

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 2000 by)
the Secretary of Revenue of North Carolina)
vs.)
Taxpayers)

FINAL DECISION
Docket No. 2004-232

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on June 29, 2004, upon an application for hearing by Taxpayers, hereinafter referred to collectively as "Taxpayers," wherein they protested the proposed assessment of additional income tax for the taxable year 2000. Taxpayer is hereinafter referred to separately as "Husband." The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayers; W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division; and Patrick G. Penny, Administrative Officer in the Personal Taxes Division.

Pursuant to G.S. 105-241.1, an assessment proposing additional tax and interest for the tax year 2000 was mailed to Taxpayers on February 24, 2004. Taxpayers objected to the proposed assessment and requested an administrative tax hearing before the Secretary of Revenue.

ISSUE

The issue to be decided in this matter is as follows:

Is the assessment for additional income tax proposed against Taxpayers for the taxable year 2000 lawful and proper?

EVIDENCE

The evidence presented 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 2000, a copy of which is designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 2000 dated February 24, 2004, a copy of which is designated as Exhibit PT-3.
4. Letter from Richard J. Scoville, Jr., Revenue Tax Auditor, to Taxpayers dated November 6, 2003, a copy of which is designated as Exhibit PT-4.
5. Letter from Husband to E. Norris Tolson dated March 1, 2004, a copy of which is designated as Exhibit PT-5.
6. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Husband dated March 15, 2004, a copy of which is designated as Exhibit PT-6.
7. Letter from Husband to Patrick G. Penny dated April 13, 2004, a copy of which is designated as Exhibit PT-7.
8. Letter from Eugene J. Cella to Taxpayers dated April 23, 2004, a copy of which is designated as Exhibit PT-8.

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 return for the tax year 2000. The return reflected four deductions from federal taxable income including a deduction of \$23,078 for state and local income tax refunds; a deduction of \$122,626 for interest income from obligations of the State of North Carolina; a deduction of \$18,180 for the taxable portion of Social Security benefits; and a deduction of \$23,252 for retirement benefits qualifying for exemption under the *Bailey Settlement*.

3. In 2002, the Department determined that Taxpayers claimed the deduction for interest income from obligations of the State of North Carolina in error. Because the interest income was excluded from Taxpayers' gross income on their federal return, it was not included in Taxpayers' federal taxable income. Taxpayers' return was adjusted to disallow the deduction of \$122,626. The Department also reduced the deduction claimed for Taxpayers' *Bailey* qualified retirement benefits to \$22,717, the amount included in federal taxable income. An assessment notice for additional tax, penalty, and interest was mailed to Taxpayers on July 16, 2002. Taxpayers did not request a hearing but rather remitted payment within thirty days.
4. On November 6, 2003, the Department mailed a letter to Taxpayers requesting that they provide documentation to substantiate the deduction of \$23,078 for state and local income tax refunds claimed on their 2000 return. Taxpayers did not respond to this letter and the Department subsequently disallowed the deduction.
5. The disallowance of the deduction of \$23,078 for state and local income tax refunds increased Taxpayers' North Carolina taxable income from \$475,773, as reflected on the previous assessment notice dated July 16, 2002, to \$498,851. As a result, Taxpayers owed additional tax and interest. Pursuant to G.S. 105-241.1, a Notice of Individual Income Tax Assessment reflecting additional tax and interest of \$2,106.38 was mailed to Taxpayers on February 24, 2004. Taxpayers objected to the second proposed assessment for the tax year 2000 and timely requested a hearing before the Secretary of Revenue.
6. Taxpayers did not receive refunds of state, local, or foreign income taxes during tax year 2000.
7. During tax years 1990 through 1994, Taxpayers paid North Carolina intangibles tax on stock that they owned.
8. In 1999, the State entered into a settlement agreement to satisfy judgments in *Smith v. State of North Carolina* and *Shaver v. State of North Carolina*. The settlement granted intangibles tax refunds to any taxpayer who paid intangibles taxes on stock to the State of North Carolina for one or more tax years 1990 through 1994.
9. Taxpayers received a refund of intangibles tax through the *Smith/Shaver Class Action Settlement* during tax year 2000.
10. Taxpayers argue that they relied on the July 16, 2002 assessment notice reflecting corrected North Carolina taxable income of \$475,773 as determined by the Department to be the final determination of their 2000 North Carolina taxable income and that the Department should be estopped from further changing their North Carolina taxable income for the tax year 2000. Taxpayers also contend that the recovery of intangibles tax paid in prior years and subsequently held to be unconstitutional should not constitute taxable income in the year of recovery.

CONCLUSIONS OF LAW

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

1. A deduction from federal taxable income is allowed for refunds of state, local, and foreign income taxes included in a taxpayer's gross income. The deduction of \$23,078 claimed on Taxpayers' 2000 return was properly disallowed since Taxpayers were unable to substantiate that they received any refunds of state, local, and foreign income taxes during tax year 2000.
2. Taxpayers were qualified claimants under the *Smith/Shaver Class Action Settlement* and were entitled to receive a refund of the unconstitutional intangibles taxes they paid on stock during the tax years 1990 through 1994.
3. Refunds of State intangibles tax are not deductible under North Carolina law.
4. For residents of this State, "North Carolina taxable income" is the taxpayer's taxable income as determined under the Internal Revenue Code, adjusted as statutorily mandated for differences in State and federal law.
5. Federal taxable income is defined by the Internal Revenue Code as gross income less deductions and personal exemptions. Gross income is defined as all income from whatever source derived unless specifically excepted.
6. Section 111 of the Internal Revenue Code provides that gross income does not include income attributable to the recovery during the taxable year of an amount deducted in a prior taxable year to the extent such amount did not reduce the federal income tax imposed. Conversely, gross income includes income attributable to the recovery during the taxable year of an amount deducted in a prior taxable year to the extent such amount reduced the tax imposed.
7. The Department of Revenue has three years from the due date of the return or the date the taxpayer actually files the return, whichever is later, to propose an assessment of tax. There is no statutory provision prohibiting the making of an assessment for a given year after an assessment has already been made for that year. A new assessment can be made upon the discovery of new facts. The February 24, 2004 assessment of additional tax and interest due as a result of the disallowance of the deduction of \$23,078 for state and local income tax refunds was timely proposed by the Department.
8. A proposed assessment does not serve as an estoppel to make another timely assessment.
9. In *Henderson v. Gill* 229 N.C. 313, 49 S.E. 2d 754 (1948), the North Carolina Supreme Court held that the State cannot be estopped from exercising a governmental or sovereign right. The State's right to collect the correct tax owed by Taxpayers for the tax year 2000 may not be estopped.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessment for the tax year 2000 to be lawful and proper.

Taxpayers contend that the Department should be estopped from further correcting their 2000 North Carolina taxable income from the amount the Department had previously determined and reflected on an assessment notice dated July 16, 2002. Taxpayers argue that they relied on that previous determination to be final, thereby closing their 2000 return from any additional changes. The Department of Revenue has the statutory authority and responsibility to ensure that the residents of North Carolina report and pay their correct income tax liabilities. There is no statutory provision prohibiting the Department from assessing additional tax for a particular year after an assessment has already been made for that year. If the Department discovers that additional tax is due from a taxpayer within three years from the due date of the return or the date the taxpayer actually files the return, whichever is later, the law requires the Department to notify the taxpayer of the deficiency. Therefore, the Department has the right to issue multiple assessments for a given tax year upon the discovery of new facts, providing the assessments are issued within the time period prescribed by the statute of limitations. The Assistant Secretary also notes that in *Henderson v. Gill* 229 N.C. 313, 49 S.E. 2d 754 (1948), the North Carolina Supreme Court held that "...facts, however potent in creating an estoppel in ordinary transactions between individuals, do not estop the State in the exercise of a governmental or sovereign right." Thus, the State's right to collect the correct tax owed by Taxpayers for the tax year 2000 may not be estopped.

Taxpayers also contend that the recovery of intangibles tax paid in prior years and subsequently found to be unconstitutional by the courts should not constitute taxable income in

the year of recovery. Husband likens the recovery of intangibles tax from the *Smith/Shaver Class Action Settlement* to the recovery of stolen property from a thief, arguing that the recovery cannot be classified as income since the ownership of the property in question was never technically surrendered. However, the reason for a recovery has no bearing on the taxability of the recovery. Whether or not the recovery must be included in a person's gross income turns on the tax benefit rule, which requires a person to include a recovery in income in the year received to the extent the deduction or credit the person took for the recovered amount reduced their tax in the earlier year. Federal tax law provides a deduction for state intangibles taxes paid during the year for taxpayers who itemize their deductions. Therefore, whether or not Taxpayers' recovery of the intangibles taxes paid during tax years 1990 through 1994 must be included in Taxpayers' gross income for tax year 2000 turns on whether Taxpayers claimed deductions in tax years 1990 through 1994 for intangibles taxes paid during those years. Taxpayers agree that the recovery amount was included on their 2000 federal return as income; however, at the hearing, Husband indicated that his inclusion of the recovery as income on the 2000 federal return was a mistake. Husband acknowledged at the hearing that Taxpayers have not amended their 2000 federal return to remove the recovery from income. Seeing no reason why Taxpayers would not have utilized the available deductions in tax years 1990 through 1994 coupled with the fact that Taxpayers included the recovery in their 2000 federal taxable income, the Assistant Secretary concludes that the recovery of intangibles taxes in tax year 2000 was properly included in Taxpayers' gross income.

The Assistant Secretary finds that Taxpayers are not entitled to claim a deduction of \$23,078 for state and local income tax refunds on their 2000 State income tax return and that the Department's disallowance of the deduction was proper. Therefore, the proposed assessment for

the tax year 2000 is hereby sustained in its entirety and is determined to be finally due and collectible.

Made and entered this 22 day of September, 2004.

Signature_____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue