

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Additional)
Income Tax for the Taxable Year 1999 by)
the Secretary of Revenue of North Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 2003-76

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on March 19, 2003, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessment of additional income tax for the taxable year 1999. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayer; 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, an assessment proposing additional tax and accrued interest totaling \$124.84 for the tax year 1999 was mailed to Taxpayer on October 15, 2002. Taxpayer filed a timely protest to the proposed assessment and requested a hearing before the Secretary of Revenue.

ISSUE

The issue to be decided in this matter is as follows:

Is the assessment for additional income tax proposed against Taxpayer for the taxable year 1999 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 1999, a copy of which is designated as Exhibit PT-2.
3. Taxpayer's amended North Carolina individual income tax return for the taxable year 1999, a copy of which is designated as PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 1999 dated October 15, 2002, a copy of which is designated as Exhibit PT-4.
5. Letter from Taxpayer to Don Scurry, Revenue Field Auditor, dated October 16, 2002, a copy of which is designated as Exhibit PT-5.
6. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Taxpayer dated October 29, 2002, a copy of which is designated as Exhibit PT-6.
7. Letter from Amy A. McLemore, Administrative Officer in the Sales and Use Tax Division, to Taxpayer dated October 29, 2002, a copy of which is designated as Exhibit PT-7.
8. Letter with several attachments from Taxpayer to Patrick G. Penny dated November 4, 2002, copies of which are collectively designated as Exhibit PT-8.
9. Letter from Patrick G. Penny to Taxpayer dated November 22, 2002, a copy of which is designated as Exhibit PT-9.
10. Letter from Amy A. McLemore to Taxpayer dated November 22, 2002, a copy of which is designated as Exhibit PT-10.
11. Letter from Taxpayer to Amy A. McLemore dated December 27, 2002, a copy of which is designated as Exhibit PT-11.
12. Letter from Eugene J. Cella to Taxpayer dated January 16, 2003, a copy of which is designated as Exhibit PT-12.

At the hearing, Taxpayer presented Treasury Regulations § 1.183-2, a copy of which is designated as Exhibit TP-1.

FINDINGS OF FACT

1. Taxpayer is and at all material times was a natural person, sui juris, and a citizen and resident of North Carolina.
2. Taxpayer timely filed his North Carolina individual income tax return for the tax year 1999. On August 4, 2002, Taxpayer filed an amended 1999 North Carolina individual income tax return to report a Schedule F farming loss of \$1,510.00. The refund requested on the amended return was refunded to Taxpayer on September 25, 2002.
3. Taxpayer filed the amended income tax return in response to a use tax examination initiated in July 2002 by the Department of Revenue regarding a piece of equipment Taxpayer purchased on May 6, 1999 at a preferential sales tax rate by signing a farmer's certificate. In October 2002, the Department disallowed the preferential sales

tax rate afforded Taxpayer based on the farmer's certificate because Taxpayer was unable to substantiate that he was a farmer at the time of the equipment purchase. Taxpayer paid the additional use tax and interest due.

4. Taxpayer resides on property owned by his mother-in-law. Approximately 24 acres of the property was planted with piedmont loblolly pines in 1994 through North Carolina's Forest Development Program (FDP). Taxpayer's mother-in-law contends that Taxpayer has managed the acreage in the FDP since 1998 and that he is expected to share in any profit from the harvest of the timber planted in 1994.
5. The Schedule F filed with the amended return listed "forestry" as the principal product. Taxpayer later clarified that the principal product was the timber planted in 1994 through the FDP. The Schedule F listed no income and the only expense shown was depreciation on the piece of equipment purchased under the farmer's certificate.
6. Upon examination, the Department of Revenue determined that Taxpayer was not engaged in a farming activity for profit during tax year 1999 and disallowed the Schedule F loss. Taxpayer has not provided any documentation, such as a contract or written agreement, to show that he has legal rights to any income or profits that the timber in the FDP may produce. Taxpayer also receives no compensation for his "farm management" duties.
7. A Notice of Individual Income Tax Assessment proposing an assessment of additional income tax and accrued interest totaling \$124.84 was mailed to Taxpayer on October 15, 2002. Taxpayer objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.
8. Taxpayer contends that he was engaged in a farming activity for profit during 1999 and, therefore, should be allowed to claim the Schedule F farming loss.
9. For residents of this State, North Carolina taxable income is defined as the taxpayer's taxable income as determined under the Internal Revenue Code ("Code"), adjusted as provided in G.S. 105-134.6 and G.S. 105-134.7. Therefore, it is necessary to look to federal regulations to determine whether this activity is not engaged in for profit under Code Section 183.

CONCLUSIONS OF LAW

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

1. An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. The term "farmer" includes both the owner and the tenant where shares of a farm are rented out and also a farm manager if his compensation is based in whole or in part on production. For an individual to be classified as a farmer, he must meet the two-fold test of participation to a significant degree in the growing process and assumption of a substantial risk of loss from that process.

2. While farming includes the operation of a nursery, an individual engaged in forestry or the growing of timber is not thereby engaged in the business of farming.
3. An individual may deduct all of the ordinary and necessary expenses incurred in carrying on a trade or business.
4. An individual may not deduct losses arising from activities not entered into for profit.
5. The determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all the facts and circumstances of each case. Greater weight is given to objective facts than to an individual's mere statement of his intent.
6. Section 183 of the Internal Revenue Code prescribes the deductions allowable for activities not engaged in for profit. In the case of an activity not engaged in for profit, the only deductions allowed are (1) deductions that would be allowable without regard to whether or not such activity is engaged in for profit, and (2) deductions that would be allowable if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable under (1).
7. Based on the fact that Taxpayer did not own or lease the property on which the trees were being grown; that Taxpayer had no contract or written agreement with the owner; and that Taxpayer received no income or compensation, the activity for which the piece of equipment was purchased and used is not an activity engaged in for profit by Taxpayer.
8. For the tax year 1999, Taxpayer's allowable deduction for depreciation on the piece of equipment purchased on May 6, 1999 is zero since Taxpayer did not have any gross income from the activity during that year.
9. The proposed assessment for the tax year 1999 is lawful and proper.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessment for the tax year 1999 to be lawful and proper in every respect.

Taxpayer contends that he was engaged in a farming activity for profit during tax year 1999 and that he purchased a [tractor] in May 1999 for use in the farming activity. Taxpayer further contends that he should be allowed to claim a deduction for depreciation on the tractor and the resulting loss even though he has not recognized any income from the alleged farming activity. 26 CFR § 1.175-3 denotes that an individual engaged in forestry or the growing of

timber is not thereby engaged in the business of farming. Pursuant to 26 CFR § 1.183-2, the determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all the facts and circumstances of each case. Greater weight is given to objective facts than to an individual's mere statement of intent. Taxpayer does not own or lease the property on which the timber in the FDP is being grown. Taxpayer has not presented any documentation, such as a contract or written agreement, which grants him any legal rights to or a vested interest in any of the income or profits that the timber may produce. Furthermore, Taxpayer has realized no income from the activity and receives no compensation for his so-called farm management duties.

The Assistant Secretary finds that Taxpayer was not engaged in the business of farming during 1999. After considering the relevant facts and circumstances, the Assistant Secretary further finds that the activity for which Taxpayer utilized the tractor purchased on May 6, 1999, is not an activity Taxpayer engaged in for profit. As such, the allowable deduction for depreciation expense is limited to the gross income realized from the activity. Since Taxpayer did not realize any income from the activity during 1999, the allowable depreciation expense for tax year 1999 is zero. Therefore, the proposed assessment for the tax year 1999 is hereby sustained in its entirety and is determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this 14th day of May, 2003.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue