

**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 2003 by )  
the Secretary of Revenue of North Carolina )  
vs. )  
[Taxpayer 1] and [Taxpayer 2] )

**FINAL DECISION**  
Docket No. 2006-314

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on May 1, 2007, upon an application for hearing by [Taxpayer 1 & Taxpayer 2], hereinafter referred to as “Taxpayers,” wherein they objected to the proposed assessment of additional income tax for the taxable year 2003. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayers’ accountant, hereinafter referred to as “CPA;” CPA’s attorney, (with Taxpayers’ permission) hereinafter referred to as “Attorney;” Nancy R. Pomeranz, Director of the Personal Taxes Division; and Gail H. Beamon, Administrative Officer in the Personal Taxes Division. S corporation is hereinafter referred to as “Company.”

Pursuant to G.S.105-241.1, an assessment proposing additional tax, penalty, and interest for the tax year 2003 was mailed to Taxpayers on October 17, 2006. Taxpayers timely objected to the proposed assessment and requested an administrative tax hearing.

**ISSUE**

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

1. Are Taxpayers entitled to a net economic loss deduction on their 2003 individual income tax return?
2. Is the assessment for additional income tax proposed against Taxpayers for the taxable year 2003 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. Notice of Individual Income Tax Assessment for taxable year 2003 dated August 22, 2006, a copy of which is designated as Exhibit PT-2
3. Notice of Individual Income Tax Assessment for taxable year 2003 dated October 17, 2006, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina Individual Income Tax Return for taxable year 1999, a copy of which is designated as Exhibit PT-4.
5. Taxpayers' North Carolina Individual Income Tax Return for taxable year 2001, a copy of which is designated as Exhibit PT-5.
6. Taxpayers' North Carolina Individual Income Tax Return for taxable year 2002, a copy of which is designated as Exhibit PT-6.
7. Taxpayers' North Carolina Individual Income Tax Return for taxable year 2003, a copy of which is designated as Exhibit PT-7.
8. Taxpayers' federal Individual Income Tax Return for taxable year 2001, a copy of which is designated as Exhibit PT-8.
9. Taxpayers' Federal Form 1045, Application for Tentative Refund, a copy of which is designated as Exhibit PT-9.
10. Company's North Carolina S corporation tax return for taxable year 2001, a copy of which is designated as Exhibit PT-10.
11. Company's North Carolina S corporation tax return for taxable year 2003, a copy of which is designated as Exhibit PT-11.
12. Undated letter with attachments from CPA to the Department of Revenue, a copy of which is designated as Exhibit PT-12.

13. Letter from CPA to Gail H. Beamon, Administrative Officer in the Personal Taxes Division, dated October 9, 2006, a copy of which is designated as Exhibit PT-13.
14. Letter from Gail H. Beamon to CPA dated October 17, 2006, a copy of which is designated as Exhibit PT-14.
15. Letter from CPA to Gail H. Beamon, a copy of which is designated as Exhibit PT-15.
16. Letter with attachments from CPA to Gail H. Beamon, a copy of which is designated as Exhibit PT-16.
17. Letter from Eugene J. Cella to CPA dated November 13, 2006, a copy of which is designated as Exhibit PT-17.
18. Facsimile letter from CPA to Eugene J. Cella dated November 17, 2006, a copy of which is designated as Exhibit PT-18.
19. Letter from Eugene J. Cella to CPA dated November 13, 2006, a copy of which is designated as Exhibit PT-19.

At the hearing, Attorney presented Pages 28 and 29 of the Individual Income Tax Bulletins for taxable years 2003 and 2004, copies of which are designated as Exhibit TP-1.

### **FINDINGS OF FACT**

1. Taxpayers were resident shareholders in Company, an S corporation, during tax years 2001, 2002, and 2003.
2. Company incurred a loss of \$329,344 in tax year 2001 and issued a NC K-1 to Taxpayers reflecting \$241,540 as their share of Company's loss and a tax credit of \$1,534.00 as their share of Company's 2001 tax credit for investing in business property.
3. Taxpayers incurred a net operating loss of \$91,329.00 in 2001 and amended their 1999 federal income tax return and thereby corrected their 1999 federal taxable income to take into account their 2001 net operating loss. For federal purposes, the entire net operating loss carried back to 1999 was absorbed in that year.
4. Taxpayers did not amend their 1999 State income tax return to carry back the 2001 net operating loss. Rather, Taxpayers claimed deductions for net economic loss carryforwards of \$89,495.00 and \$77,557.00 on their 2002 and 2003 State income tax returns, respectively.

5. Upon examination, the auditor determined that the net economic loss deduction claimed by Taxpayers for tax year 2002 was in error. However, because the statute of limitations for making an assessment had expired, no assessment was proposed for that year.
6. Because the statute of limitations for making a refund for the tax year 1999 has expired, no relief is available to Taxpayers for the net operating loss that should have been carried back to that tax year.
7. Taxpayers' 2003 return included an addition and a deduction from federal taxable income of \$29,270.00 for section 179 adjustments.
8. The examining auditor adjusted Taxpayers' 2003 return to disallow deductions totaling \$106,827.00, which included the net economic loss deduction of \$77,557.00 and the section 179 deduction of \$29,270.00.
9. A Notice of Individual Income Tax Assessment proposing additional tax, penalty, and interest for taxable year 2003 was mailed to Taxpayers on August 22, 2006.
10. Taxpayers objected to the proposed assessment and timely requested an administrative tax hearing.
11. Subsequent to the proposed assessment, the Department determined Taxpayers' portion of the tax credit installment for the tax year 2003 was \$1,534.00 as shown on the NC K-1 rather than \$1,834.00 as claimed by Taxpayers' on their 2003 return.
12. Subsequent to the proposed assessment, the Department determined that no section 179 adjustment of \$29,270.00 is required, either as an addition or deduction from federal taxable income.
13. The Department further determined that an addition to federal taxable income of \$1,534.00 is required at the individual level because the credit for investing in business property flowed through from Company to individual shareholders.
14. The Department reduced the tax credit from \$1,834.00 to \$1,534.00; disallowed the net economic loss deduction of \$77,557.00 and the section 179 deduction of \$29,270.00; reduced North Carolina taxable income by the section 179 addition of \$29,270.00; and increased the addition to federal taxable income by \$1,534.00 for the credit that flowed through from Company to Taxpayers.
15. A corrected Notice of Individual Income Tax Assessment proposing additional tax, penalty, and interest was mailed to Taxpayers on October 17, 2006. This assessment is the subject of the hearing.
16. The Department asserted the twenty-five percent negligence penalty for the tax year 2003 because Taxpayers understated taxable income by an amount equal to twenty-five percent or more of gross income.

17. At the hearing, CPA and Attorney agreed to all of the 2003 adjustments other than the disallowance of the claimed net economic loss deduction.
18. Page 28 of the 2003 and 2004 North Carolina Individual Income Tax Bulletins states that “Since federal taxable income is the starting point for determining North Carolina taxable income, the amount of net operating loss determined for federal income tax purposes is also the net operating loss for State income tax purposes...the law does not require or permit a separate calculation of a net operating loss for State purposes. The amount of net operating loss is the same for State and federal purposes.”
19. The State S corporation return is merely an informational return and the items of income, loss, deduction, and credit flow through to the individual income tax return and are considered in determining a potential net operating loss.
20. A net operating loss carried back from tax year 2001 to 1999 changes federal taxable income for the tax year 1999 and, therefore, changes North Carolina taxable income in that same tax year.
21. Because federal taxable income is the starting point in determining North Carolina taxable income, Taxpayers incorrectly claimed a net economic loss carryforward from taxable year 2001 to 2003 rather than a net operating loss carryback to the taxable year 1999.

### **CONCLUSIONS OF LAW**

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

1. An addition to federal taxable income of \$1,534.00 is required for the tax credit installment for investing in business property that flowed through from Company to Taxpayers as shareholders.
2. G.S. 105-134.5(a) defines North Carolina taxable income for residents as “the taxpayer’s taxable income as determined under the [Internal Revenue] Code, adjusted as provided in G.S. 105-134.6 and G.S. 105-134.7.”
3. Pursuant to G.S. 105-131.1(a), an S corporation is not subject to the corporate income tax imposed under G.S. 105-130.3. Instead, each shareholder’s pro rata share of an S corporation’s income attributable to the State, shall be taken into account by the shareholder subject to the adjustments provided in Parts 2 and 3 of Article 4 and section 1366 of the Code and shall be subject to the tax levied under parts 2 and 3 of Article 4.

4. S corporation items of income, loss, deduction, and credit are characterized as though received or incurred by the S Corporation and not its shareholder.
5. During the period at issue, G.S. 105-134.6(a) provided that the pro rata share of shareholders in an S corporation's income attributable to the State was to be adjusted as provided in G.S. 105-130.5.
6. G.S. 105-130.5(b)(4) provides that, pursuant to G.S. 105-130.8, losses in the nature of net economic losses sustained by a corporation in any or all of the preceding years shall be deducted from a corporation's federal taxable income to determine the corporation's State net income.
7. G.S. 105-130.8(a)(1) provides that "the purpose in allowing the deduction of a net economic loss of a prior year is to grant some measure of relief to the corporation that has incurred economic misfortune or is otherwise materially affected by a strict adherence to the annual accounting rule in the determination of net income. The deduction allowed in this section does not authorize the carrying forward of any particular items or category of loss except to the extent that the loss results in the impairment of the net economic situation of the corporation so as to result in a net economic loss as defined in this section."
8. 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. The burden is on the taxpayer to show that he or she comes within an exemption or an exception. Taxpayers have failed to meet this burden.
9. When Article 4 of Chapter 105 of the General Statutes is viewed as a whole, it becomes clear that shareholders of an S corporation are not intended to be able to claim a net economic loss deduction. This is evidenced by the following:
  - a. Since S corporations are not subject to the corporate income tax, allowing a net economic loss to be calculated and carried forward at the S corporation level does not satisfy the stated purpose of a net economic loss in that it would not provide any tax relief to the corporation. In addition, the S corporation was not materially affected by the strict adherence of the annual accounting rule.
  - b. There is no provision that recognizes a net operating loss at the federal S corporation level. A net operating loss for federal C corporate income tax purposes (Code section 172) and a net economic loss for North Carolina C corporate income tax purposes (G.S. 105-130.8(a)(2) are very similar. The primary difference is that, in determining the amount of net operating loss, federal law does not make the taxpayer reduce its losses by all income, including nontaxable income, while State law does. The purpose of G.S. 105-130.5(a)(6) and G.S. 105-130.5(b)(4) is to reconcile the differences between State and federal

law on the North Carolina C corporate income tax return; those provisions do not give a corporation a tax benefit that is not allowed for federal purposes.

10. Pursuant to G.S. 105-266, the period for filing a return that relates to the refund attributable to a net operating loss carryback shall be the period which ends three years after the time prescribed by law for filing the return for the taxable year of the net operating loss which results in such carryback. Had Taxpayers amended their 1999 North Carolina individual income tax return timely, they would have been afforded the only relief provided them under the law.
11. As set out in G.S. 105-130.8, a net economic loss deduction is intended to grant a measure of relief in circumstances which have not been shown to exist in this case. The net economic loss deduction is not intended to provide a measure of relief to taxpayers such as Taxpayers who failed to timely file an amended individual income tax return.
12. Taxpayers are not entitled to a net economic loss deduction on their 2003 individual income tax return.
13. The proposed assessment for the tax year 2003 is lawful and proper; however, because Taxpayers relied on professional advice, the Assistant Secretary finds reasonable cause for waiver of the negligence penalty.

#### DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessment of the tax and interest for the tax year 2003 to be lawful and proper. The assessment is, therefore, sustained in its entirety (less penalty) and is declared to be finally due and collectible.

Made and entered this \_\_\_\_\_ day of \_\_\_\_\_, 2007

Signature \_\_\_\_\_

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings  
North Carolina Department of Revenue