

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 1994 through 1998 by the)
Secretary of Revenue of North Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 2002-29

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, on February 12, 2002, upon an application for a hearing by [Taxpayer], wherein he protested the proposed assessments of individual income tax, penalties, and interest for the taxable years 1994 through 1998. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayer and W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division.

ISSUE

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

Are the individual income tax assessments proposed against Taxpayer for the taxable years 1994 through 1998 lawful and proper?

EVIDENCE

The evidence presented at the hearing by W. Edward Finch, Jr., included 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. Notice of Individual Income Tax Assessment for the taxable year 1994 dated May 21, 2000, a copy of which is designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 1995 dated May 21, 2000, a copy of which is designated as Exhibit PT-3.

4. Notice of Individual Income Tax Assessment for the taxable year 1996 dated May 21, 2000, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1997 dated May 21, 2000, a copy of which is designated as Exhibit PT-5.
6. Notice of Individual Income Tax Assessment for the taxable year 1998 dated May 21, 2000, a copy of which is designated as Exhibit PT-6.
7. Field Auditor's Report for the taxable year 1994 dated April 21, 2000, a copy of which is designated as Exhibit PT-7.
8. Field Auditor's Report for the taxable year 1995 dated April 21, 2000, a copy of which is designated as Exhibit PT-8.
9. Field Auditor's Report for the taxable year 1996 dated April 21, 2000, a copy of which is designated as Exhibit PT-9.
10. Field Auditor's Report for the taxable year 1997 dated April 21, 2000, a copy of which is designated as Exhibit PT-10.
11. Field Auditor's Report for the taxable year 1998 dated April 21, 2000, a copy of which is designated as Exhibit PT-11.
12. Internal Revenue Service's Statement – Income Tax Changes for the taxable years 1994 and 1995, a copy of which is designated as Exhibit PT-12.
13. Internal Revenue Service transcripts of Taxpayer's federal individual income tax accounts for the taxable years 1994 and 1995, copies of which are designated as Exhibit PT-13.
14. Letter from C. K. Honeycutt, Tax Auditor in the Office Examination Division, to Taxpayer dated July 8, 1999, on which Taxpayer wrote his reply dated July 14, 1999, a copy of which is designated as Exhibit PT-14.
15. Letter from Richard P. Dowdy, Field Auditor, to Taxpayer dated March 2, 2000, on which Taxpayer wrote his reply dated March 18, 2000, a copy of which is designated as Exhibit PT-15.
16. Taxpayer's brief entitled Protest of Assessment and Request for Hearing dated May 12, 2000, a copy of which is designated as Exhibit PT-16.
17. Letter from Gregory B. Radford, former Assistant Director in the Personal Taxes Division, dated June 16, 2000, a copy of which is designated as Exhibit PT-17.
18. Letter from Taxpayer to Gregory B. Radford dated July 10, 2000, a copy of which is designated as Exhibit PT-18.
19. Letter from Richard P. Dowdy to Taxpayer dated July 13, 2000, a copy of which is designated as Exhibit PT-19.

20. Letter from Taxpayer to Richard P. Dowdy dated July 31, 2000, a copy of which is designated as Exhibit PT-20.
21. Letter from Eugene J. Cella, Assistant Secretary of Revenue, to Taxpayer dated December 4, 2001, a copy of which is designated as Exhibit PT-21.
22. Letter from W. Edward Finch, Jr., Assistant Director in the Personal Taxes Division, to Taxpayer dated December 11, 2001, a copy of which is designated as Exhibit PT-22.
23. Letter from Taxpayer to Eugene J. Cella dated December 13, 2001, a copy of which is designated as Exhibit PT-23.
24. Letter from Eugene J. Cella to Taxpayer dated December 21, 2001, a copy of which is designated as Exhibit PT-24.

At the hearing, Taxpayer submitted a brief dated February 12, 2002, 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. Taxpayer is and at all material times was a natural person, sui juris, and a citizen and resident of North Carolina.
2. Taxpayer did not file North Carolina individual income tax returns for the tax years 1994 through 1998. Taxpayer also did not file federal income tax returns for the tax years 1994 and 1995. The examining auditor notified Taxpayer in writing that the Department of Revenue had no record of him filing State returns for the years at issue and requested that he file. Taxpayer did not comply, citing constitutional arguments.
3. The Department received a report from the Internal Revenue Service indicating that the Internal Revenue Service had determined Taxpayer's federal taxable income to be \$147,743.00 for the tax year 1994 and \$133,458.00 for the tax year 1995. The amounts were determined based on a filing status of married filing separately and allowing the standard deduction and one personal exemption.
4. The auditor calculated Taxpayer's North Carolina taxable income for each year by increasing Taxpayer's federal taxable income as reported by the Internal Revenue Service for the differences between the State and federal standard deduction and personal exemption allowances. North Carolina taxable income was determined to be \$148,868.00 for the tax year 1994 and \$134,483.00 for the tax year 1995.
5. According to the federal report, Taxpayer's rental income increased by approximately \$10,000.00 from tax year 1994 to tax year 1995. Based on that increase, the auditor estimated Taxpayer's gross income to be \$139,000.00 for the tax year 1996; \$149,000.00 for the tax year 1997; and \$159,000.00 for the tax year 1998, an increase of \$10,000.00 each year. The auditor allowed the standard deduction for the married

filing separately filing status and one personal exemption in determining federal taxable income.

