

STATE OF NORTH CAROLINA

**BEFORE THE
SECRETARY OF REVENUE**

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessments of Additional)
Income Tax for the Taxable Years 2004)
and 2005 by the Secretary of Revenue of)
North Carolina.)

vs.)

[Taxpayer 1] & [Taxpayer 2])

FINAL DECISION

Docket No. 2007-199

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon application for hearing by Taxpayer 1 and Taxpayer 2, hereinafter referred to collectively as "Taxpayers" and separately as "Husband" and "Wife," respectively, wherein they objected to the proposed assessments of additional income tax for the taxable years 2004 and 2005. At Husband's request, the hearing was conducted via written communication. The hearing was conducted by the Assistant Secretary under the provisions of G.S. 105-260.1.

Pursuant to G.S.105-241.1, assessments proposing additional income tax, penalties, and accrued interest for tax years 2004 and 2005 were mailed to Taxpayers on May 8, 2007. Taxpayers objected to the proposed assessments and timely requested an administrative tax hearing.

Company, is hereinafter referred to as "Corporation."

ISSUE

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

1. Is Husband entitled to the business bad debt deduction claimed for taxable years 2004 and 2005?
2. Is Wife entitled to the deduction for business use of home claimed for taxable years 2004 and 2005?

3. Are the proposed assessments for taxable years 2004 and 2005 lawful and proper?

EVIDENCE

The evidence presented by the Personal Taxes Division consisted of the following:

1. Taxpayers' North Carolina individual income tax return for the taxable year 2004, a copy of which is designated as Exhibit PT-1.
2. Taxpayers' North Carolina individual income tax return for the taxable year 2005, a copy of which is designated as Exhibit PT-2.
3. Taxpayers' federal individual income tax return for taxable year 2004, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' federal individual income tax return for taxable year 2005, a copy of which is designated as Exhibit PT-4.
5. Auditor's report of individual income tax for taxable year 2004, a copy of which is designated as Exhibit PT-5.
6. Auditor's report of individual income tax for taxable year 2005, a copy of which is designated as Exhibit PT-6.
7. Notice of Individual Income Tax Assessment for taxable year 2004 dated May 8, 2007, a copy of which is designated as Exhibit PT-7.
8. Notice of Individual Income Tax Assessment for taxable year 2005 dated May 8, 2007, a copy of which is designated as Exhibit PT-8.
9. Letter from LaToya Gardner, Revenue Tax Auditor, to Taxpayers dated January 12, 2007, a copy of which is designated as Exhibit PT-9.
10. Letter from Husband to LaToya Gardner dated April 13, 2007, a copy of which is designated as Exhibit PT-10.
11. Letter from Husband to Department of Revenue dated May 15, 2007, a copy of which is designated as Exhibit PT-11.
12. Letter from Jeffrey C. Davenport, Administrative Officer in the Personal Taxes Division, dated June 20, 2007, a copy of which is designated as Exhibit PT-12.

13. Letter from Husband to Jeffrey C. Davenport dated June 26, 2007, a copy of which is designated as Exhibit PT-13.
14. Letter from Husband to LaToya Gardner dated August 8, 2007, a copy of which is designated as Exhibit PT-14.
15. Letter from Reginald S. Hinton, Secretary of Revenue, to Taxpayers dated September 5, 2007, a copy of which is designated as Exhibit PT-15.
16. Letter from Husband to Reginald S. Hinton dated September 7, 2007, a copy of which is designated as Exhibit PT-16.
17. Letter from Eugene J. Cella to Taxpayers dated September 20, 2007, a copy of which is designated as Exhibit PT-17.
18. Promissory notes between Husband and Corporation, copies of which are collectively designated as Exhibit PT-18.
19. News article dated October 25, 2002, a copy of which is designated as PT-19.

Husband submitted a cover letter dated October 30, 2007, and related attachments to Eugene J. Cella, copies of which are collectively 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. 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 tax years 2004 and 2005.
3. Taxpayers claimed itemized deductions of \$28,590.00 and \$24,605.00 on their 2004 and 2005 federal income tax returns, respectively. These deductions were also claimed for purposes of North Carolina taxable income.
4. Taxpayers furnished documentation that substantiated itemized deductions of \$28,649.00 and \$25,962.00 for tax years 2004 and 2005, respectively.
5. Husband claimed a business bad debt deduction of \$17,060.00 and \$27,670.00 on his Schedule C for tax years 2004 and 2005, respectively.

6. Wife claimed an expense for business use of home on her Schedule C of \$1,865.00 and \$2,363.00 for tax years 2004 and 2005, respectively.
7. The auditor disallowed the deductions for bad debt claimed by Husband and the business use of home deductions claimed by Wife.
8. Notices of Individual Income Tax Assessment reflecting the additional, tax, penalties, and interest were mailed to Taxpayers on May 8, 2007. Taxpayers objected to the proposed assessments and timely requested an administrative tax hearing.
9. Husband contends that he was a business consultant to Corporation and that he loaned the company money for the development of a future product with the hope of future consulting income.
10. During 2003 and 2004, Husband operated Corporation as acting President and served on its Board of Directors without compensation, as he continued to fund development of the technology.
11. By the end of 2004, Husband saw little potential that the company would be able to repay the loans. At this point, he began to take a business bad debt deduction.
12. Husband's position is that the monies provided to Corporation are bona fide business loans in accordance with Internal Revenue Service guidelines.
13. Upon further examination, the Department determined the loans were equity investments. Husband's advances possessed the seeming indicia of loans; however, as a matter of economic reality, the advances were capital contributions.
14. Advances by a shareholder that are placed at risk of a corporation's business are likely contributions to capital.
15. Husband anticipated that repayment of his advances would come from the profits from product sales. Thus, he did not enjoy an expectation of repayment, regardless of the success of the business as all advances were placed at risk.
16. As the holder of the instrument, as well as being the President and Chief Executive Officer of Corporation, Husband was in a unique position to control both sides of the terms and nature of the advances with full knowledge that there was no current source of income to cover interest and principal payments.
17. A bona fide lender would be concerned with interest. Husband's purported debt instruments contained provisions for interest. However, Corporation did not pay interest (or principal) on any of the advances.

18. Husband continued to advance funds despite Corporation's failure to make any interest (or principal) payments due on the advances.
19. Corporation did not file bankruptcy.
20. Husband contends Corporation's business operations were suspended; however, Corporation continues to exist as an on-going concern and received approval for a product on April 7, 2006.
21. Even if monies advanced to Corporation qualify as loans, Husband has not proven that the debts are worthless.
22. Wife's office is a corner of the family den where she occupies a table. She schedules appointments for child photography sittings, reviews proofs, checks status of orders and performs other administrative duties.
23. Taxpayers' den does not meet the exclusive use test since the family uses it for recreational purposes.
24. Wife's advertising expense on her Schedule C for taxable year 2004 is allowable.

CONCLUSIONS OF LAW

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

1. A taxpayer claiming a deduction must bring himself within the statutory provisions authorizing the deduction.
2. Pursuant to sections 162 and 212 of the Internal Revenue Code, a taxpayer is allowed to deduct the ordinary and necessary expenses paid during the income year in carrying on a trade or business or for the production or collection of income. A taxpayer must be able to prove that the expenses were in fact paid or incurred.
3. Courts have considered the following nonexclusive list of factors in determining whether advances, such as those involved in the instant case, are loans or equity investments: (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; and (8) the provision of a fixed rate of interest.

4. Internal Revenue Code Section 166 allows as a deduction any debt which becomes worthless within the taxable year. A debt becomes worthless when there is no longer any chance that the amount owed will be paid. The determination of when a debt becomes worthless is a question of fact that is based on all of the pertinent evidence. A taxpayer must prove the debt had value at the beginning and is wholly without value at the end of the tax year to deduct the bad debt for that tax year.
5. Section 280(A) of the Internal Revenue Code states that taxpayers who use a portion of their home for business purposes may be able to take a home office deduction if they meet certain requirements. In order to claim a deduction for that part of a home used for business, taxpayers must use that part of the home: (1) Exclusively and regularly as their principal place to meet or deal with patients, clients, or customers in the normal course of their business, or in connection with their trade or business where there is a separate structure not attached to the home; or (2) on a regular basis for certain storage use such as inventory or product samples, as rental property, or as a home daycare facility.
6. Husband is not entitled to a bad debt deduction. Wife is not entitled to a deduction for business use of home.
7. The Secretary of Revenue is authorized to reduce or waive penalties. The Assistant Secretary finds reasonable cause to waive all penalties.
8. Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessments for tax years 2004 and 2005 are lawful and proper and are determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this day 5th of, December 2007.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department Of Revenue