

**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 2001, )  
2002, and 2003 by the Secretary of Revenue )  
of North Carolina )  
vs. )  
[Taxpayer 1] and [Taxpayer 2], Taxpayers )

**FINAL DECISION**  
Docket No. 2005-370

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon an 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 2001, 2002, and 2003. At Taxpayers’ request, the hearing was conducted via written communication and the Assistant Secretary allowed Taxpayers until February 22, 2006, to provide any arguments, documents, or other evidence in support of their objections to the assessments. 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 interest for the tax years 2001, 2002, and 2003 were mailed to Taxpayers on August 2, 2005. Taxpayers filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.

## **ISSUES**

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

1. Are Taxpayers entitled to deductions for charitable contributions and business expenses in excess of the amounts allowed by the Department?
2. Are the assessments for additional income tax, penalties, and interest proposed against Taxpayers for the taxable years 2001, 2002, and 2003 lawful and proper?

## **EVIDENCE**

The evidence presented by 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' federal income tax return for taxable year 2001, a copy of which is designated as Exhibit PT-2.
3. Taxpayers' North Carolina individual income tax return for taxable year 2001, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' federal income tax return for taxable year 2002, a copy of which is designated as Exhibit PT-4.
5. Taxpayers' North Carolina individual income tax return for taxable year 2002, a copy of which is designated as Exhibit PT-5.
6. Taxpayers' federal income tax return for taxable year 2003, 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. Notice of Individual Income Tax Assessment for the taxable year 2001 dated August 2, 2005, a copy of which is designated as Exhibit PT-8.
9. Notice of Individual Income Tax Assessment for the taxable year 2002 dated August 2, 2005, a copy of which is designated as Exhibit PT-9.

10. Notice of Individual Income Tax Assessment for the taxable year 2003 dated August 2, 2005, a copy of which is designated as Exhibit PT-10.
11. Field audit reports of individual income tax for taxable years 2001, 2002, and 2003, copies of which are collectively designated as Exhibit PT-11.
12. Letter from John D. Boyd, Revenue Field Auditor, to Taxpayers dated February 4, 2005, a copy of which is designated as Exhibit PT-12.
13. Letter from John D. Boyd to Taxpayers dated February 22, 2005, a copy of which is designated as Exhibit PT-13.
14. Document entitled Waiver of Time Limitation, a copy of which is designated as Exhibit PT-14.
15. Letter from Taxpayers to North Carolina Tax Review Board dated August 17, 2005, a copy of which is designated as Exhibit PT-15.
16. Letter from Carla R. Helms, Administrative Officer in the Personal Taxes Division, to Taxpayers dated September 1, 2005, a copy of which is designated as Exhibit PT-16.
17. Letter from Taxpayers to E. Norris Tolson dated October 6, 2005, a copy of which is designated as PT-17.
18. Letter from Eugene J. Cella to Taxpayers dated November 4, 2005, a copy of which is designated as PT-18.
19. Letter from Taxpayers to Eugene J. Cella dated November 14, 2005, a copy of which is designated as PT-19.
20. Letter from Eugene J. Cella to Taxpayers dated November 15, 2005, a copy of which is designated as PT-20.
21. Schedule entitled Autolog 1 for taxable year 2001, a copy of which is designated as Exhibit PT-21.
22. Schedule entitled Autolog 2 for taxable year 2002, a copy of which is designated as Exhibit PT-22.
23. Schedule entitled Autolog 3 for taxable year 2003, a copy of which is designated as Exhibit PT-23.
24. Form 1099-MISC for tax year 2001 issued to Husband by newspaper publishing company, a copy of which is designated as Exhibit PT-24.

Taxpayers submitted Taxpayer's Brief for Tax Hearing on February 22, 2006, 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. Taxpayers are, and at all material times were, natural persons, sui juris, and citizens and residents of North Carolina.
2. Taxpayers' tax return preparer was indicted by the Department of Revenue pursuant to G.S. 105-236(9a) for willfully aiding, assisting in, procuring, counseling, or advising the preparation, presentation, or filing of a fraudulent or false return, and was convicted by the County Superior Court for aiding or assisting in the preparation of fraudulent North Carolina individual income tax returns.
3. On returns prepared by Taxpayers' tax return preparer, deductions for such items as contributions and job-related expenses were consistently overstated without factual records to support the deductions. For this reason, Taxpayers' 2001 through 2003 returns were examined.
4. Taxpayers claimed itemized deductions on their federal income tax returns as follows. These deductions were also claimed for purposes of North Carolina taxable income.

<b><u>Deduction Claimed</u></b>	<b><u>2001</u></b>	<b><u>2002</u></b>	<b><u>2003</u></b>
Medical	\$ 0.00	\$ 245.00	\$ 0.00
Taxes	3,339.00	3,773.00	4,242.00
Interest	11,819.00	11,037.00	10,180.00
Gifts to Charity	4,860.00	2,065.00	2,150.00
Unreimbursed employee expenses	<u>9,702.00</u>	<u>10,195.00</u>	<u>12,970.00</u>
Total	<u>\$29,720.00</u>	<u>\$27,315.00</u>	<u>\$29,542.00</u>

5. At the auditor's request, Taxpayers furnished documentation for each tax year that adequately substantiated the itemized deductions claimed, except for gifts to charity and job expenses.
6. The auditor allowed \$500.00 for gifts to charity for each tax year although the sole documentation furnished by Taxpayers was a church contribution statement for tax year 2002 that verified only \$20.00.

7. Taxpayers claimed the following expenses on their 2001 federal Schedule C relating to Husband's newspaper delivery service:

Car and Truck Expenses	\$ 7,445.00
Supplies	<u>2,290.00</u>
Total	<u>\$ 9,735.00</u>

8. Taxpayers did not provide any documentation to substantiate supply expenses of \$2,290.00 claimed on Husband's 2001 Schedule C.
9. The auditor allowed expenses of \$3,204.00, the amount of income reported, on the 2001 Schedule C. The 2001 Form 1099-MISC reflects direct sales to Husband of more than \$5,000.
10. Husband claimed the following mileage on each return:

	<u>2001</u>	<u>2002</u>	<u>2003</u>
Schedule C-newspaper delivery	21,580		
Schedule A-Form 2106-EZ	21,622	22,943	26,117

11. In support of the mileage claimed for Husband's employment as a car salesman and a loan sales representative, he furnished printed schedules for each tax year, which he called autologs. Taxpayers also furnished a printed schedule in support of the mileage claimed on Husband's 2001 Schedule C.
12. Husband's autologs show the date, general business purpose, odometer reading, and the business, commuter, and personal miles. The autologs do not show the business destinations.
13. Although requested to do so, Husband has not provided supporting records, such as a daily planner or other documentary evidence, to support the business purposes shown on his autologs nor has he provided the business destinations.
14. Taxpayers did not provide any documentation to substantiate other business and meals and entertainment expenses claimed on Form 2106-EZ, Unreimbursed Employee Business Expenses, for each tax year.
15. Husband was employed by three different loan companies during 2002 and 2003. The business purposes shown on the autologs for each employment were general statements such as, "prospect," "sell loan proposals," "get loan docs signed," "deliver loan docs," "pick up docs," and, "obtain loan packages." Husband did not furnish the business destinations or proof of any of the business purposes shown on the logbooks.

16. Discrepancies were found with several of the business purposes shown in the autologs. For example, in January 2003, when Husband was employed as a loan representative, he lists the following business purposes: “transport customer,” “demonstration tapes,” and, “drive to location to pick up driver.” These types of business purposes do not relate to the nature of Husband’s work as a loan representative. These same entries were also listed during 2001 and January 2002 when Husband was employed as a car salesman.
17. In connection with Husband’s loan sales for tax years 2002 and 2003, the auditor reduced Husband’s claimed business miles to 10,000 for each tax year. Although Husband’s records were not adequate to support the mileage claimed, the auditor allowed 10,000 miles each year based on the nature of Husband’s employment.
18. No mileage was allowed for 2001 when Husband was employed as a car salesman because information was not provided to show that Husband was not eligible for reimbursement from his employer for expenses incurred.
19. Taxpayers contend that the autologs provided are adequate and reliable and that the mileage claimed on their returns should be allowed.
20. Notices of Individual Income Tax Assessment reflecting the adjustments for the tax years 2001, 2002, and 2003 were mailed to Taxpayers on August 2, 2005.
21. The auditor asserted the twenty-five percent negligence penalty for the tax year 2001 because Taxpayers understated taxable income by an amount equal to twenty-five percent or more of gross income. Taxpayers did not understate taxable income by at least twenty-five percent for tax years 2002 and 2003. The ten percent negligence penalty was asserted for tax years 2002 and 2003.
22. Taxpayers filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.

### **CONCLUSIONS OF LAW**

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

1. The law is well settled that the ultimate responsibility for a correct tax return lies with the taxpayer who signs and files the return, even if someone else prepares the return.
2. 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. 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). To claim any deductions, a taxpayer must be able to prove that the expenses were in fact paid or incurred.

3. Taxpayers must exercise due diligence to comply with the tax laws by claiming only those deduction and expenses to which they are entitled and for which they have maintained proper documentation.
4. North Carolina taxable income means the taxpayer's taxable income as determined under the Internal Revenue Code, adjusted for certain differences in federal and State law.
5. G. S. 105-258 provides that the Secretary of Revenue has the power to examine any books, papers, records, or other relevant data for the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the tax liability of a person, or collecting any such tax. If the taxpayer does not provide adequate and reliable information upon which to compute his tax liability, G.S. 105-241.1 provides that 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.
6. A taxpayer is allowed deductions for amounts paid during the taxable year for certain nonbusiness expenses. The deductions include but are not limited to qualifying taxes, interest paid, charitable contributions, and miscellaneous deductions. Taxpayers' nonbusiness 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.
7. For cash contributions of less than \$250.00, a taxpayer is required to keep a cancelled check, a receipt, or other reliable written records from the charitable organization. For contributions of \$250.00 or more, a taxpayer must have an acknowledgment of the contribution from the qualified organization. For noncash contributions, a taxpayer 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 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.

8. Pursuant to sections 162 and 212 of the Internal Revenue Code, a taxpayer is allowed to deduct 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. 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.
9. Internal Revenue Code section 274(d) requires substantiation of the amounts claimed by adequate records or by other sufficient evidence corroborating the claimed expenses. 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, and documentary evidence which, in combination, are sufficient to establish each element of the expense.
10. 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. Taxpayers have failed to provide the required documentation to substantiate other business expenses or meals and entertainment expenses claimed on their returns. With regard to the autologs, Husband has not shown that the autologs were prepared contemporaneously as required by Internal Revenue Code section 1.274-5T(c)(2). Furthermore, the autologs fail to establish all of the required elements that a taxpayer must provide to support a deduction for transportation expenses.
11. In this case, Taxpayers have not furnished sufficient information to establish that they are entitled to deductions for charitable contributions or to business expenses in excess of the amounts allowed by the Department.
12. A twenty-five percent negligence penalty is imposed pursuant to G.S.105-236(5)b 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. A penalty of \$340.50 was properly asserted for the tax year 2001. 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. Penalties of \$64.70 and \$86.80 were properly asserted for the tax years 2002 and 2003, respectively.



**DECISION**

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessments for the tax years 2001, 2002, and 2003 to be lawful and proper and 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 12th day of May, 2006

Signature \_\_\_\_\_

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings  
North Carolina Department of Revenue