IN THE OREGON TAX COURT
MAGISTRATE DIVISION
Income Tax

ORMOND H. ORMSBY and BARBARA J. ORMSBY,	)	
Plaintiffs,	)	TC-MD 020034A
v.	)	
DEPARTMENT OF REVENUE, STATE OF OREGON,	)	
Defendant.	)	**DECISION**

Ormond and Barbara Ormsby, Plaintiffs, have appealed adjustments to their personal income tax liabilities for the 1996 and 1997 tax years. They appeared at trial and made their arguments. The Department of Revenue, Defendant, was represented by Rae Parsons, of its staff.

For the 1996 tax year, Defendant adjusted Plaintiffs' return for income and expense items that resulted in a net total adjustment of $117,082. The greatest changes were a $12,281 decrease to Schedule A expenses, and an increase to Schedule C net income of $103,461. In 1997 the total net change was $79,771, with the decrease to Schedule A expenses and increase to Schedule C net income respectively $26,252 and $55,441. The main issue in examining the legitimacy of these adjustments is Plaintiffs' allegation that they are the victims of an abuse of power by the Oregon Department of Revenue. Considerable effort was devoted by Plaintiffs to demonstrating this conclusion. The court gave Plaintiffs every opportunity to prove this point.

After reviewing the evidence, the conclusion of the court is that while the audit was a harrowing experience for Plaintiffs, the cause of that distress was not the qualities of the agency staff who dealt with them. Instead, the finding of the court is that the reason the

audit so quickly, and dramatically, polarized Plaintiffs is because it required them to examine, in painstaking and painful detail, the circumstances under which a quarter of a million dollars of their money was lost in an unsuccessful business.

Plaintiffs demonstrated that the agency's auditor, Rae Parsons, was not a certified public accountant. The court does not see this as a deficiency, for the task to which Parsons was assigned did not involve public accountancy. It was shown that Parsons was not a member of the Internal Auditor Professional Association. However, Parsons is not an internal auditor. Instead, Parsons is the possessor of a bachelor's degree in accounting who, after periods of self-employment and working as a staff accountant, began with the Department of Revenue in 1999, and since then has had the duty of examining Oregon income tax returns. As reviewing Oregon income tax returns is a specialized field, it is hardly surprising that in performing this function she holds no professional licenses and has had only limited training from outside the agency. In her demeanor during the two days of trial, unassisted by counsel, and often under grueling examination, Parsons was very professional. Plaintiffs' point that Parsons must have lacked expertise because her final conclusions subsequently departed from the findings of her preliminary audit report does not carry much weight. The changes between the preliminary audit report and Defendant's final assessment are not as to the method of the audit, but instead due to Plaintiffs' providing more accurate information. The court does not agree with Plaintiffs' assertion that the Department of Revenue's auditor lacked the skills, or professionalism, to examine their return.

Plaintiffs' next contention was that Department of Revenue staff was deceptive in their dealings. Two specific instances were referenced. In the first, Plaintiffs presented an instance in which agency staff, asked to sign for the receipt of documents proffered by the

Ormsbys, reportedly gave the signature "Ponce de Leon," the ill-fated Spanish explorer who searched Florida for the fountain of youth. The Department of Revenue explained that it does have an employee, Rome Deleon, who was in a position where he would be expected to sign for documents. In its review of the disputed signature the court sees the mark of Mr. Deleon. The second example presented by Plaintiffs occurred when Ormond Ormsby, asking to speak with Parson's supervisor, was directed to Gary Helig. The Ormsbys describe this as a deceptive practice, characterizing Helig as a "mentor" or "cubicle mate." Parsons explained that Gary Heilig was her supervisor for purposes of meeting with Plaintiffs as she could not issue a Notice of Deficiency, an indispensable requirement for seeking additional tax from Plaintiffs, without his assent. The court finds this to be an important point. Although Heilig may not have had the unilateral ability to terminate or otherwise discipline Parsons, the fact that he controlled the results of her audit is enough to justify their good-faith belief that they were responding to Plaintiffs' request to speak to a supervisor when they presented Heilig. The court does not believe these two instances demonstrate Defendant's plan to deceive or mislead Plaintiffs.

Plaintiffs' third point as to the manner in which they were audited dealt with the intensity of the audit. Plaintiffs' characterized Defendant's method as an example of the "throw mud on the wall and see what sticks" approach. Plaintiffs alleged that Defendant arbitrarily selected facts which were misconstrued to describe situations which did not exist, that the body of tax law was ignored, and that Defendant never provided to Plaintiffs the methodology on which it based its adjustments. The legitimacy of this assertion is best tested by focusing on the individual issues in Defendant's adjustment of Plaintiffs' income tax liability.

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The calculation of gross income: Barbara Ormsby is a flight attendant for Delta Airlines, and the amount of income she earned from commissions on sales of duty-free items is a point in controversy. In 1996 her employer reported $493 in commission sales on her W-2. As to 1997, Barbara Ormsby testified that Delta no longer reported commission sales on her W-2, and that her log showed a total of $344 in commissions. The court finds this number to be Plaintiffs' commission income.

Income from other sources consisted of unreported taxable pension distributions, capital gains, and dividends. For 1996 these produced an increase in income above that reported on the return of $4,784. In 1997 that figure was $301. Plaintiffs did not dispute Defendant's statement that the income had been omitted.

Schedule A expenses: State income taxes paid, as verified by the Plaintiffs' W-2s and checked by Defendant's records, were $4,656 for 1996 and $4,050 for 1997. These taxes paid were less than the taxes claimed on the 1996 and 1997 returns, at $5,547 and $4,329. In the absence of additional W-2s, or other proof of payment of state tax, the audit result is persuasive. Real estate taxes paid by Plaintiffs, even after the adjustments made during trial, were less than the $5,079 and $6,536 stated on the returns. The court's review of Plaintiffs' records do not account for the discrepancy. For 1996 Plaintiffs' claimed $25 as a personal property tax. That amount was denied, for reasons the court agrees are correct, upon audit when it was discovered that this sum was a vehicle registration fee.

Home mortgage interest, as stated on the return, was $16,061 for 1996 and $23,177 for 1997, paid to MBL Life Assurance Corporation, Beneficial Oregon, and Atlantic Mortgage. However, interest paid according to Forms 1098 only totaled $9,179

and $15,449. In the absence of other proof of interest paid the adjustment stands. For 1996 and 1997 Plaintiffs claimed contributions of approximately $2,000. Upon audit, and at trial, no checks or other proof of payment were presented as to any of the organizations listed on Plaintiffs' tax returns. Although Defendant chose to deny the deduction in full, from the court's perspective it is reasonable that a family would have some level of charitable giving, especially as the Ormsbys attend church. The decision of the court is that a contribution deduction of $1,000 is appropriate for each year.

The Ormsbys both claimed employee business expenses for each year. For Barbara Ormsby, those expenses were in connection with her duties on overseas flights, and consisted of meals and incidentals, accessories to wear with her uniform, and an implement carrier. The specific sum in controversy is the amount paid by Barbara Ormsby in excess of the reimbursed amount as shown on her W-2s, with meals limited to half of their cost and incidental expenditures are figured at their actual expense, as set out in IRC section 274(n). In 1996 Plaintiffs claimed some $2,000 as unreimbursed employee expenses for Barbara Ormsby; for 1997 that figure was increased 100 percent, to $4,110.

No receipts were provided. Defendant was also concerned that the uniform accessories and implement carrier could be adapted for personal use. Another area of contention was the number of meals Barbara Ormsby would have consumed and when and where they would have been eaten. Although for 1996 no audit adjustment was made to Barbara Ormsby's employee business expenses, for 1997 Defendant decreased the amount claimed on the return by $2,885. This result is not without its merits, however, the conclusion of the court is that a flight attendant is restricted as to when he or she may take their meals, and that the adaptability of an attendant's items for personal use is limited. On this reasoning the court will set Barbara Ormsby's unreimbursed employee business

expenses for 1997 at $2,250, an amount which, while substantially less than the $4,110 sum claimed by Plaintiffs, is nonetheless a 25 percent increase over the previous year. The court's last thought on this topic is that this amount may be too generous, for Barbara Ormsby's employer reimbursements, which were presumably done on the basis of overseas flights, declined slightly from 1996 to 1997.

Ormond Ormsby's employee business expenses are much more complicated. In addition to his business as a financial planner, he was also the 100 percent shareholder of a separate business, United Recycling. On his 1997 return he reported his wages from United Recycling. He then deducted, as an employee business expense, uncashed paychecks in the amount of $4,800. Plaintiffs explained that his payroll checks were done by a payroll preparation company. If United Recycling had the funds, Ormsby explained, he would cash his check. When insufficient funds were present to cover the payroll, Ormsby would retain the check.

Defendant disallowed this $4,800 deduction for a host of reasons. From the court's perspective, the most important is the matter of verification. A taxpayer must be able to verify his or her expenses. Although the court is willing to extend some leniency as to proof of charitable contributions, or Barbara Ormsby's unreimbursed employee expenses, it is remarkable that checks are issued and not cashed. Ormsby is very believable in his testimony that key individuals in a struggling business often forgo their pay. At the same time, it is not unreasonable to require them to prove that they did so, and Plaintiffs have not produced a single unnegotiated check. Moreover, an important distinction is that the most accurate characterization of Ormsby is not as an employee or officer of the corporation. He was a 100 percent shareholder. As such the best description of his foregone wages would be as a shareholder loan, or a contribution to capital. In neither case is the tax

treatment advantageous. Defendant's disallowance of Ormsby's asserted employee business expenses is sustained. Moreover, Plaintiffs' attempted to double any deduction which might be attributable to Ormsby's payroll checks by claiming them again on the 1997 Schedule A as union or professional dues. The sum is not appropriate in either category.

Schedule C expenses: Closely related to the prior discussion of unnegotiated checks in the context of Schedule A employee business expenses is the expenses for unreimbursed purchases for United Recycling, Inc. taken on the Schedule C. Again, Ormsby is not a shareholder-employee, but its 100 percent shareholder. It is extremely realistic to presume that as Ormsby made the purchases on behalf of the corporation, it was his expectation that he would be reimbursed at some future date as funds became available. It is also obvious that, as the sole shareholder, Ormsby would have control over the time and manner of reimbursement. In this situation the expenditures are best treated as a loan to the corporation, or a contribution to its capital, and not as a Schedule C expense. Defendant's adjustments are sustained on this reasoning, although lack of substantiation of the expenses would be an alternative rationale.

Another Schedule C adjustment dealt with equipment leases between Ormsby and his corporation, United Recycling, Inc. The business was thinly capitalized. Ormsby had to take on personal liability to purchase the necessary equipment, a wheeled loader, field loader, and roll crusher. He in turn leased the property to his business. At trial Orsmby spoke as to how the leasing of assets is a common business practice. However, while the leasing of assets is a common business practice, the manner in which these leases were treated on Plaintiffs' Schedule C is remarkable. Deductions for the depreciation of the equipment were taken, and principle and interest payments were claimed as rent expense.

Although Ormsby's status as 100 percent shareholder of the corporation and purchaser of the equipment made him both lessor and lessee, he cannot claim the desirable tax consequences of each end of the transaction on his personal return. That point is fatal to Plaintiffs' arguments, without regard to Defendant's other claims as to the validity of the transactions, the source and amount of the payments made, or the character of the leases as purchase and sale leases rather than business leases.

Other Schedule C adjustments were to the vehicle expenses. Plaintiffs elected to calculate their vehicle expenses using the actual mileage method, but did not keep records of odometer reading, destination, and business that took place, nor were receipts kept. No allowance was made for personal use. Despite these deficiencies the audit only decreased the 1997 return's vehicle expense from $4,941 to $4,130. The audit as to 1996 decreased that return's vehicle expense from $7,450 to $4,956. Plaintiffs did not show that their returns' asserted vehicle expense was more reliable than the results of the audit. Along with the depreciation of the United Recycling equipment discussed earlier, Plaintiffs claimed depreciation as to their vehicle. Defendant denied this deduction, for proper reasons. A taxpayer cannot depreciate a vehicle for which expenses have been claimed according to actual milage.

Another Schedule C item is office expenses and postage. Plaintiffs claimed office expenses of $1,147 in 1996 and $12,772 in 1997. Defendant's audit only found respective expenses of $356 and $219. Plaintiffs did not demonstrate the reliability of their return, and particularly did not show how they came to claim a figure six times as great as their apparent actual expenses in 1997. On the other hand the audit produced a net increase in the deduction available for postage expenses over the two years at issue; the audit also resulted in an increase to rent expense for the 1996 year.

Schedule C deductions as to meal and phone expense were the subject of some discussion. Plaintiffs told of their need for meal and entertainment expenses, and multiple telephones and telephone lines, but did not show that the amount of money spent in these areas was greater than that found on audit. Although the adjustment to the meal and entertainment expense was comparatively minor, the adjustment to phone expenses showed the returns for each year had been overstated by a factor of three. Less attention was focused upon an even more remarkable adjustment. For 1996 and 1997 Plaintiffs asserted legal and professional expenses of $54,882 and $7,300. On audit Defendant could find no such expenditures. Plaintiffs presented no proofs of these expenses at trial.

1997 dependency exemption: Upon audit Defendant disallowed a dependency exemption for Plaintiffs' daughter, Brianna, as she was 19 years old and sufficient proofs had not been presented under IRC Section 151. At trial Plaintiffs made a sufficient case to meet this test. The dependency exemption claimed on the return is restored.

Self employment tax deduction and understatement of income penalty: As a consequence of the changes worked at audit, the deduction for the self employment tax due on the federal return and the 20 percent penalty for understatement of income penalty apply.

* * * * *

The conclusion of the court is that Plaintiffs have not succeeded in their allegation that the Department of Revenue subjected them to an intensity of audit unwarranted under the circumstances. Aside from relatively minor changes ordered by the court as to the amount of commission income from duty free sales, contributions, the unreimbursed employee expenses of Barbara Ormsby, and the dependency exemption for Brianna, the

audit result has been endorsed by the court.

Other elements do not demonstrate Plaintiffs to have been the victims of an overzealous audit. To select only the most notable points, Plaintiffs did not speak as to how over the course of these two years some $60,000 in apparently nonexistent legal fees were claimed as deductions, why office expenses in 1997 were six times the sum that could be verified at audit, or how the same uncashed checks could be simultaneously claimed as deductions for Ormond Ormsby's unreimbursed employee expenses and as union or professional fees.

The court understands how Plaintiffs could be perplexed as to how, in pursuing a business that failed, they would end up owing a tax liability to the state of Oregon. However, the application of the state and federal codes to the manner in which Plaintiffs operated during the year at issue demonstrates that Plaintiffs' personal income tax liabilities is greater than was set out on their returns.

Now, therefore,

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IT IS THE DECISION OF THIS COURT that this appeal is granted only to the extent of the minor adjustments set out above.

Dated this _____ day of June, 2003.

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SCOT A. SIDERAS
MAGISTRATE

IF YOU WANT TO APPEAL THIS DECISION, FILE A COMPLAINT IN THE REGULAR DIVISION OF THE OREGON TAX COURT, FOURTH FLOOR, 1241 STATE ST., SALEM, OR 97301-2563. YOUR COMPLAINT MUST BE SUBMITTED WITHIN 60 DAYS AFTER THE DATE OF THE DECISION OR THIS DECISION BECOMES FINAL AND CANNOT BE CHANGED.

THIS DOCUMENT WAS SIGNED BY MAGISTRATE SCOT A. SIDERAS ON JUNE 18, 2003. THE COURT FILED THIS DOCUMENT ON JUNE 18, 2003.