

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessments of Individual)
Income Tax, Penalties, and Interest for the)
Taxable Years 1993 and 1994 by the)
Secretary of Revenue of North Carolina)
vs.)
[Taxpayers])

FINAL DECISION
Docket No. 2002-558

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon an application for a hearing by [Taxpayers, Husband and Wife], wherein they protested the proposed assessments of individual income tax, penalties, and interest for the taxable years 1993 and 1994. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1. At Taxpayers' request, the hearing was conducted via written communication and is based on all information presented for the record as of November 22, 2002.

ISSUE

The issues to be decided in this matter are:

1. Did the auditor properly determine Taxpayers' income based on the information available?
2. Are the assessments proposed against Taxpayers for the taxable years 1993 and 1994 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 1993, a copy of which is designated as Exhibit PT-2.

3. Taxpayers' North Carolina individual income tax return for the taxable year 1994, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina individual income tax return for the taxable year 1995, a copy of which is designated as Exhibit PT-4.
5. Taxpayers' federal individual income tax return for the taxable year 1993, a copy of which is designated as Exhibit PT-5.
6. Taxpayers' federal individual income tax return for the taxable year 1994, a copy of which is designated as Exhibit PT-6.
7. Taxpayers' federal individual income tax return for the taxable year 1995, a copy of which is designated as Exhibit PT-7.
8. Notice of Individual Income Tax Assessment for the taxable year 1993 dated December 3, 1996, a copy of which is designated as Exhibit PT-8.
9. Notice of Individual Income Tax Assessment for the taxable year 1994 dated December 3, 1996, a copy of which is designated as Exhibit PT-9.
10. Revenue Field Auditor's Report for the taxable year 1993 dated November 15, 1996, a copy of which is designated as Exhibit PT-10.
11. Revenue Field Auditor's Report for the taxable year 1994 dated November 15, 1996, a copy of which is designated as Exhibit PT-11.
12. Revenue Field Auditor's Report for the taxable year 1995 dated November 15, 1996, a copy of which is designated as Exhibit PT-12.
13. Letter from [Taxpayers' attorney] to the Department of Revenue dated December 18, 1996, a copy of which is designated as Exhibit PT-13.
14. Letter from Gregory B. Radford, former Assistant Director of the Personal Taxes Division, to [Taxpayers' attorney] dated February 14, 1997, a copy of which is designated as Exhibit PT-14.
15. Letter from Curtis A. Rich, Revenue Field Audit Supervisor, to [Taxpayers' attorney] dated July 17, 1997, a copy of which is designated as Exhibit PT-15.
16. Letter from M. W. Goodin, Field Auditor, [Taxpayers' attorney] dated March 2, 1998, a copy of which is designated as Exhibit PT-16.
17. The Assistant Secretary's Final Decision in the matter of the sales and use tax assessment for the period November 1, 1993 through September 30, 1996, dated August 29, 2001, a copy of which is designated as Exhibit PT-17.
18. Letter from W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division, to James P. Ashburn dated September 6, 2001, a copy of which is designated as Exhibit PT-18.

19. Notice of intent to petition the Tax Review Board for review of the Assistant Secretary's Final Decision regarding the sales and use tax assessments filed on Husband's behalf by [an attorney] dated September 27, 2001, a copy of which is designated as Exhibit PT-19.
20. Petition for Administrative Review of the Assistant Secretary's Final Decision regarding the sales and use tax assessments filed on Husband's behalf by [an attorney] dated September 27, 2001, a copy of which is designated as Exhibit PT-20.
21. Brief for the Secretary of Revenue, regarding Husband's petition for review of the Assistant Secretary's final decision in the matter of the sales and use tax assessments dated March 11, 2002, a copy of which is designated as Exhibit PT-21.
22. The Administrative Decision of the Tax Review Board in the matter of the Assistant Secretary's final decision regarding the sales and use tax assessments dated June 17, 2002, a copy of which is designated as Exhibit PT-22.
23. Letter from W. Edward Finch, Jr., to [an attorney] dated July 18, 2002, a copy of which is designated as Exhibit PT-23.
24. Letter from [an attorney] to W. Edward Finch, Jr., dated August 15, 2002, a copy of which is designated as Exhibit PT-24.
25. Letter from Eugene J. Cella to Taxpayers dated September 9, 2002, a copy of which is designated as Exhibit PT-25.
26. Letter from [an attorney] to Eugene J. Cella dated October 21, 2002, a copy of which is designated as Exhibit PT-26.
27. Letter from Eugene J. Cella to Taxpayers dated October 22, 2002, a copy of which is designated as Exhibit PT-27.

In lieu of appearing at the hearing, Taxpayers requested that the matter be resolved via written communication. The Assistant Secretary granted the request and allowed Taxpayers until November 22, 2002, to furnish information in support of their objections to the assessments. Taxpayers did not provide any additional information.

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. During the tax years at issue, Husband operated several [retail convenience stores]. In conjunction with a sales and use tax audit, the examining auditor, using a source and application of funds audit method, determined that there was a significant discrepancy between the amounts deposited into Taxpayers' bank accounts and the total income

reported on their income tax returns. The auditor determined that Taxpayers had underreported their income by \$67,764.19, \$100,250.38, and \$20,136.82 for the tax years 1993, 1994, and 1995, respectively.

3. The auditor increased the deduction for one half of self-employment tax resulting from the increase in self-employment income for the tax years 1993 and 1994. Federal law allows self-employed individuals to deduct one half of their self-employment tax. The auditor made a mathematical error in computing the increased deduction for self-employment tax for the tax year 1994.
4. Because Taxpayers reported State taxable income of negative \$25,229.00 on their North Carolina return for the tax year 1995, the auditor's adjustments resulted in no additional tax due for that year.
5. The auditor imposed the 10 percent late payment penalty and the 10 percent negligence penalty for the tax years 1993 and 1994.
6. Notices of Individual Income Tax Assessment reflecting the auditor's adjustments for the tax years 1993 and 1994 were mailed to Taxpayers on December 3, 1996.
7. Taxpayers objected to the proposed assessments and timely requested an administrative tax hearing before the Secretary of Revenue.
8. Subsequent to receiving Taxpayers' hearing request, the auditor adjusted the proposed sales and use tax assessments to allow beneficial adjustments for properly documented cigarette manufacturer "buy down funds," gasoline sales, and wholesale sales because these sales are not subject to the sales and use tax. However, for individual income tax purposes, these sales are fully taxable requiring no adjustment to the income tax.
9. The auditor also adjusted the audit report to decrease the ending inventory for the tax year 1994 from \$134,879.00 to \$86,322.00 because Husband had used the retail value rather than the cost. This adjustment decreased the understatement of income for 1994 from the \$100,250.38 previously determined to \$51,693.00. This change flowed through to the 1995 schedule C resulting in a corresponding decrease in beginning inventory on Husband's schedule C (Profit or Loss From Business) for the tax year 1995 effectively increasing the understatement of income for that year from \$20,126.82 to \$68,683.82. In error, the auditor did not amend the proposed assessment for the tax year 1994 to reflect the decreased understatement of income nor did he propose an assessment for the tax year 1995 resulting from the corresponding increase in income.

Allowing the auditor's adjustments, Taxpayer's State individual income tax liability for the tax year 1994 is recomputed as follows:

State taxable income previously determined	\$96,546.53
Less: Decrease in income due to inventory revaluation	48,557.00
Additional self-employment deduction as corrected	<u>228.29</u>
Corrected taxable income	\$47,761.24
Tax as corrected	\$ 3,132.00
Late payment penalty	313.20
Negligence penalty (10%)	313.20
Interest (to 2/15/03)	<u>2,003.28</u>
Total	<u>\$ 5,761.68</u>

Because of the general three-year statute of limitations on assessments, the Department is prohibited from assessing the additional tax for the tax year 1995.

10. Taxpayers also requested an administrative tax hearing with respect to the sales and use tax assessments. The hearing on the sales and use tax assessments was held on October 31, 2000. The Assistant Secretary's Final Decision sustaining the sales and use tax assessments was mailed to Taxpayers' attorney on August 29, 2001. Taxpayers timely filed a petition to the Tax Review Board for administrative review of the Final Decision. The Board confirmed the Assistant Secretary's Final Decision and served a copy of its administrative decision on Taxpayers' attorney on June 17, 2002.

CONCLUSIONS OF LAW

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

1. The Secretary of Revenue may require a taxpayer to furnish records, books of account, and any other information necessary to verify the correctness of his or her income tax return.
2. In cases where the taxpayer does not provide adequate and reliable information upon which his liability may be determined, 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.
3. A taxpayer is required to compute net income using a method of accounting that is consistent with respect to both income and deductions. Where the method does not accurately reflect the taxpayer's income, the computation is required to be made by a method which in the opinion of the Secretary of Revenue does accurately reflect his income, following as nearly as practical the federal practice unless contrary to the context and intent of State law. The method used must be reasonable.
4. A penalty of 10 percent of the tax is required for negligent failure to comply with any of individual income tax laws without intent to defraud.

5. In the case of failure to pay any tax when due, without intent to evade the tax, a penalty of 10 percent of the tax (minimum \$5.00) is required.

DECISION

Except for matters pertaining to whether sales of certain items (gasoline, cigarettes, wholesale sales) are subject to sales and use tax, the individual income tax issues are essentially the same as those previously heard at the sales and use tax hearing and at the Tax Review Board hearing with regard to the determination of unreported income. The Assistant Secretary previously held in the sales tax hearing that the records furnished by Taxpayers were not sufficient to overcome the presumption of correctness of the assessment. The Assistant Secretary further held that Taxpayers failed to demonstrate that the indirect audit methodology used by the auditor was flawed. Taxpayers petitioned the Tax Review Board for administrative review of the Assistant Secretary's decision in the matter of the sales and use tax. Upon review, the Board confirmed the Assistant Secretary's decision. Further, Taxpayers have not furnished any additional information that would indicate that the individual income tax assessments are in error.

Based on the foregoing findings of fact and conclusions of law, the Assistant Secretary finds that the auditor properly determined Taxpayers' income based on the best information available. Therefore, the proposed individual income tax assessment for the tax year 1993 and the proposed individual income tax assessment for the tax year 1994 as herein modified, are lawful and proper and are declared to be finally determined and immediately due and collectible together with interest as allowed by law.

Made and entered this 18th day of February, 2003.

Signature_____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue