

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 2002 and)
2003 by the Secretary of Revenue of North)
Carolina)

FINAL DECISION

Docket No. 2007-101

vs.

)

)

Taxpayer)

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on October 23, 2007, upon an application for hearing by "Taxpayer," wherein she objected to the proposed assessments of additional income tax for the taxable years 2002 and 2003. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayer's attorney, hereinafter referred to as "Attorney"; Nancy R. Pomeranz, Director of the Personal Taxes Division; and Carla R. Helms, Administrative Officer in the Personal Taxes Division.

Pursuant to G.S. 105-241.1, assessments proposing additional income tax, penalty, and interest for tax years 2002 and 2003 were mailed to Taxpayer on November 29, 2005. Taxpayer objected to the proposed assessments and timely requested an administrative tax hearing.

ISSUES

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

1. Is Taxpayer entitled to the losses claimed on her 2002 and 2003 individual income tax returns from her dog breeding/showing activity?
2. Are the assessments for additional income tax proposed against Taxpayer for the taxable years 2002 and 2003 lawful and proper?

EVIDENCE

The evidence presented by the Personal Taxes Division, consisted of the following;

1. Taxpayer's North Carolina individual income tax return for the taxable year 2002, a copy of which is designated as Exhibit PT-1.
2. Taxpayer's North Carolina individual income tax return for the taxable year 2003, a copy of which is designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 2002 dated November 29, 2005, a copy of which is designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 2003 dated November 29, 2005, a copy of which is designated as Exhibit PT-4.
5. Taxpayer's federal individual income tax return for taxable year 2002, a copy of which is designated as Exhibit PT-5.
6. Taxpayer's federal individual income tax return for taxable year 2003, a copy of which is designated as Exhibit PT-6.
7. Field audit report of individual income tax for taxable years 2002 and 2003, a copy of which is designated as Exhibit-7.
8. Letter from Christy A. Tyler, Revenue Field Auditor, to Taxpayer dated February 23, 2003, a copy of which is designated as Exhibit PT-8.
9. Letter from Christy A. Tyler to Taxpayer's CPA, dated August 2, 2005, a copy of which is designated as Exhibit PT-9.
10. Letter from Attorney to North Carolina Department of Revenue dated December 28, 2005, a copy of which is designated as Exhibit PT-10.
11. Letter from Attorney to North Carolina Department of Revenue dated February 9, 2006, a copy of which is designated as Exhibit PT-11.
12. Letter from Christy A. Tyler to Attorney dated February 13, 2006, a copy of which is designated as Exhibit PT-12.
13. Letter from Attorney to Christy A. Tyler dated February 17, 2006, a copy of which is designated as Exhibit PT-13.

14. Letter from Carla R. Helms to Attorney, dated February 22, 2006, a copy of which is designated as Exhibit PT-14.
15. Letter from Christy A. Tyler to Attorney dated May 1, 2006, a copy of which is designated as Exhibit PT-15.
16. Letter from Attorney to Christy A. Tyler dated May 17, 2006, a copy of which is designated as Exhibit PT-16.
17. Undated memorandum from Taxpayer to her CPA, a copy of which is designated as Exhibit PT-17.
18. Letter from Christy A. Tyler to Attorney dated November 17, 2006, a copy of which is designated as Exhibit PT-18.
19. Letter from Attorney to Christy A. Tyler dated November 28, 2006, a copy of which is designated as Exhibit PT-19.
20. Letter from Carla R. Helms to Attorney dated March 9, 2007, a copy of which is designated as Exhibit PT-20.
21. Letter from Attorney to Carla R. Helms dated April 18, 2007, a copy of which is designated as Exhibit PT-21.
22. Letter from Attorney to Carla R. Helms dated May 2, 2007, a copy of which is designated as Exhibit PT-22.
23. Letter from Carla R. Helms to Attorney dated May 11, 2007, a copy of which is designated as Exhibit PT-23.
24. Letter from Eugene J. Cella to Attorney dated May 14, 2007, a copy of which is designated as Exhibit PT-24.
25. Letter from Eugene J. Cella to Attorney dated August 9, 2007, a copy of which is designated as Exhibit PT-25.
26. Letter from Carla R. Helms to Attorney dated August 16, 2007, a copy of which is designated as Exhibit PT-26.
27. Letter from Reginald S. Hinton, Secretary of Revenue, to Taxpayer dated September 5, 2007, a copy of which is designated as Exhibit PT-27.
28. Letter from Eugene J. Cella to Attorney dated October 4, 2007, a copy of which is designated as Exhibit PT-28.

29. Memorandum from Christy A. Tyler dated May 10, 2007, a copy of which is designated as Exhibit PT-29.
30. Response from Attorney to Eugene J. Cella, a copy of which is designated as Exhibit PT-30.

At the hearing, Attorney submitted into evidence a schedule showing expenses for Taxpayer's dog breeding/showing activities, a copy of which is designated as Exhibit TP-1.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary makes the following 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 her North Carolina individual income tax returns for the tax years 2002 and 2003.
3. Taxpayer claimed itemized deductions of \$35,054.00 and \$14,461.00 on her 2002 and 2003 federal income tax returns, respectively. These deductions were also claimed for purposes of North Carolina taxable income.
4. At the auditor's request, Taxpayer furnished documentation to substantiate the itemized deductions claimed, except for gifts to charity of \$14,067.00 claimed on the 2002 return. Based on the documentation furnished, the auditor allowed an additional expense for miscellaneous deductions of \$2,791.00 on the 2002 return.
5. For taxable years 2002 and 2003, Taxpayer filed federal Schedules C for her interior design business and for her dog breeding/showing activity.
6. During the years at issue, Taxpayer's principal source of income was from her interior design business where she reported gross receipts of \$1,015,884.00 and \$762,845.00 on her federal Schedules C for taxable years 2002 and 2003, respectively. Taxpayer reported a net profit of \$118,833.00 and \$96,901.00 on her federal Schedules C for taxable years 2002 and 2003, respectively.
7. Upon examination, no changes were made to the federal Schedules C with respect to Taxpayer's interior design business.

8. For the dog breeding/showing activity, Taxpayer reported expenses of \$17,703.00, \$16,261.00, and \$14,301.00 on her federal Schedules C for taxable years 2001, 2002, and 2003, respectively. The only gross receipts reported were \$5,549.00 on her 2002 return.
9. Upon examination, the auditor determined from the evidence presented that the losses claimed on the federal Schedules C for taxable years 2002 and 2003 were not allowable under section 162 of the Internal Revenue Code as Taxpayer was unable to show the activity was engaged in for profit. Therefore, the auditor disallowed the losses claimed.
10. During the examination, the only item provided to support the amounts claimed on the federal Schedules C for Taxpayer's dog breeding/showing activity was a small box containing pictures, receipts, and invoices. The amounts on the receipts and invoices did not equal the income or expense amounts claimed on Taxpayer's 2002 or 2003 federal Schedules C. The records were not organized and the auditor was unable to distinguish between personal versus potential business expenses.
11. Taxpayer did not maintain records to track income and expenses attributable to any dog. There were no accounting books for this activity that would allow her to analyze profit potential of the activity so as to make informed business decisions with regard to its profitability.
12. Taxpayer used the same checking account to pay for expenses for her interior design business and her dog breeding/showing activity.
13. Taxpayer did not develop a business plan for the activity.
14. Taxpayer did not indicate how much time and effort was put into the dog breeding/showing activity.
15. The losses reported were not due to circumstances beyond Taxpayer's control.
16. Taxpayer is a member of various kennel clubs and she attended classes on grooming and handling the dogs.
17. Taxpayer has not been successful in a similar activity in the past.
18. Taxpayer did not add value to her dog breeding/showing activity.
19. Notices of Individual Income Tax Assessment reflecting the additional tax, penalties, and interest were mailed to Taxpayer on November 29, 2005. Taxpayer objected to the proposed assessments and timely requested an administrative tax hearing.

20. The auditor asserted the ten percent negligence penalty for tax years 2002 and 2003.
21. Taxpayer states that she began her business in August 1997. However, Taxpayer filed federal Schedules C for this activity only in 2001, 2002, and 2003.
22. Taxpayer contends that she was engaged in the dog breeding/showing activity for profit and, therefore, should be allowed to claim the Schedule C losses on her 2002 and 2003 returns.
23. Although Taxpayer states she intended to make a profit, she has not furnished any meaningful projections showing how she could expect to make a profit.

CONCLUSIONS OF LAW

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

1. An individual may deduct all of the ordinary and necessary expenses incurred in carrying on a trade or business.
2. An individual may not deduct losses arising from activities not entered into for profit.
3. 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.
4. North Carolina taxable income is defined as taxpayer's taxable income 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.
5. 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).
6. Treasury regulations set forth nine criteria to be considered in determining whether the taxpayer has the requisite profit motive: (1) the extent to which the

taxpayer carries on the activity in a businesslike manner; (2) the time and effort expended by the taxpayer which may indicate the intent to make a profit; (3) dependency on income from the activity for one's livelihood; (4) losses are due to circumstances beyond taxpayer's control; (5) methods of operation are changed in an attempt to improve profitability; (6) taxpayer or advisors have the knowledge needed to carry on the activity as a successful business; (7) taxpayer has success in making a profit in similar activities in the past; (8) taxpayer makes a profit in some years, and the amount of profit; and, (9) the expectation that assets used in the activity may appreciate in value.

7. Section 1.183-2(b)(1) of the Income Tax Regulations provides that a taxpayer who carries on an activity in a businesslike manner and keeps a complete and accurate set of books and records indicates that the activity is engaged in for profit.
8. Deductions are privileges, not matters of right, and are allowed as a matter of legislative grace. The burden of proof to establish a deductible loss is on the taxpayer.
9. The evidence and facts do not support Taxpayer's contention that she was engaged in the dog breeding/showing activity for profit during the years at issue, and she has not carried her burden of proof that such was the case.
10. 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.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessments for tax years 2002 and 2003, to the extent hereinafter modified, to be lawful and proper and are hereby affirmed.

After considering the facts and circumstances, the Assistant Secretary finds reasonable cause to waive the ten percent negligence penalties. Therefore, the proposed assessments for tax years 2002 and 2003, modified to exclude the ten percent negligence penalties, are hereby sustained in their entireties and are determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this _____ 6th _____ day of _____ December _____, 2007.

Signature _____

Eugene J. Cella
Assistant Secretary for Administrative
Tax Hearings
North Carolina Department of Revenue