

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessments of Individual)
Income Tax for the Taxable Years 2000,)
2001, and 2002 by the Secretary of Revenue)
of North Carolina)
vs.)
Taxpayers)

FINAL DECISION
Docket No. 2004-276

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, on August 12, 2004, upon an application for a hearing by Taxpayers, hereinafter referred to collectively as "Taxpayers," and separately as "Husband" and "Wife," wherein they protested the proposed assessments of individual income tax, penalties, and interest for the taxable years 2000, 2001, and 2002. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Husband; Nancy R. Pomeranz, Director of the Personal Taxes Division; and Gail H. Beamon, Administrative Officer in the Personal Taxes Division.

Pursuant to G.S. 105-241.1, assessment notices reflecting additional tax, penalties, and interest totaling \$6,804.14 for the tax years 2000, 2001, and 2002 were mailed to taxpayers on April 13, 2004. The proposed assessments resulted from the disallowance of itemized deductions, rental expenses, and child care expenses claimed by taxpayers. Taxpayers filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue. Subsequent to receipt of Taxpayers' request for hearing, corrected notices for tax years 2000, 2001, and 2002 were mailed to Taxpayers along with a letter of explanation on August 6, 2004.

ISSUES

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

1. Are Taxpayers entitled to deductions and credits in excess of the amounts allowed by the Department?

2. Are the assessments for additional tax, penalties, and interest proposed against Taxpayers for the taxable years 2000, 2001, and 2002 lawful and proper?

EVIDENCE

The evidence presented by Nancy R. Pomeranz, 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 2000, a copy of which is designated as Exhibit PT-2.
3. Taxpayers' North Carolina individual income tax return for the taxable year 2001, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina individual income tax return for the taxable year 2002, a copy of which is designated as Exhibit PT-4.
5. Taxpayers' federal individual income tax return for the taxable year 2000, a copy of which is designated as Exhibit PT-5.
6. Taxpayers' federal individual income tax return for the taxable year 2001, a copy of which is designated as Exhibit PT-6.
7. Taxpayers' federal individual income tax return for the taxable year 2002, a copy of which is designated as Exhibit PT-7.
8. Field Auditor's reports of individual income tax for the taxable years 2000, 2001, and 2002, copies of which are collectively designated as Exhibit PT-8.
9. Notice of Individual Income Tax Assessment for the taxable year 2000 dated April 13, 2004, a copy of which is designated as Exhibit PT-9.
10. Notice of Individual Income Tax Assessment for the taxable year 2001 dated April 13, 2004, a copy of which is designated as Exhibit PT-10.
11. Notice of Individual Income Tax Assessment for the taxable year 2002 dated April 13, 2004, a copy of which is designated as Exhibit PT-11.
12. Notice of Individual Income Tax Assessment for the taxable year 2000 dated July 29, 2004, a copy of which is designated as Exhibit PT-12.

13. Notice of Individual Income Tax Assessment for the taxable year 2001 dated July 29, 2004, a copy of which is designated as Exhibit PT-13.
14. Notice of Individual Income Tax Assessment for the taxable year 2002 dated August 6, 2004, a copy of which is designated as Exhibit PT-14.
15. Schedule of Corrected Taxable Income for the taxable years 2000, 2001, and 2002, a copy of which is designated as Exhibit PT-15.
16. Letter from Melissa S. Dann, Revenue Field Auditor, to Taxpayers dated August 25, 2003, a copy of which is designated as Exhibit PT-16.
17. Letter from Melissa S. Dann to Taxpayers dated October 16, 2003, with attachment from federal publication 526, a copy of which is designated as Exhibit PT-17.
18. Letter from Husband to Melissa S. Dann dated October 21, 2003, with attached Certificate of Release or Discharge from Active Duty, a copy of which is designated as Exhibit PT-18.
19. Letter from Husband to Melissa S. Dann dated November 21, 2003, with attached birth certificate of child, a copy of which is designated as Exhibit PT-19.
20. Letter from Taxpayers to the Department of Revenue, dated April 19, 2004, a copy of which is designated as Exhibit PT-20.
21. Letter from Angela C. Quinn, former Administrative Officer in the Personal Taxes Division, to Taxpayers dated May 25, 2004, a copy of which is designated as Exhibit PT-21.
22. Letter from Husband to Angela C. Quinn dated May 26, 2004, a copy of which is designated as Exhibit PT-22.
23. Letter from Eugene J. Cella to Taxpayers dated June 7, 2004, a copy of which is designated as Exhibit PT-23.
24. Letter from Gail H. Beamon, Administrative Officer in the Personal Taxes Division, to Taxpayers dated August 6, 2004, a copy of which is designated as Exhibit PT-24.
25. Questionable contribution receipts with letterhead bearing the name of a Church for the taxable years 2000 and 2001, a copy of which is designated as Exhibit PT-25.
26. Written testimony of Senior Pastor, of a church dated May 21, 2004, a copy of which is designated as Exhibit PT-26.
27. Written testimony of Church Clerk, of a church, dated May 21, 2004, a copy of which is designated as Exhibit PT-27.

28. Written testimony of Financial Recording Secretary, of a church, dated May 21, 2004, a copy of which is designated as Exhibit PT-28.
29. Letters from the Office Administrator, and Owner and Director, of Child Care Facility located in a North Carolina County, dated June 15 and July 28, 2004, respectively, copies of which are collectively designated as Exhibit PT-29.
30. Letter from the Director, of a business located in a Georgia County, to Gail H. Beamon, dated July 27, 2004, a copy of which is designated as Exhibit PT-30.
31. Letter from the Assistant Property Manager, of Apartment Complex, located in North Carolina, dated July 30, 2004, a copy of which is designated as Exhibit PT-31.

At the hearing, Husband presented the following evidence:

1. Written statement by Husband regarding military income, contributions, and child and dependent care expenses, a copy of which is designated as Exhibit TP-1.
2. Contributions Statement for the tax year 2000 bearing the name of a church, a copy of which is designated as Exhibit TP-2.
3. Contributions Statement for the tax year 2001 bearing the name of a church, a copy of which is designated as Exhibit TP-3.
4. Contributions Statement issued to Husband for the tax year 2001 from the church, a copy of which is designated as Exhibit TP-4.
5. Contributions Statement issued to Wife for the tax year 2001 from the church, a copy of which is designated as Exhibit TP-5.
6. Contributions Statement issued to Taxpayers for the tax year 2002 from the church, a copy of which is designated as Exhibit TP-6.
7. Contributions Statement for the tax year 2002 bearing the name of a church, a copy of which is designated as Exhibit TP-7.
8. Child Care Statement bearing the name of a Child Care Facility, in a North Carolina County, for the tax year 2001, a copy of which is designated as Exhibit TP-8.
9. Letter from Child Care Facility to the Department of Revenue dated August 11, 2004, a copy of which is designated as Exhibit TP-9.
10. Envelope addressed to Melissa Dann, a copy of which is designated as Exhibit TP-10.
11. Letter from the Child Care Facility dated June 15, 2004, a copy of which is designated as Exhibit TP-11.

At the conclusion of the hearing, the Assistant Secretary allowed Taxpayers thirty days to submit additional documentation to support the deductions and credits claimed for the years at issue. No further documentation was provided by Taxpayers.

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 2000, 2001, and 2002 reflecting overpayments of \$905.00, \$592.00, and \$1,150.00, respectively. The overpayments for the tax years 2000 and 2002 were refunded to Taxpayers. Subsequent to issuing the refund for the tax year 2000, the Department determined that an error was made in claiming the tax credit for charitable contributions because Taxpayers claimed itemized deductions on the 2000 return and the credit is available only to nonitemizers. For the tax year 2001, \$449.12 of the overpayment reflected on the return was applied to the 2000 tax liability and the remaining \$142.88 was refunded to Taxpayers.