6. For each tax year at issue, the auditor asserted the 25 percent penalty for failure to timely file the return; the 10 percent penalty for failure to pay the tax when due; the 25 percent penalty for negligent failure to comply with the individual income tax laws; and accrued interest. The auditor also asserted the penalty for underpayment of estimated income tax for the tax years 1995 through 1998.
7. Notices of Individual Income Tax Assessment for the tax, penalties, and interest due for the tax years 1994 through 1998 were mailed to Taxpayer on May 21, 2000.
8. Taxpayer objected to the proposed assessments and filed a timely request for a hearing before the Secretary of Revenue.
9. Subsequent to his request for the administrative tax hearing, Taxpayer met with the auditor and furnished summaries of gross receipts and expenses from the realtor that handled Taxpayer's rentals in Durham, North Carolina during 1994 and 1995. Taxpayer also furnished some limited information regarding interest paid on loans for the tax years 1994 and 1995. Taxpayer did not provide any information for the tax years 1996, 1997, or 1998. The information indicated that Taxpayer also had rental property in various locations other than Durham which was not included in the realtor's summary. The auditor determined that because the information furnished by Taxpayer reflected only a portion of his total income and expenses, it was not adequate to warrant adjustments to the amounts determined by the Internal Revenue Service or the Department.
10. The Department responded to Taxpayer's initial request for a hearing on June 16, 2000. The Department advised Taxpayer that the proposed assessments were based on the best information available and that if Taxpayer would provide complete information to the examining auditor, the issues could possibly be resolved outside of the hearing process. The examining auditor met with Taxpayer on September 27, 2000; however, the information furnished by Taxpayer was incomplete and Taxpayer refused to allow copies to be made. Taxpayer did not furnish any further information subsequent to that meeting.

CONCLUSIONS OF LAW

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

1. North Carolina imposes an individual income tax upon the taxable income of (1) every resident of this State and (2) every nonresident individual deriving income from North Carolina sources attributable to the ownership of any interest in real or tangible personal property in this State or deriving income from a business, trade, profession, or occupation carried on in this State.
2. The term "taxpayer" is defined as an individual subject to the income tax. The term "individual" is defined as a human being.

3. For residents of this State, "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.
4. Federal taxable income is defined in section 63 of the Internal Revenue Code as gross income less deductions and personal exemptions. Gross income is defined in section 61 of the Code as all income from whatever source derived unless specifically excepted. Gross income includes interest, dividends, patronages, and rents.
5. An individual is required to file a federal income tax return if his gross income for the year equals or exceeds the allowable exemption amount (Code section 6012(a)(1)(A)). Because Taxpayer's gross income exceeded his allowable exemption amount, he was required to file federal returns.
6. A resident of this State is required to file a North Carolina individual income tax return if the individual is required to file a federal income tax return. The North Carolina return shall show the taxable income and adjustments to federal taxable income required by statute. An income tax return shall be filed as prescribed by the Secretary and must be in the form prescribed by the Secretary. For a calendar-year taxpayer, the return is due on or before the fifteenth of April of the calendar year following the tax year. Tax payable as shown on the return must be paid to the Secretary within the time allowed for filing the return.
7. If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer is required to file a return with the Secretary of Revenue reflecting the corrected or determined taxable income.
8. If the 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.
9. For the failure to file any return on the date it is due, a penalty is required equal to five percent of the amount of the tax if the failure is for not more than one month, with an additional five percent for each additional month, or fraction thereof, during which the failure continues, not exceeding twenty-five percent in the aggregate, or five dollars (\$5.00), whichever is the greater.
10. For the failure to pay any tax when due, a penalty is required equal to ten percent of the tax, except that the penalty shall in no event be less than five dollars (\$5.00).
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. An individual is required to pay estimated income tax if the tax shown due on the income tax return for the taxable year, reduced by North Carolina tax withheld and allowable tax credits, is \$1000 (\$500 before tax year 1998) or more. A penalty is imposed for any underpayment of estimated income tax.

13. 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. No penalty is imposed 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.
14. Before a statutory violation can give rise to civil damages, the violation must be wrongful and prejudicial. In addition, regardless of the extent of actual injury, not every statutory violation creates a concomitant cause of action. A remedy for injuries is only guaranteed in accordance with due cause of law. The remedy must be legally cognizable and the legislature defines the circumstances under which the remedy is legally cognizable and when it is not.
15. The Secretary of Revenue's duties include administering the laws enacted by the General Assembly relating to the assessment and collection of individual income taxes. As an official of the Executive branch of the government, the Secretary lacks the authority to determine the constitutionality of legislative acts. The question of constitutionality of a statute is for the judicial branch.

DECISION

Taxpayer contends that the Department of Revenue has the burden of proof with regard to the unreported income at issue; that the Department and the Internal Revenue Service erred in their determination of the amounts of unreported income and; estimated amounts of deductions for expenses incurred in earning the unreported income should be allowed. Taxpayer also contends that the proposed assessments should be withdrawn because the administrative tax hearing was not scheduled within 90 days of his request.

The information obtained by the Internal Revenue Service from third party sources clearly establishes that Taxpayer had gross income well in excess of the minimum amount requiring him to file State and federal income tax returns. Information furnished by Taxpayer in an effort to refute the assessments reflected only a portion of his total income and expenses. Because Taxpayer refused to file the required State income tax returns or to provide adequate and reliable information upon which to compute his entire tax liability, the proposed

assessments were properly made upon the basis of the best information available and are deemed to be correct under the law.

Taxpayer relies on *Senter v. Commissioner*, T.C. Memo. 1995-311,70 T.C.M (CCH) 54 (1995) in which the court indicates that the burden of proof may shift from the taxpayer to the Internal Revenue Service when the notice of deficiency is determined to be arbitrary or excessive with regard to the determination of unreported income. The court held that the Internal Revenue Service's determination of unreported income in that case would not be accorded the presumption of correctness unless the Commissioner provides some "predicate evidence" supporting the determination that the taxpayer received unreported income. In this case, for the tax years 1994 and 1995, the Internal Revenue Service determined that Taxpayer had unreported income in the form of dividends, interest, patronages, and rents. The Internal Revenue Service based its determination on information obtained from third party payers of those amounts to Taxpayer. Taxpayer has not furnished any information to establish that the Internal Revenue Service amended or withdrew its assessments nor did he file State income tax returns to report the federal determination. Taxpayer has furnished no evidence or information to indicate that he did not continue to have income from the sources identified in the federal report and in similar amounts in tax years 1996, 1997 and 1998. Consequently, the Department has met the minimum evidentiary foundation necessary to maintain the presumption of correctness and to require that the burden of proof remain on Taxpayer.

In *R. L. Goodmon v. Commissioner*, 761 F.2d 1522, 85-2 USTC ¶9456 (1985), a case similar to Taxpayer's, the court held that the Internal Revenue Service properly computed the taxpayer's rental income based on the highest yearly rent received as indicated on his prior returns where the taxpayer failed to produce or maintain adequate records. The court concluded that the Commissioner may use any reasonable method of calculation where the taxpayer fails to produce or maintain adequate records from which actual income may be

ascertained and that the method of calculation is presumed correct and the burden of proof is on the taxpayer to disprove the deficiency.

The Department does not dispute the fact that it did not meet the statutory timetable for scheduling the hearing or notifying Taxpayer of the scheduled hearing date. However, there is no evidence of malicious intent on the part of the Department. It is most interesting to note that the General Assembly, when enacting the legislation imposing the timetables, provided no remedy to the taxpayer for the Department's failure to comply. Since the law affords no redress, there is no basis to strike the assessments.

Taxpayer has raised various other defenses as to whether he can be held liable for an income tax, including contentions that the federal income tax is voluntary and the filing of federal income tax returns is not legally required; that the 16th amendment of the U.S. Constitution was never ratified; that federal income taxes are not used to operate the federal government; and that individuals must first file a federal income tax return before a State return is required. There is a long list of cases in which other taxpayers have made similar arguments that have been repeatedly rejected by the courts as frivolous and without merit. Also, the underlying principle behind these defenses is a taxpayer's constitutional rights. The question of the constitutionality of a statute is for the judicial branch as the Secretary of Revenue lacks the authority to determine the constitutionality of legislative acts [*Great American Insurance Co. v. Gold*, 254 NC 168, 118 SE2d 792 (1961)]. However, the Assistant Secretary notes that the income tax is clearly not voluntary. While both the Internal Revenue Service and the Department of Revenue rely heavily on voluntary compliance by taxpayers, the filing of an income tax return and the payment of income tax are mandatory. Otherwise, the law would not impose penalties, both civil and criminal, for failure to do so.

The 16th Amendment to the United States Constitution provides that Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

The 16th Amendment was ratified by 40 states, including Ohio, and issued by proclamation in 1913. Shortly thereafter, two other states also ratified the Amendment. Under Article V of the Constitution, only three-fourths of the states are needed to ratify an amendment. There were enough states ratifying the 16th Amendment even without Ohio to complete the number needed for ratification. Furthermore, the U.S. Supreme Court upheld the constitutionality of the income tax laws enacted subsequent to ratification of the 16th Amendment in *Brushaber v. Union Pacific Railroad Company*, 240 U.S. 1, 36 S.Ct. 236 (1916). Since that time, the courts have consistently upheld the constitutionality of the federal income tax.

The issue of whether or not federal income taxes are used to operate the federal government is immaterial with regard to the imposition of the North Carolina individual income tax.

The individual income tax assessments for the taxable years 1994 through 1998 are hereby sustained in their entireties and are finally determined and immediately due and collectible as allowed by law.

Made and entered this 3rd day of May, 2002.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue