

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 1996)
and 1997 by the Secretary of Revenue of)
North Carolina)
)
vs.)
)
[Taxpayer])

FINAL DECISION
Docket No. 2000-340

This matter was heard before the Assistant Secretary of Revenue, Michael A. Hannah, in the city of Raleigh on September 12, 2000, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessments of additional income tax for the taxable years 1996 and 1997. The hearing, held by the Assistant Secretary of Revenue under the provisions of G.S. 105-260.1, was attended by Taxpayer; Gregory B. Radford, Assistant Director of the Personal Taxes Division; and [an acquaintance of Taxpayer].

Taxpayer filed North Carolina individual income tax returns for the taxable years 1996 and 1997 reflecting federal and North Carolina taxable incomes of zero, North Carolina income tax of zero, and requesting refunds of \$922.00 and \$951.00, respectively.

Upon examination, the Department determined that Taxpayer was excluding his wages and pension income from federal taxable income. Pursuant to G.S. 105-241.1, an assessment proposing additional tax and accrued interest totaling \$1,114.33 for 1996 was mailed to Taxpayer on April 8, 2000. An assessment for additional tax, a twenty-five percent negligence penalty, and accrued interest totaling \$246.32 for 1997 was mailed to Taxpayer on April 15, 1999.

Taxpayer filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.

ISSUE

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

Are the assessments for additional income tax proposed against Taxpayer for the taxable years 1996 and 1997 lawful and proper?

EVIDENCE

The evidence presented by Gregory B. Radford, Assistant Director of the Personal Taxes Division, consisted of the following:

1. Memorandum from Muriel K. Offerman, Secretary of Revenue, to Michael A. Hannah, Assistant Secretary of Revenue, dated April 18, 1996, a copy of which is designated as Exhibit PT-1.
2. Taxpayer's North Carolina individual income tax return for the taxable year 1996 with related attachments, copies of which are collectively designated as Exhibit PT-2.
3. Taxpayer's North Carolina individual income tax return for the taxable year 1997 with related attachments, copies of which are collectively designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 1996, dated April 8, 2000, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1997, dated April 15, 2000, a copy of which is designated as Exhibit PT-5.
6. Title 17, North Carolina Administrative Code, subchapter 6B, rule .0101, a copy of which is designated as Exhibit PT-6.
7. A paper extract of Taxpayers' 1996 federal income tax return detail information provided by the Internal Revenue Service to the Department of Revenue, a copy of which is designated as Exhibit PT-7.
8. Letter from Taxpayer to the North Carolina Department of Revenue, received by the Department on April 12, 2000, a copy of which is designated as Exhibit PT-8.
9. Letter from Taxpayer to the North Carolina Department of Revenue, received by the Department on May 4, 2000, a copy of which is designated as Exhibit PT-9.
10. Letter from Gregory B. Radford to Taxpayer dated May 17, 2000, a copy of which is designated as Exhibit PT-10.
11. Letter from Gregory B. Radford to Taxpayer dated May 24, 2000, a copy of which is designated as Exhibit PT-11.

12. Taxpayer's reply to Exhibits PT-10 and PT-11, received by the Department on June 7, 2000, a copy of which is designated as Exhibit PT-12.
13. Letter from Michael A. Hannah to Taxpayer dated June 9, 2000, a copy of which is designated as Exhibit PT-13.
14. Letter from Michael A. Hannah to Taxpayer dated August 24, 2000, a copy of which is designated as Exhibit PT-14.

At the hearing, Taxpayer presented the following for the record:

1. Taxpayer's 1996 U.S. individual income tax return, a copy of which is designated as Exhibit T-1.
2. Taxpayer's 1997 U.S. individual income tax return, a copy of which is designated as Exhibit T-2.
3. Letter from Taxpayer to the Internal Revenue Service dated December 7, 1997, with related attachments, copies of which are collectively designated as Exhibit T-3.
4. *Doyle v. Mitchell Brothers Company*, 247 U.S. 179, a copy of which is designated as Exhibit T-4.
5. *Eisner v. Macomber*, 252 U.S. 189, a copy of which is designated as Exhibit T-5.
6. *Merchants' Loan and Trust Co. v. Smetanka*, 255 U.S. 509, a copy of which is designated as Exhibit T-6.
7. *Stratton's Independence, Limited v. Howbert*, 231 U.S. 399, a copy of which is designated as Exhibit T-7.
8. *U.S. v. Ballard*, 535 F.2d 400, a copy of which is designated as Exhibit T-8.

At the hearing, the Assistant Secretary allowed Taxpayer until September 28, 2000, to submit additional information for the record to support his objection to the proposed assessments. The following evidence was subsequently entered into the record:

1. Letter from Michael A. Hannah to Taxpayer dated September 12, 2000, a copy of which is designated as Exhibit S-1.
2. Letter from Taxpayer to Michael A. Hannah dated September 24, 2000, with exhibits marked by Taxpayer as Exhibits H through W, copies of which are collectively designated as Exhibit T-9.

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 timely filed his North Carolina individual income tax returns for the tax years 1996 and 1997.
3. Taxpayer's 1996 return reflected federal taxable income of zero, North Carolina taxable income of zero, North Carolina tax withheld of \$922.00, and an overpayment of \$922.00, which Taxpayer requested to be refunded. Taxpayer included with the return a wage and tax statement from [a place of employment], showing wages of \$20,011.19.
4. The Department of Revenue applied \$522.00 of the overpayment to a debt Taxpayer owed to the Internal Revenue Service and issued a refund check to Taxpayer for \$400.00.
5. Upon examination, the Department calculated Taxpayer's North Carolina taxable income to be \$14,111.00, equal to Taxpayer's federal taxable income as reported to the Department by the Internal Revenue Service. The information provided by the Internal Revenue Service reflected wages of \$20,011.00. In arriving at federal taxable income, Taxpayer was allowed the standard deduction for a married person filing a separate return and one personal exemption.
6. Pursuant to G.S. 105-241.1, a Notice of Individual Income Tax Assessment proposing an assessment of additional income tax and accrued interest totaling \$1,114.33 was mailed to Taxpayer on April 8, 2000.
7. For the tax year 1996, Taxpayer understated taxable income by 71% of gross income.
8. Taxpayer's 1997 return reflected federal taxable income of zero, North Carolina taxable income of zero, North Carolina tax withheld of \$951.00, and an overpayment of \$951.00, which Taxpayer requested to be refunded. Taxpayer included with the return a wage and tax statement from [a place of employment] showing wages of \$12,659.16; a wage and tax statement from [another place of employment] showing wages of \$7,719.75; and a Form 1099-R from [an insurance company] showing pension plan distributions of \$3,001.13.
9. The Department did not issue a refund to Taxpayer for the tax year 1997.
10. Upon examination, the Department calculated Taxpayer's federal taxable income to be \$16,580.00 by allowing the standard deduction for an unmarried individual and one personal exemption and calculated North Carolina taxable income to be \$17,880.00 by increasing federal taxable income for the difference in the State and federal standard deductions and personal exemptions.

11. Taxpayer was asked to identify the employer for which [the insurance company] was administering the pension plan and whether he was still working for the employer at the time he received the distribution. Taxpayer did not provide the information requested.
12. Pursuant to G.S. 105-241.1, a Notice of Individual Income Tax Assessment proposing an assessment of additional income tax, a twenty-five percent negligence penalty, and accrued interest totaling \$246.32 was mailed to Taxpayer on April 15, 2000.
13. For the tax year 1997, Taxpayer understated taxable income by 76% of gross income.
14. Taxpayer objected to the proposed assessments and timely 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. It is the duty of the North Carolina Department of Revenue to collect taxes due to the State.
2. 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.
3. "Taxpayer" is defined as an individual subject to the individual income tax. "Individual" is defined as a human being.
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. Gross income includes compensation for services rendered and pensions. Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, tips, and bonuses are all includable in gross income.
6. Additions to federal taxable income are required for the amount by which the taxpayer's standard deduction has been increased and the amount by which each of the taxpayer's personal exemptions has been increased for inflation under the Code. The increase in the personal exemption for inflation is reduced by \$500.00 if the taxpayer's federal adjusted gross income is below the threshold for his filing status. Additions of \$900.00 are proper

for the tax year 1996 but were not included in the assessment. Additions of \$1,300.00 were properly made for the tax year 1997.

7. A taxpayer may claim a deduction from federal taxable income of up to \$4,000.00 for governmental retirement benefits and up to \$2,000.00 for private retirement benefits included in federal taxable income. Retirement benefits are defined as amounts paid to a former employee under a written retirement plan established by the employer to provide payments to the employee after the end of the employee's employment.
8. 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.
9. 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. The Secretary of Revenue may require a taxpayer to verify any information on the taxpayer's individual income tax return. An income tax return shall be filed as prescribed by the Secretary. The return shall be in the form prescribed by the Secretary. Form D-400 and Form D-400EZ are the forms prescribed by the Department of Revenue as the proper forms for individual income taxpayers to file.
10. The Secretary of Revenue may require a taxpayer to file a supplementary return if the Secretary believes that the taxpayer has failed to include taxable income on the return. The Secretary may proceed to propose an assessment of tax or additional tax whether or not a supplementary return is required.
11. 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.
12. 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.
13. 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. Assessments must generally be proposed within three years of the date the return was filed or the date the return was due to be filed, whichever is later.
14. A twenty-five percent negligence penalty is imposed 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 negligence penalty of \$236.50 is due for the tax year 1996 but was not included in the assessment. A penalty of \$43.25 was properly assessed for the tax year 1997.

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.
16. The proposed assessments for the tax years 1996 and 1997 are lawful and proper based on the best information available except that additions to federal taxable income of \$900.00 and a negligence penalty of \$236.50 should have been included in the 1996 assessment. However, the proposed income tax liability may not be increased because the statute of limitations has expired for the tax year 1996.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary of Revenue finds the proposed assessments for the tax years 1996 and 1997 to be lawful and proper and are hereby affirmed. For the tax year 1996, Taxpayer's federal taxable income should have been increased for the amounts by which the federal allowances for the standard deduction and personal exemptions had been increased for inflation and Taxpayer should have been assessed the twenty-five percent negligence penalty for a large understatement of income. However, the assessment may not be increased because the statute of limitations for assessing additional tax for the tax year 1996 has expired.

Taxpayer contends that he does not have income because the Internal Revenue Code does not define "income" and that the United States Supreme Court has defined "income" to include only corporate profits. As Taxpayer states by citing *U.S. v. Ballard*, 535 F.2d 400 (1976), the term "income" is not defined in the Internal Revenue Code, nor is it defined in the North Carolina Revenue Laws. However, both federal and State law impose the individual income tax on the "taxable income" of every individual (Code section 1, G.S. 105-134). The State's definition of taxable income (G.S. 105-134.1(16)) refers to the definition of taxable income in Code section 63. Taxable income for federal purposes means gross income less allowable

deductions. Gross income is defined by Code section 61 as, except as otherwise provided, all income from whatever source derived, including compensation for services. The decision in *U.S. v. Ballard* does not support Taxpayer's position that he has no North Carolina income tax liability. In *Ballard*, the court recited the Code's definition of "gross income," which includes compensation for services, including fees, commissions, and similar items (26 U.S.C. 61). *Ballard* was concerned primarily with income from a merchandising business and whether gross income was the gross receipts from the business or the gross receipts less expenses. The taxpayer had reported wages in gross income and did not argue that wages were not taxable. Therefore, the question is not whether there is such a thing as income but whether wages or other compensation received for services rendered are considered income.

Taxpayer contends that income is limited to corporate profit and cites *Eisner v. Macomber*, 252 U.S. 189, *Merchant's Loan and Trust Co. v. Smietanka*, 255 U.S. 509, *Doyle v. Mitchell Brothers*, 247 U.S. 179, *Stratton's Independence v. Howbert*, 231 U.S. 399, and *Southern Pacific v. Lowe*, 247 U.S. 330, in support of his position. None of the cases supports his argument. In *Eisner*, the court held that stock dividends are not income and hence are not taxable as such. The basis for the court's decision is that the shareholder received nothing as a result of the stock dividend for his separate use and benefit; on the contrary, every dollar of his investment remained the property of the company. The court defined income as "the gain derived from capital, from labor, or from both combined..." In *Glenshaw Glass Co.*, S. Ct., 348 U.S. 426, 55-1 USTC ¶9308, the court concluded that *Eisner v. Macomber* was not meant to provide a touchstone to all future gross income questions. A taxpayer is taxable on "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." The statutory definition of gross income is "all-inclusive." In *Merchant's Loan and*

Trust Co., the court found that the word “income” must be given the same meaning in all of the income tax acts of Congress that was given to it in the Corporation Excise Tax Act of 1909. However, that does not imply that income can only be a derivative of corporate activity. In *Merchant’s Loan and Trust Co.*, the plaintiff was a trust established at the death of the grantor. The trust sold stock and received sales proceeds in excess of the basis in the stock. The court held that a trust was a taxable person; therefore, it is clear that income is not limited to corporate activities. The court also held that the gain from the sale of stock was income, stating that income may be defined as the gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital assets. *Doyle, Stratton’s Independence, and Southern Pacific* are not relevant; in each case, the plaintiff was a corporation. Therefore, the question of whether wages received by an individual is income was not at issue in those cases. The courts have consistently held that wages and other forms of compensation for services rendered are income. (See *E.M. Lonsdale*, CA-10, 90-2 USTC ¶50,581, *H.H. McKinley*, DC Ohio, 92-2 USTC ¶50,509, *A. Ficalora*, CA-2, 85-1 USTC ¶ 9103, *C. Stelly*, CA-5, 85-2 USTC ¶9436, *Coleman v. Commissioner of Internal Revenue*, 791 F.2d 68 (7th Cir. 1986.) Taxpayer can cite no case that rules otherwise.

Taxpayer contends that no section of the Internal Revenue Code imposes an income tax or provides that income taxes have to be paid on the basis of a return. A hearing before the Secretary of Revenue with respect to a proposed assessment of North Carolina income tax is not the proper forum to determine if the Internal Revenue Code imposes an income tax or requires a return to be filed; those issues are between Taxpayers and the Internal Revenue Service. However, I note that section 1 of the Internal Revenue Code imposes an income tax on individuals and Code section 6012(a)(1)(A) requires an individual to file a federal income tax

return if his gross income for the year equals or exceeds the allowable exemption amount. More importantly, since a North Carolina income tax liability is at issue, G.S. 105-134 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. A resident of this State is required under G.S. 105-152 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. The law clearly and unequivocally imposes a State income tax on Taxpayer and requires him to file a State income tax return.

Taxpayer contends that the Department of Revenue stated that the 1996 assessment was not based on information received from the Internal Revenue Service and asks that the 1996 assessment be abated because the assessment was indeed based on federal information.

Taxpayer's contention is unfounded. In the Brief for Tax Hearing presented by the Department at the hearing, the Department states "Upon examination, the Department calculated Taxpayer's North Carolina taxable income to be \$14,111.00, equal to Taxpayer's federal taxable income as reported to the Department by the Internal Revenue Service." The Department also presented as evidence a paper extract of Taxpayers' 1996 federal income tax return detail information provided by the Internal Revenue Service to the Department of Revenue. (Exhibit PT-7)

Although the assessment for the tax year 1996 was based on federal information, the information provided by Taxpayer with his tax return was sufficient by and of itself to determine the State tax liability. The 1997 assessment was not based on federal information; instead, the proposed

liability was determined based solely on the tax information provided by Taxpayer with his tax return.

Taxpayer contends that no section of the Internal Revenue Code gives anyone the authority to change his return and the Internal Revenue Service has not perfected its assessment against him. Again, a hearing before the Secretary of Revenue with respect to a proposed assessment of North Carolina income tax is not the proper forum to determine if the Internal Revenue Service has authority to adjust a taxpayer's federal income tax return; that issue is between Taxpayer and the Internal Revenue Service. However, I note that Chapter 63 of the Internal Revenue Code addresses assessments and deficiencies. It is clear from my reading of that section of the Code that the Internal Revenue Service is authorized to determine if the return filed by a taxpayer is correct and to assess any deficiency resulting from the taxpayer's errors. Likewise, I cannot resolve the issue of whether the Internal Revenue Service has properly notified Taxpayer of the adjustments to his 1996 federal return. However, whether the Internal Revenue Service perfected its assessment has no effect on the State's assessment. G.S. 105-159 provides that the Secretary "shall determine from all available evidence the taxpayer's correct tax liability for the taxable year." The information provided by the Internal Revenue Service is available evidence and Taxpayers have not established that the evidence is incorrect.

Finally, Taxpayer contends that the income tax is voluntary. Such is clearly not the case. 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. (See *United States v. Gerads*, 999 F.2d 1255, *Schiff v. United States*, 919 F.2d

830, *United States v. Hartman*, 915 F.Supp. 1227, *Flora v. United States*, 362 U.S. 145, *Helvering v. Mitchell*, 303 U.S. 391.)

I find all of Taxpayer's arguments to be without merit. The proposed assessments for the tax years 1996 and 1997 are hereby sustained in their entireties and are determined to be final and collectible, together with interest as allowed by law.

Made and entered this 11th day of December, 2000.

Signature_____

Michael A. Hannah
Assistant Secretary of Revenue