3. Taxpayers claimed itemized deductions on their federal income tax returns as follows:

	<u>2000</u>	<u>2001</u>	<u>2002</u>
Taxes	\$ 4,849.00	\$ 4,731.00	\$ 9,000.00
Interest	11,723.00	13,261.00	19,773.00
Contributions	28,500.00	12,500.00	12,000.00
Employee business expenses	<u>27,664.00</u>	<u>12,759.00</u>	<u>13,549.00</u>
TOTAL	<u>\$ 72,736.00</u>	<u>\$ 43,251.00</u>	<u>\$ 54,322.00</u>

4. Taxpayers claimed a rental loss of \$22,023.00 on their federal Schedule E for the taxable year 2002.

5. Taxpayers claimed child care expenses on their federal income tax returns as follows:

	<u>2000</u>	<u>2001</u>	<u>2002</u>
Child Care Facility	\$ 4,800.00		
Child Care Facility		\$ 2,952.00	\$ 1,200.00
Child Care Facility		<u>1,544.00</u>	<u>2,500.00</u>
TOTAL	<u>\$ 4,800.00</u>	<u>\$ 4,496.00</u>	<u>\$ 3,700.00</u>

6. Taxpayers furnished receipts, bank statements, and other documents to the auditor reflecting both deductible and nondeductible expenditures during the tax years at issue.

7. For the tax year 2000, Taxpayers furnished wage and tax statements showing state tax withheld of \$3,194.00, which was allowed. Taxpayers deducted State and local taxes of \$3,451.00.
8. For the tax year 2000, Taxpayers furnished a mortgage company statement showing property taxes of \$1,149.00. Taxpayers deducted real estate taxes of \$1,148.00. There was no supporting documentation provided for the personal property taxes of \$250.00 claimed on the 2000 return.
9. For the tax year 2000, Taxpayers furnished a mortgage company statement showing home mortgage interest of \$10,473.00. Although the home mortgage interest of \$10,473.00 was substantiated as claimed, the personal seller home interest of \$1,250.00 was disallowed due to a lack of supporting documentation from Taxpayers.
10. The auditor reduced the deduction for charitable contributions for the tax year 2000 from \$28,500.00 to \$250.00. While Taxpayers furnished a statement for the tax year 2000 from a charitable organization that shows donations of \$950.00 for clothing, \$5,000.00 for furniture, and \$1,000.00 for miscellaneous items, the auditor allowed only \$250.00 because Taxpayers did not furnish information to show a reasonable detailed description of the property contributed or other required information.
11. The 2000 net miscellaneous deduction of \$27,664.00, including \$17,625.00 employee business expenses and \$12,500.00 educational expenses (\$30,124.00 gross miscellaneous before the 2% adjustment) was disallowed because Taxpayers furnished no documentation to support the deductions.
12. The auditor disallowed the credit for child and dependent care expenses for the tax year 2000 because Taxpayers offered no supporting documentation for the expenses. Subsequent to the audit, a tax credit of \$26.00 was allowed for child and dependent care expenses for tax year 2000 based on information obtained by the Department from Child Care Facility.
13. The Department allowed the *Bailey* retirement deduction of \$13,828.00 claimed by Taxpayers for the tax year 2000 and a \$2,000.00 private retirement deduction based on the husband's distribution of \$2,952.00 from a Financial Services.
14. Although Taxpayers substantiated the state and local taxes of \$4,303.00 claimed on federal Schedule A for the tax year 2001, the auditor disallowed the real estate taxes and personal property taxes claimed since there was no supporting documentation furnished for these items.
15. The auditor allowed home mortgage interest of \$13,261.00 based on mortgage company statements furnished by Taxpayers for the tax year 2001.
16. Contributions of \$12,500.00 claimed for the tax year 2001 were reduced to \$4,790.00 based on the documentation furnished.

17. The tax year 2001 net miscellaneous deduction of \$12,759.00, including \$7,030.00 of Wife's Employee Business Expenses, \$2,350.00 of Husband's Employee Business Expenses, and \$5,500.00 educational expenses (\$14,880.00 gross miscellaneous before 2% adjustment) was disallowed since no supporting documentation was furnished for these items.
18. The auditor allowed a *Bailey* retirement deduction of \$14,379.00 for the tax year 2001 based on supporting documentation from Husband showing his dates of service in the United States Government. Taxpayers did not claim this deduction on their 2001 income tax return.
19. The auditor disallowed the credit for child and dependent care expenses for the tax year 2001 because Taxpayers did not furnish supporting documentation. Subsequent to the audit, a tax credit of \$274.00 was allowed for child and dependent care expenses based on information obtained by the Department from the Child Care Facility.
20. Husband's military retirement income has not been taxed by North Carolina for any of the years at issue.
21. For the tax year 2002, the auditor corrected federal Schedule E from a net loss of \$22,023.00 to a net gain of \$5,405.00 based on documentation furnished. The auditor confirmed that Taxpayers reported the correct gross rental income of \$14,400.00 in the tax year 2002 based on the rents shown on form 1099-misc issued by a Realty Business. The federal Schedule E mortgage expense of \$7,555.00 was allowed as claimed based on the mortgage interest statement provided by Taxpayers. The management fees of \$1,440.00 were allowed as claimed by the auditor because that amount is within the industry standard of ten percent of the rental property income. All other federal Schedule E expenses were disallowed because there was no supporting evidence furnished.
22. The auditor allowed the deduction of \$4,914.00 for State and local taxes for the tax year 2002 as supported by the wage and tax statements. The auditor disallowed the real estate taxes and personal property taxes claimed on the 2002 federal Schedule A based on a lack of supporting documentation. Subsequent to the audit, an additional \$110.00 deduction was allowed for property taxes paid based on the statement furnished by Taxpayers from the County Tax Collector.
23. The auditor reduced the tax year 2002 charitable contributions from \$12,000.00 to \$2,040.00 based on the documentation furnished, including a deduction of \$200 for contributions to a charitable organization. While Taxpayers furnished a receipt that shows a clothing donation of \$1,000.00 and a donation of \$2,500.00 for miscellaneous items for the tax year 2002, Taxpayers did not furnish the information required to support such contributions.
24. The 2002 net miscellaneous deduction of \$13,549.00, including \$4,500.00 of Wife's Employee Business Expenses, \$4,800.00 of Husband's Employee Business Expenses, and \$6,570.00 other Employee Business Expenses (\$15,870.00 gross miscellaneous before the 2% adjustment) were disallowed due to lack of supporting documentation.

25. The auditor allowed a *Bailey* retirement deduction of \$14,724.00 for the tax year 2002 based on documentation furnished by Husband from the United States Air Force (Form DD 214). Taxpayers did not claim this deduction on their North Carolina income tax return.
26. The auditor also disallowed the credit for child and dependent care expenses for the tax year 2002 because Taxpayers furnished no documentation for the expenses.
27. Notices of Individual Income Tax Assessment reflecting the adjustments for the tax years 2000, 2001, and 2002 were mailed to Taxpayers on April 13, 2004.
28. The fifty percent fraud penalty was asserted for tax years 2000 and 2001 because the contributions statements provided to the tax auditor by Taxpayers purportedly from the Church does not agree with church records. Church records indicate that Taxpayers did not begin attending until 2002. The Pastor confirms that he signed blank statements provided to him with the understanding that Taxpayers would have the church secretary enter the correct contribution amounts on those signed statements. He did not notice that those statements reflected tax years 2000 and 2001. The church secretary has confirmed with the Department that she did not enter any names or amounts on those statements.
29. The auditor assessed the twenty-five percent negligence penalty for the tax year 2002 because Taxpayers understated taxable income by an amount equal to twenty-five percent or more of gross income. Taxpayers did not understate taxable income by at least twenty-five percent for tax years 2000 and 2001.
30. Taxpayers filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.
31. Subsequent to Taxpayers' request for hearing, the Department discovered that the audit reports for the tax years 2000, 2001, and 2002 contained several errors. These corrections are addressed in the letter of August 6, 2004, labeled Exhibit PT-24.
32. Also, subsequent to the request for hearing, the Department obtained information that indicates the child care expenses of \$1,200.00 listed on Taxpayers' federal form 2441 for the tax year 2002 as paid to Child Care Facility are questionable. While the name of the care provider is shown as Child Care Facility, the address associated with this provider on federal form 2441 for that year is that of a business. Neither the Child Care Facility nor the business has a record of providing child care for either of the dependent children for the tax year 2002. Therefore, the Department replaced the twenty-five percent negligence penalty previously assessed for the tax year 2002 with the fifty percent fraud penalty for that year.
33. Corrected Notices of Individual Income Tax Assessment dated July 29, 2004, for the tax years 2000 and 2001, and August 6, 2004, for the tax year 2002 were mailed to Taxpayers on August 6, 2004. While the corrections resulted in a reduction of income tax for the tax years 2000 and 2001, the tax was increased for the tax year 2002 from the amount previously shown on the Notices of Individual Income Tax Assessment mailed to Taxpayers on April 13, 2004.

34. At the hearing, Husband stated that since Taxpayers had children and both spouses worked, someone had to have cared for their children. However, Taxpayers furnished no evidence that child care expenses were paid in excess of the amounts previously allowed.

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 taxes, interest paid, charitable contributions, and miscellaneous deductions. 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, a taxpayer is required to keep a cancelled check, a receipt, or other reliable written records from the charitable organization. For contributions of \$250.00 or more, a taxpayer must have an acknowledgment of the contribution from the qualified organization. For noncash contributions, a taxpayer 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 noncash contributions of \$250.00 or more, the records must 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. Fair market value is the price which property will bring when offered for sale by a willing seller to a willing buyer, neither being obligated to buy or sell.
3. Pursuant to sections 162 and 212 of the Internal Revenue Code, a taxpayer is allowed to deduct 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, 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. Educational expenses are deductible only if the expenses are required by the taxpayer's employer or the law to keep the taxpayer's present salary, status, or job; or the education maintains or improves skills needed in the taxpayer's present work. Even if the education meets one of these requirements, it is not deductible if it is needed to meet the minimum educational requirements of the taxpayer's present trade or business; or, it is part of a program of study that can qualify the taxpayer for a new trade or business. Qualifying expenses must also be substantiated by adequate records such as cancelled checks, tuition bills, travel records, statements from employer, etc.
5. An addition to federal taxable income is required on the North Carolina return for the amount of state income tax deducted on the federal return since North Carolina does not allow a deduction for state income tax. Federal law requires certain itemized deductions to be phased out or limited when federal adjusted gross income exceeds \$137,300 for married taxpayers filing jointly in the taxable year 2002. When taxpayers do not receive the benefit of the entire State tax deduction because of the limitation on their itemized deductions, they are not required to add the entire State tax deduction on the North Carolina return.
6. Pursuant to G.S. 105-151.11, an individual who is allowed a credit for child and dependent care expenses on the federal income tax return under section 21 of the Internal Revenue Code shall be allowed a credit on the North Carolina income tax return. The North Carolina credit for child and dependent care expenses for taxpayers filing as married filing jointly with adjusted gross income over \$40,000 for a dependent child under the age of seven is computed at the rate of ten percent of the qualified child care expenses. A nonresident or part-year resident is allowed the tax credit in the proportion that federal taxable income (as adjusted) is taxable to North Carolina.
7. Pursuant to G.S. 105-134.6(b)(5b), an individual may deduct the amount received during the taxable year from one or more State, local or federal government retirement plans to the extent the amount is exempt from tax pursuant to a court order in settlement of *Bailey/Emory/Patton v. State*.
8. Pursuant to G.S. 105-134.6(b)(6)c, an individual may deduct the amount received from one or more retirement plans other than state, local, or federal government retirement plans, not to exceed \$2,000.00 during a taxable year.
9. A ten percent penalty is required pursuant to G.S. 105-236(5)a 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.
10. Pursuant to G.S. 105-236(6), 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.

11. The corrected proposed assessments dated July 29, 2004, for the taxable years 2000 and 2001, and August 6, 2004, for the tax year 2002 are lawful and proper, modified to withdraw the fifty percent fraud penalty for the tax years at issue. The ten percent negligence penalty is hereby asserted for the tax years 2000 and 2001, and the twenty-five percent negligence penalty is asserted for the tax year 2002.

DECISION

Husband contends that he was improperly taxed by the State of North Carolina on his federal military pension. The Assistant Secretary finds that Taxpayers were properly allowed a deduction for the pension included in their federal taxable income on their State income tax returns for the years at issue and, therefore, have not been unfairly taxed on that income.

Husband contends that church personnel were deliberately misleading the Department regarding Taxpayers' contributions because Husband had an adverse relationship with the church staff.

Husband also stated at the hearing that someone must have provided care for Taxpayers' child while Taxpayers worked and he posed the question that if the child care center did not provide care for their child, then who did?

Deductions are privileges, not matters of right, and are allowed as a matter of legislative grace. A taxpayer claiming a deduction must bring himself within the statutory provisions authorizing the deduction, *Ward v. Clayton* N.C. App. 53, 167 S.E. 2d 808 (1969), aff'd, 276 N.C. 411, 172 S.E.2d 531 (1970). The burden is on a taxpayer to show that he or she comes within an exemption or an exception. *Sabine v. Gill*, 229 N.C. 599, 51 S.E. 2d 1 (1948). The Assistant Secretary finds that Taxpayers have not met their burden of proof of entitlement to deductions for itemized deductions, rental expenses, or child care expenses in excess of amounts previously allowed by the Department. Subsequent to hearing Taxpayers furnished no additional

information, such as cancelled checks, to substantiate entitlement to any additional deduction for contributions, other deductions at issue, or tax credits.

The Department alleges that Taxpayers completed blank contribution statements signed by the pastor for tax years 2000 and 2001 and also claimed child care expenses paid to a day care facility during a period when the facility has no record of caring for Taxpayers' child. The Department contends that such behavior was an attempt to deceive the Department and, therefore, fraudulent. The fifty percent fraud penalty was asserted for the tax years 2000, 2001, and 2002. However, Husband's written statement, Exhibit TP-1, offered at the hearing states that Taxpayers began attending one church in late 2000 and began attending another church in 2001. Husband further stated that Taxpayers subsequently left the second church and again attended the initial church. The Assistant Secretary finds that based on this sequence of events, the church staff may have overlooked the initial attendance by Taxpayers in 2000. The Assistant Secretary further finds that the incorrect listing of the child care center shown on Taxpayers' federal child care expense form may have been a simple mistake, with no deliberate attempt to deceive the Department. Therefore, the Assistant Secretary does not find the fifty percent fraud penalty to be proper in this case but rather sustains the ten percent negligence penalty for the taxable years 2000 and 2001, and the twenty-five percent negligence penalty for the taxable year 2002.

Based on the foregoing findings of fact and conclusions of law, the proposed assessments modified to replace the fraud penalty with the negligence penalty, are found to be lawful and

proper in every respect; are hereby sustained in their entireties; and are declared to be final and immediately due and collectible, together with interest as allowed by law.

Made and entered this 8th day of December, 2004.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue