals	<u>\$17,895.00</u>	<u>\$ 16,000.00</u>	<u>\$20,861.00</u>

Schedule C Business Expenses:

<u>Expense Claimed</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Car and Truck	\$ 3,282.00	\$ 8,567.00	\$ 8,731.00
Depreciation	1,280.00	2,948.00	2,669.00
Office Expense	0.00	365.00	365.00
Meals & Entertainment	1,530.00	510.00	0.00
Utilities	3,200.00	2,650.00	2,650.00
Other Expenses	3,174.00	0.00	0.00
Totals	<u>\$12,466.00</u>	<u>\$ 15,040.00</u>	<u>\$14,415.00</u>

5. Upon the auditor's request, Taxpayer provided documentation to substantiate the majority of the Schedule A deductions. For all three years, Taxpayer had incorrectly listed her job-related education expenses as other miscellaneous deductions not subject to the 2% AGI limitation. The auditor reclassified these expenses as job expenses and applied the 2% AGI limitation. For tax year 2001, the auditor disallowed \$2,776.00 of the amount claimed as state and local income taxes paid due to lack of substantiation. The auditor also disallowed the medical care expenses claimed for tax year 2001 since the hair removal treatments and facial treatments claimed by Taxpayer as medical care expenses do not qualify as "medical care" expenses for purposes of the deduction allowed under section 213 of the Internal Revenue Code ("Code").
6. Taxpayer was unable to provide documentation to substantiate most of the business expenses claimed on Schedules C. The auditor did allow some car and truck, travel, and meal expenses based on mileage logs and client letters provided by Taxpayer.
7. Based on the evidence submitted and the information available, the auditor allowed the following deductions and expenses on Schedules A and C:

Schedule A Itemized Deductions:

<u>Deduction Allowed</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Taxes	\$ 720.00	\$ 0.00	\$ 236.00
Gifts to Charity	11,000.00	11,000.00	11,150.00
Job Expenses / Misc.	5,475.00	3,755.00	4,516.00
Totals	<u>\$17,195.00</u>	<u>\$ 14,755.00</u>	<u>\$ 15,902.00</u>

Schedule C Business Expenses:

<u>Expense Allowed</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Car and Truck	\$ 379.61	\$ 364.00	\$ 383.64
Travel	136.00	0.00	0.00
Meals & Entertainment	<u>527.00</u>	<u>0.00</u>	<u>62.00</u>
Totals	<u>\$ 1,042.61</u>	<u>\$ 364.00</u>	<u>\$ 445.64</u>

8. For tax year 2001, the auditor adjusted taxable wages to include unreported wages of \$15,875.51 from [a company]. These wages were omitted from the "corrected" federal return in error.
9. Because the auditor's adjustments resulted in Schedule C net profits for each year, the auditor allowed deductions for one-half of the federal self-employment tax due for each year.
10. After making all appropriate adjustments, the auditor determined Taxpayer's North Carolina taxable income for tax years 1999, 2000, and 2001 to be \$16,041.00, \$45,513.00, and \$57,320.00, respectively.
11. During 2000 and 2001, Taxpayer submitted withholding allowance certificates to her employer which reflected either exempt status or 9 or 10 allowances. During 1999, Taxpayer earned taxable wages of \$19,760.00 from [a corporation], of which only \$191.00 was withheld for State income taxes.
12. A 50% penalty for underwithholding was asserted on each year. A 25% negligence penalty was also imposed on each year. In addition, for tax year 1999, late filing and late payment penalties have been imposed. For tax year 2000, a late filing penalty and a penalty for underpayment of estimated income tax have been imposed. For tax year 2001, a penalty for underpayment of estimated income tax has been imposed.
13. Notices of Individual Income Tax Assessment reflecting additional tax, penalties, and interest of \$936.71, \$6,883.30, and \$4,685.86 for the tax years 1999, 2000, and 2001, respectively, were mailed to Taxpayer on September 1, 2003. Taxpayer objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.
14. Taxpayer's submission of the 1999 return during the audit constitutes a filing of the return. Since the 1999 return submitted by Taxpayer does not reflect a balance of tax due, a late payment penalty cannot be imposed until after Taxpayer has been properly notified of the additional tax due. Therefore, the late payment penalty of \$27.43 imposed on tax year 1999 is premature. If Taxpayer does not pay the additional tax due for tax year 1999 within 30 days of the mailing of this decision, the late payment penalty will be reinstated. Based on the amounts reflected on the 1999 return submitted by Taxpayer, the 25% negligence penalty was properly imposed.
15. Accountant contends that all of Taxpayer's records for the years at issue were lost during Taxpayer's move to a new residence. Accountant argues that all the business expenses claimed on the "corrected" Schedules C should be allowed even though Taxpayer cannot provide evidence to support the expenses.

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, charitable contributions, and unreimbursed employee expenses. Taxpayer's 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. Pursuant to section 213 of the Code, a taxpayer is allowed to deduct the expenses paid during the year, not compensated for by insurance or otherwise, for medical care, to the extent that such expenses exceed 7.5 percent of adjusted gross income ("AGI"). The term "medical care" does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease. "Cosmetic surgery" means any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.
3. Miscellaneous itemized deductions (i.e. unreimbursed employee expenses) for any taxable year are allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.
4. Pursuant to section 162 of the Code, a taxpayer is allowed to deduct the ordinary and necessary expenses paid during the income year in carrying on a trade or business. 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, Treasury 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 substantiating all amounts claimed.
5. A penalty is required for failure to file a return when due. The penalty is equal to five percent of the tax for each month, or fraction of a month, the return is late (minimum \$5.00, maximum twenty-five percent). Late filing penalties of \$68.58 and \$764.75 were properly imposed on tax years 1999 and 2000, respectively.
6. A twenty-five percent negligence penalty is required 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. Penalties

of \$68.58, \$764.75, and \$493.50 were properly assessed for the tax years 1999, 2000, and 2001, respectively, because Taxpayer understated taxable income by 25 percent or more of gross income.

7. G.S. 105-163.5(f) provides that if an individual furnishes his or her employer with an exemption certificate that contains information which has no reasonable basis and that results in a lesser amount of tax being withheld than would have been withheld if the individual had furnished reasonable information, the individual is subject to a penalty of fifty percent (50%) of the amount not properly withheld. Because Taxpayer has not presented any evidence that would entitle her to exempt status or 9 or 10 allowances for the years at issue, the penalty provided under G.S. 105-163.5(f) has been properly imposed on each of the years.
8. A penalty is imposed for underpayment of estimated income tax if the taxpayer does not pay estimated income tax of at least ninety percent of the tax shown on the current year's return, or if no return is filed, ninety percent of the tax for that year or one hundred percent of the tax shown due on the previous year's return, whichever is less. The penalty is not due if the tax due on the return, reduced by the North Carolina tax withheld and allowable tax credits, is less than \$1,000.00. Penalties of \$52.79 and \$70.73 for underpayment of estimated income tax were properly assessed for the tax years 2000 and 2001.

DECISION

Accountant contends that all of Taxpayer's records for the years at issue were lost during Taxpayer's move to a new residence. Taxpayer was able to obtain sufficient documentation to substantiate the majority of the itemized deductions claimed on Schedules A. At the hearing, after realizing that the auditor had allowed the job-related education expenses as claimed, subject to the 2% AGI limitation, and that the medical expenses claimed would not exceed 7.5% of AGI, Accountant accepted the audit adjustments to the Schedules A. However, Accountant does not agree with the disallowance of most of the business expenses claimed on Schedules C. Accountant argues that all the business expenses claimed on the "corrected" Schedules C should be allowed even though Taxpayer cannot provide evidence to support the expenses. In support of his position, Accountant cites the *Cohan* rule, which permits deductible expenses that have not been adequately substantiated to be allowed based on a reasonable estimate. For Taxpayer's travel, entertainment, and meal expenses, for which the *Cohan* rule is not applicable, Accountant cites the provision which allows a taxpayer to substantiate claimed

deductions by a reasonable reconstruction of the expenditures in cases where a taxpayer has established that the records have been lost due to circumstances beyond the taxpayer's control, such as destruction by fire, flood, or other casualty. Legally, the Assistant Secretary concludes that misplacement or loss of records during a move as Taxpayer alleges does not constitute a casualty for which the provision cited by Accountant applies. Factually, in light of Taxpayer's other actions, such as submitting withholding allowance certificates falsely claiming exempt status and not filing a return until after the commencement of an audit, Taxpayer's credibility on this issue has been seriously impaired. The Assistant Secretary is unable to conclude that the records were indeed lost during the move as Taxpayer alleges.

Furthermore, under the *Cohan* rule and the other provision cited by Accountant, Taxpayer must still show that the expenses were incurred and otherwise deductible, and a basis on which to make a reasonable estimate must be present. For the majority of the expenses claimed on Schedules C, Taxpayer has not established that the expenses were incurred and otherwise deductible. The Accountant's statement that Taxpayer conducted a business and that carrying on a business always incurs expenses is not sufficient basis for the expenses claimed. Therefore, the Taxpayer has not carried her burden of proof to establish that she is entitled to the Schedule C business expenses that have been disallowed by the auditor.

Accountant also contests the imposition of the 50% underwithholding penalty imposed pursuant to G.S. 105-163.5(f) for the tax year 1999. Accountant argues that the Secretary cannot impose the penalty on tax year 1999 since the Department does not have a copy of a fraudulent withholding allowance certificate submitted by Taxpayer during 1999. The Department has presented several copies of withholding allowance certificates submitted by Taxpayer during 2000 and 2001. On each of these certificates, Taxpayer has claimed either exempt status or 9 or 10 allowances. There is no basis in law entitling Taxpayer to exempt status or 9 or 10 allowances. For tax year 2001, Taxpayer had taxable wages of \$64,583.00 of which only \$236.00 was withheld for North Carolina income tax. For tax year 2000, Taxpayer

had taxable wages of \$54,947.00 of which \$0.00 was withheld for North Carolina income tax. During 1999, Taxpayer had taxable wages of \$19,760.00 from [a corporation], of which only \$190.83 was withheld for North Carolina income tax. Based on the minimal amount of North Carolina income tax withheld from the wages earned from [a corporation] during 1999, it can only be concluded that Taxpayer filed similar withholding certificates with [a corporation]. Therefore, the Assistant Secretary finds that the Department had adequate basis to impose penalties pursuant to G.S. 105-163.5(f) on all three years at issue.

Based on the evidence and information presented, Taxpayer has failed to show that she is entitled to business expenses in excess of the amounts allowed by the auditor. Therefore, the proposed assessments for the tax years 1999, 2000, and 2001, modified to withdraw the late payment penalty of \$27.43 for tax year 1999, are hereby sustained in their entireties and are determined to be finally due and collectible.

Made and entered this 14th day of May, 2004.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue