

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Individual)
Income Tax, Penalty, and Interest for the)
Taxable Year 1997 by the Secretary)
of Revenue of North Carolina)
vs.)
[Taxpayers])

FINAL DECISION
Docket No. 2002-364

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, on July 2, 2002, upon an application for a hearing by [Taxpayers, Husband and Wife], wherein they protested the proposed assessment of individual income tax, penalty, and interest for the taxable year 1997. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Wife and W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division. At Wife's request, the hearing was also attended by her [Mother].

ISSUE

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

1. Are the auditor's adjustments disallowing Taxpayers' itemized deductions, nonbusiness bad debt, moving expenses, and rental expenses proper?
2. Is the individual income tax assessment proposed against Taxpayers for the taxable year 1997 lawful and proper?

EVIDENCE

The evidence presented at the hearing 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. Taxpayers' North Carolina individual income tax return for the taxable year 1997, a copy of which is designated as Exhibit PT-2.

3. Notice of Individual Income Tax Assessment for the taxable year 1997 dated September 3, 1999, a copy of which is designated as Exhibit PT-3.
4. Field Auditor's Report for the taxable year 1997 dated August 4, 1999, a copy of which is designated as Exhibit PT-4.
5. Letter from Bruce B. Taylor, Revenue Field Auditor Supervisor, to Taxpayers dated April 20, 1999, a copy of which is designated as Exhibit PT-5.
6. Letter from Bruce B. Taylor to Taxpayers dated June 10, 1999, a copy of which is designated as Exhibit PT-6.
7. Letter from Wife to the Department of Revenue dated August 30, 1999, a copy of which is designated as Exhibit PT-7.
8. Letter from W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division, to Taxpayers dated April 23, 2002, a copy of which is designated as Exhibit PT-8.
9. Letter from Wife to W. Edward Finch, Jr., dated April 30, 2002, a copy of which is designated as Exhibit PT-9.
10. Letter from Eugene J. Cella to Taxpayers dated May 21, 2002, a copy of which is designated as Exhibit PT-10.

Wife stated at the hearing that the rental income and expenses were related to two properties rather than one as was indicated on Schedule E of the 1997 federal return. One rental house was located [in another state] and the other [in North Carolina]. Wife also stated that she and Husband were the owners of the [out-of-state] property during the tax year 1997. Mother stated at the hearing that she gave the [out-of-state property] to Taxpayers in 1993 who in turn gave it back to her in 1998.

There was considerable discussion at the hearing regarding record keeping requirements, organization of receipts, and general requirements for properly substantiating deductions and losses claimed on Taxpayers' return. At the conclusion of the hearing, the Assistant Secretary allowed Taxpayers sixty days to furnish additional information to substantiate the amounts disallowed by the auditor. At Wife's request, the file was referred to the [North Carolina] field audit office. Wife agreed to organize the records and meet with an assigned auditor for review in order to substantiate the deductions, rental losses, capital losses, and moving expenses claimed on the return. The Assistant Secretary later extended the deadline to November 1, 2002.

The following evidence was entered into the record subsequent to the hearing:

1. Letter from W. Edward Finch, Jr., to Taxpayers dated July 11, 2002, a copy of which is designated as Exhibit PT-11.
2. Letter from Wife to Eugene J. Cella dated August 27, 2002, a copy of which is designated as Exhibit PT-12.

3. Interoffice Memorandum from Melissa Dann, Revenue Field Auditor in [North Carolina] to W. Edward Finch, Jr., dated September 9, 2002, a copy of which is designated as Exhibit PT-13.
4. Letter from Wife to Governor Michael F. Easley dated September 17, 2002, a copy of which is designated as Exhibit PT-14.
5. Letter from Eugene J. Cella to Wife dated September 19, 2002, a copy of which is designated as Exhibit PT-15.
6. Letter from E. Norris Tolson to Wife dated October 16, 2002, a copy of which is designated as Exhibit PT-16.
7. Interoffice memorandum from Melissa Dann to W. Edward Finch, Jr., dated November 7, 2002, a copy of which is designated as Exhibit PT-17.
8. Certification of Conveyances from the Office of the Register of Conveyances [of another state] dated September 19, 2002, a copy of which is designated as Exhibit PT-18.

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 filed their North Carolina individual income tax return for the tax year 1997 on June 10, 1998, under an approved six-month extension of time for filing the return. The return reflected an overpayment of \$3,327.00, which was not refunded.
3. Taxpayers claimed itemized deductions on their federal income tax return for the tax year 1997 as follows:

Medical expenses	\$ 1,323.55
Taxes	1,870.05
Interest	8,688.13
Charitable contributions	7,350.00
Job expenses and other miscellaneous deductions	<u>7,963.67</u>
Total	<u>\$27,195.40</u>

4. Taxpayers claimed a capital loss of \$3,000.00 for a non-business bad debt and a deduction for moving expenses of \$12,867.13. Taxpayers reported gross rental income on their 1997 federal income tax return of \$3,600 and claimed rental expenses of \$34,669.30 for a net rental loss of \$31,069.30.
5. At his request, Taxpayers met with the examining auditor in order to substantiate the above deductions and losses and to verify ownership of the rental property; however, the auditor found the information furnished too disorganized and insufficient to verify the

amounts claimed. The auditor asked Wife to better organize the records and then schedule a later appointment. The auditor subsequently wrote to Taxpayers on April 20 and June 10, 1999, requesting that they furnish properly organized records to substantiate the deductions and losses claimed. Taxpayers did not furnish any further information at that time.

6. The auditor adjusted Taxpayers' 1997 return to disallow all of the aforementioned deductions, the rental and capital losses, and to allow the standard deduction. Because the adjustments increased Taxpayers' adjusted gross income above the required threshold, the auditor also adjusted the return to disallow the tax credit for children of \$120 and to increase the adjustment for the difference between the federal and State personal exemption amounts from \$600 to \$2,600.
7. The auditor imposed the 25 percent negligence penalty and accrued interest.
8. A Notice of Individual Income Tax Assessment reflecting the auditor's adjustments was mailed to Taxpayers on September 3, 1999. In error, the notice did not reflect the auditor's disallowance of the credit for children of \$120.00. Taxpayers filed a timely protest to the proposed assessment and requested a hearing before the Secretary of Revenue.
9. As was agreed at the hearing, Taxpayers' file was referred to the Department's office in [North Carolina] and was assigned to Field Auditor Melissa Dann. In meetings with Wife on August 5 and 9, 2002, the auditor reviewed the information provided. The auditor and Wife discussed at length the necessary record keeping requirements and what additional information was needed to properly substantiate the items at issue. Taxpayer alleges that the auditor did not give adequate consideration to the information furnished and improperly declined to allow the deductions previously disallowed by the original auditor. However, based on the information furnished, the auditor determined that the following deductions had been properly substantiated:

State income tax	\$ 3,737.00
Real estate tax	694.16
Mortgage interest	<u>7,202.47</u>
Total	<u>\$11,633.63</u>

CONCLUSIONS OF LAW

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

1. 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). In order to claim any deduction, a taxpayer must be able to prove that the expenses were in fact paid or incurred.

2. If a taxpayer does not provide adequate and reliable information upon which to compute his tax liability, an assessment may be made upon the basis of the best information available and, in the absence of information to the contrary, such assessment is deemed to be correct. The burden to show otherwise is upon the taxpayer.
3. 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. 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. Documentary evidence must be furnished which is 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. A taxpayer is allowed deductions for amounts paid during the taxable year for certain non business expenses. The deductions include but are not limited to qualifying medical expenses, taxes, interest paid and charitable contributions. Taxpayers' non-business 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. Consequently, State income tax of \$3,737.00 substantiated by Wife and allowed by the auditor in determining federal taxable income must be added to Taxpayers' federal taxable income in computing their North Carolina taxable income.
5. Taxpayers' personal exemptions for State income tax purposes are the same as for federal purposes except that North Carolina does not increase the exemptions each year for inflation. Therefore, an addition is required on the State return for the amount each personal exemption has been increased for inflation. This amount is reduced by \$500.00 for each personal exemption if the taxpayers' adjusted gross income is less than a certain amount. For taxpayers filing jointly, the amount is \$100,000.00. Because Taxpayers' gross income exceeds that amount, an addition of \$650.00 is required for each exemption claimed.
6. Married individuals filing jointly whose adjusted gross income is less than \$100,000.00 are allowed a tax credit equal to \$60.00 for each dependent child for whom they were entitled to deduct a personal exemption. Because Taxpayers' adjusted gross income exceeds \$100,000.00, the auditor's adjustment to disallow the credit for two children of \$120.00 is correct.
7. For cash contributions of less than \$250.00, taxpayers are required to keep a cancelled check, a receipt, or other reliable written records from the charitable organization. For contributions of \$250.00 or more, taxpayers must have an acknowledgement of the contribution from the qualified organization. For noncash contributions, taxpayers 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 generally 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.

8. 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, etc.
9. Non-business bad debts are treated as short-term capital losses, subject to a \$3,000 per year deduction limitation, and are deductible only when totally worthless. To be deductible, the debt must have arisen from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money. A taxpayer must have a basis in the debt, that is, the taxpayer must have already included the amount in income or loaned out funds.
10. Certain moving expenses are deductible if the move is closely related to the start of work; the taxpayer's new main job location is at least 50 miles farther from his former home than his old job location; and the moving expenses are incurred within one year from the date the taxpayer first reported to work at the new location. A taxpayer claiming moving expenses must satisfy the specific statutory provisions authorizing the deduction and must also bear the burden of proving entitlement to it.
11. A twenty-five percent negligence penalty is required 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.
12. When a taxpayer makes a timely request for a hearing, the Secretary of Revenue is required to set the time for the hearing and notify the taxpayer of the designated time within 60 days of the request and at least 10 days prior to the date set for the hearing. The date set for the hearing must be within 90 days after the timely request for a hearing was filed or at a later date mutually agreed upon by both parties. The revenue laws do not provide for a penalty if the timetable is not met. Moreover, even where actual damages are shown and a statutory remedy has been provided, absent malicious intent, the remedy is only commensurate to the actual prejudice established. Before a statutory violation can give rise to civil damages, the violation must be wrongful and prejudicial.
13. North Carolina taxable income is defined as the taxpayer's taxable income as determined under the Internal Revenue Code, adjusted for certain differences in State and federal law. "Taxable income as determined under the Code" does not mean the taxable income a taxpayer chooses to report on his or her return, but rather the taxable income as it should actually be calculated under the Code. Therefore, if an individual calculates federal taxable income incorrectly or reports no taxable income on his federal

return, the State is not bound by the amount reported. The Department of Revenue is authorized to examine materials for the purpose of ascertaining the correctness of any return or determining a person's liability for State tax. Therefore, the Department of Revenue has the authority to use information other than that provided on a taxpayer's federal return to determine what taxes are actually owed to the State.

14. The proposed assessment of additional income tax for the taxable year 1997 was properly issued and is, under the facts, lawful and proper except to the extent hereinafter modified.

DECISION

Wife contends that the Department, by and through its auditors, has given inadequate consideration to information she believes sufficiently substantiates deductions, capital losses, rental expenses and rental property ownership.

The record shows that the Department has given Taxpayers' ample opportunity to comply with the necessary substantiation requirements. Wife met with the original auditor and was instructed to organize her records so that each record could be associated with the particular item claimed on the return. This is a reasonable request. Although the law does not require that a taxpayer organize the information they furnish to substantiate items claimed on a return in a certain manner, the information must be presented in a reasonable order so as to facilitate the association of the evidence with the item it is intended to verify. Wife was afforded ample time to do this and was asked to meet again with the auditor. When Wife did not do so, the auditor adjusted the return based on the best information available and proposed an assessment against Taxpayers.

Upon receipt of the proposed assessment dated September 3, 1999, Taxpayers timely requested an administrative tax hearing. Through inadvertent oversight, the Department did not respond to the hearing request and took no further action on the file until being contacted by Wife in April 2002. Wife indicates that she had previously contacted the Department by phone but furnished no factual evidence of such contact. The Department regrets the length of time that ensued until the scheduled hearing. Nevertheless, Taxpayers have made no showing that

the delay caused any actual prejudice such as the loss of tax records, or prevented them from receiving a tax hearing upon the merits of their claims. Under these circumstances, there are no legal grounds upon which the assessment could be adjusted.

A review of some of Taxpayers' records at the hearing indicated that many were mere receipts with no corresponding corroborating records to associate the particular receipt to the expense it was ostensibly intended to verify. In an effort to afford Taxpayers every opportunity to furnish information and to address Wife's allegations of unfair treatment by the auditor, the Assistant Secretary transferred the case to a different Examination Office and auditor. Wife was asked to organize all records and meet with the auditor in order to substantiate the various deductions, rental losses, capital losses, and moving expenses claimed. However, Wife again expressed disagreement with the second auditor's requests for pertinent information necessary to verify deductions, expenses, losses and to verify ownership of the rental property. After two meetings and some telephone conversations with the auditor, Wife discontinued contact.

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). In order to claim any deduction, a taxpayer must be able to prove that the expenses were in fact paid or incurred and Taxpayers have not satisfactorily done so except for the deductions of \$11,633.63 (finding of fact number 9).

Taxpayers claimed miscellaneous deductions of \$9,013.90 consisting of employee business expenses, union dues, education, tax preparation fees, and other expenses identified on the return as "copies, postal services and phone calls." They furnished no information that these expenses were ordinary and necessary business expenses or what amount, if any, was reimbursed by their employers.

The bankruptcy documents furnished by Wife are insufficient to verify the alleged bad debt deduction. Although requested to do so, Wife did not provide a copy of the interest bearing loan agreement or proof of payment of the loan proceeds to the borrower. Consequently, Taxpayers have not carried their burden of proof of entitlement to the deduction.

Taxpayers reported gross rental income on their 1997 federal income tax return of \$3,600.00 and claimed rental expenses of \$34,669.30 for a net rental loss of \$31,069.30. Two issues are involved. First, have Taxpayers properly substantiated the rental expenses claimed and two, did Taxpayers own the rental properties during tax year 1997? Wife furnished some information such as cash register receipts; however, the information was not sufficiently organized to enable the auditor to associate the expense to a particular item on the return whether rent-related or otherwise. Taxpayers listed only one rental property on their return, reflecting an address in [another state]. At the hearing, Wife stated that the rental income and expenses actually were derived from two properties, the [out-of-state property] and another in North Carolina. The North Carolina property was used by Taxpayers as their personal residence until at least January of 1997 and was owned by them during all of tax year 1997. Taxpayers never produced a lease agreement for either property. At the hearing, Mother stated that she gave the [out-of-state property] to Taxpayers in 1993 who in turn gave it back to her in 1998. However, evidence obtained by the auditor subsequent to the hearing from the Office of the Register of Conveyances [of another state] shows that Taxpayers gave the property to Mother in 1995 and have not been the owners of record since that time.

Subsequent to the hearing, Wife furnished information substantiating non-business itemized deductions of \$11,633.63. The Assistant Secretary finds that Taxpayers have not met their burden of proof that the auditor's adjustments are otherwise in error or that they are entitled to amounts greater than those herein allowed. Consequently, Taxpayers' North Carolina income tax liability is recalculated as follows to allow the deductions and to disallow the tax credit for children of \$120.00, which had previously been allowed in error.

Adjusted gross income previously determined		\$100,947.99
Less: Itemized deductions	\$11,633.63	
Personal exemptions	<u>10,600.00</u>	<u>22,233.63</u>
Corrected federal taxable income		\$ 78,714.36
Add: State income tax		3,737.00
Personal exemption inflation adjustment (\$650 x 4)		<u>2,600.00</u>
Corrected North Carolina taxable income		\$ 85,051.36
Tax as corrected		\$ 5,741.08
Less: Husband's State tax withheld	\$1,418.00	
Wife's State tax withheld	2,319.00	
Dependent care credit	<u>480.00</u>	<u>4,217.00</u>
Net tax due as corrected		\$ 1,524.08
Negligence penalty (25 percent)		381.00
Interest to February 28, 2003		<u>569.60</u>
TOTAL DUE		<u>\$ 2,474.68</u>

The proposed assessment for the taxable year 1997 as herein modified is declared to be finally determined and immediately due and collectible together with interest as allowed by law.

Made and entered this 27th day of January, 2003.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue