STATE OF NORTH CAROLINA **BEFORE THE SECRETARY OF REVENUE**

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessment of Additional Income Tax for the Taxable Year 1996 by the Secretary of Revenue of North Carolina	)	
vs.	)	**FINAL DECISION** Docket No. 2000-370
[Taxpayers]	)	

This matter was heard before the Assistant Secretary of Revenue, Michael A. Hannah, in the city of Raleigh on September 11, 2000, upon an application for hearing by [Taxpayers, Husband and Wife], wherein they protested the proposed assessment of additional tax and interest for the taxable year 1996. The hearing was held by the Assistant Secretary of Revenue under the provisions of G.S. 105-260.1 and was attended by Husband and Gregory B. Radford, Assistant Director of the Personal Taxes Division.

Taxpayers timely filed their North Carolina individual income tax return for the tax year 1996 reflecting federal taxable income of zero and North Carolina income tax of zero. Taxpayers requested a refund of $1,019.00, equal to the entire amount of tax withheld, which was issued by the Department.

Upon examination, the Department calculated Taxpayers' North Carolina taxable income to be $32,314.00, equal to Taxpayers' federal taxable income as reported to the Department by the Internal Revenue Service. A Notice of Individual Income Tax Assessment dated March 26, 2000, proposing an assessment of additional income tax and accrued interest totaling $2,581.23 was mailed to Taxpayers on April 5, 2000. Taxpayers objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.

ISSUE

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

Is the assessment for additional income tax and interest proposed against Taxpayers for the taxable year 1996 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. Taxpayers' North Carolina individual income tax return for the taxable year 1996, a copy of which is designated as Exhibit PT-2.

3. Notice of Individual Income Tax Assessment for the taxable year 1996 dated March 26, 2000, a copy of which is designated as Exhibit PT-3.

4. 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-4.

5. Letter from Husband to the Department of Revenue dated April 15, 2000, a copy of which is designated as Exhibit PT-5.

6. Letter from Husband to the North Carolina Department of Revenue dated April 31, 2000, a copy of which is designated as Exhibit PT-6.

7. Letter from Gregory B. Radford to Taxpayers dated May 23, 2000, a copy of which is designated as Exhibit PT-7.

8. Letter from Husband to the North Carolina Department of Revenue dated June 9, 2000, a copy of which is designated as Exhibit PT-8.

9. Letter from Michael A. Hannah to Husband dated June 22, 2000, a copy of which is designated as Exhibit PT-9.

10. Letter from Husband to Michael A. Hannah dated June 29, 2000, a copy of which is designated as Exhibit PT-10.

11. Letter from Michael A. Hannah to Husband dated July 13, 2000, a copy of which is designated as Exhibit PT-11.

During the hearing, Husband presented a "Brief for Tax Hearing" and exhibits marked by Taxpayers as Exhibit 1 through Exhibit 44. Copies of the brief and exhibits are collectively designated as Exhibit TP-1.

At the hearing, the Assistant Secretary allowed Taxpayers until September 27, 2000, to submit additional information for the record to support their objection to the proposed assessment. The following evidence was subsequently entered into the record:

1. Letter from Michael A. Hannah to Taxpayers dated September 11, 2000, a copy of which is designated as Exhibit S-1.

2. Letter from Husband to Michael A. Hannah dated September 25, 2000, with an addition to the "Brief for Tax Hearing" and exhibits marked by Taxpayers as Exhibits A45 through A49, copies of which are collectively designated as Exhibit TP-2.

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 timely filed their North Carolina income tax return for the tax year 1996.

3. Taxpayers' 1996 return reflected federal taxable income of zero, North Carolina income tax of zero, North Carolina tax withheld of $1,019.00, and an overpayment of $1,019.00, which Taxpayers requested to be refunded.

4. Taxpayers were issued a refund check for $1,019.00 on February 24, 1997.

5. Upon examination, the Department calculated Taxpayers' North Carolina taxable income to be $32,314.00, equal to Taxpayers' federal taxable income as reported to the Department by the Internal Revenue Service. The information provided by the Internal Revenue Service reflected wages of $44,114.00. In arriving at federal taxable income of $32,314.00, Taxpayers were allowed the standard deduction and two personal exemptions.

6. In 1982, the Department of Revenue and the Internal Revenue Service executed an Agreement on Coordination of Tax Administration that allows for the continuous sharing of tax information between the two agencies.

7. Pursuant to G.S. 105-241.1, a Notice of Individual Income Tax Assessment dated March 26, 2000, proposing an assessment of additional income tax and accrued interest totaling $2,581.23 was mailed to Taxpayers on April 5, 2000.

8. For the tax year 1996, Taxpayer understated taxable income by 77% of gross income.

9. Taxpayers objected to the proposed assessment 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 provided 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. 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 $1,800.00 are proper for the tax year 1996 but were not included in the assessment.

7. 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.

8. 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.

9. The Secretary of Revenue may require a taxpayer to file a supplementary return if the Secretary is of the opinion 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.

10. 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.

11. 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.

12. The Internal Revenue Code provides that federal income tax returns and return information are open to inspection by, or disclosure to, any State agency, body, or commission which is charged under the laws of that State with responsibility for the administration of the State's tax laws. Such inspection or disclosure is permitted only upon written request by the head of the agency or an individual designated by the head of the agency. The Agreement on Coordination of Tax Administration between the Department of Revenue and the Internal Revenue Service is a standing agreement that satisfies the written request requirement of federal law.

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 the 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 $544.00 is due for the tax year 1996 but was not included in the assessment.

15. The proposed assessment for the tax year 1996 is lawful and proper based on the best information available except that additions to federal taxable income of $1,800.00 and a negligence penalty of $544.00 should have been included in the assessment. However, the proposed income tax liability may not be increased at this time 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 assessment for the tax year 1996 to be lawful and proper and is hereby affirmed. Taxpayers' 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 Taxpayers 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.

Taxpayers present many arguments in defense of their position that the assessment is in error. These arguments can be divided into two general themes: (1) the proposed assessment is not legal; and (2) the amount of tax is not correct. Taxpayers contend that the assessment is not legal because (1) the Department of Revenue is in violation of G.S. 105-159, G.S. 105-241.1, and G.S. 105-258; (2) the Internal Revenue Service is in violation of Code section 6103; and (3) the Department of Revenue is in violation of the North Carolina Constitution. Taxpayers contend that the amount of tax is not correct because they do not have income according to the Internal Revenue Code.

Taxpayers contend that the Department of Revenue is in violation of G.S. 105-159 because (1) there is no section of the Internal Revenue Code that allows anyone to change the tax as calculated by a taxpayer; (2) the Internal Revenue Service never sent Taxpayers a notice of correction or a final determination; (3) the fact that the only notice received from the Internal Revenue Service was a "Request for Tax Payment" proves that Taxpayers filed their federal return correctly but the Internal Revenue Service still contends that Taxpayers owe money to the

Internal Revenue Service with no proof; and (4) Taxpayers have two years after the Internal Revenue Service notifies them of a change to the federal return to notify the State of the change; therefore, the assessment should not have been proposed since Taxpayers have not received notification of a change to the federal 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 Service has authority to adjust a taxpayer's federal income tax return; that issue is between Taxpayers 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 Taxpayers of the adjustments to their 1996 federal return. However, whether the Internal Revenue Service perfected the 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. It cannot be determined from the information provided by the Internal Revenue Service whether Taxpayers' federal income tax return was filed reflecting federal taxable income of $32,314 or if the Internal Revenue Service corrected the return filed by Taxpayers to increase taxable income from whatever amount was reported by Taxpayers to $32,314. Once again, it makes no difference. G.S. 105-159 is applicable whether the Internal Revenue Service corrected federal taxable income or determined federal taxable income. Finally, the fact that a taxpayer is given two years to notify the Department of Revenue of a federal correction or determination without penalty does not preclude the Department of Revenue from proposing an assessment before the two-year period expires. G.S. 105-241.1(e) provides time limits for making assessments; assessments not made within those time limits are considered untimely and may not be collected. The statute does not forbid an assessment based on federal changes from being proposed as soon as the information is received; instead, it places a positive burden on a taxpayer to report the changes to the State because the taxpayer's act of voluntarily reporting the changes and paying the additional tax reduces the effort required of the Department to assess and collect the tax.

Taxpayers contend that the Department of Revenue is in violation of G.S. 105-241.1 and G.S. 105-258 because (1) the Secretary of Revenue never assessed tax according to law; (2) the Secretary never notified or delegated anyone to notify individuals according to law; (3) no delegation of authority has been provided for the person who discovered the proposed assessment; and (4) the Department of Revenue is not following the laws set forth by the General Assembly of North Carolina. Taxpayers contend that the proposed assessment is void because the Secretary of Revenue did not individually propose the assessment or specifically, in writing, delegate the authority to issue the proposed assessment to an employee of the Department. Taxpayers' position is simply not reasonable. The Secretary of Revenue, as the head of the Department of Revenue, cannot individually propose assessments and that is certainly not the intent of the law. Assessments of tax must be "of the Secretary," meaning that the assessments may only be proposed by the Department of Revenue. The law also does not require the Secretary to issue a delegation of authority in writing to each of the Department's employees to perform the duties of their job. G.S. 105-258 empowers the Secretary to appoint agents to determine liabilities of all persons for any tax imposed under the Revenue Act. The authority of an employee of the Department of Revenue to perform the duties of his or her position is implicit and arises automatically from the individual's appointment by the Secretary to that position. In the case at hand, the assessment issued by the Department was computer-generated based on a comparison of the federal taxable income reported by the Internal Revenue Service to the Department of Revenue and the federal taxable income reported by Taxpayers on their North Carolina return. Therefore, no one individual agent or employee discovered the liability or issued the assessment. This kind of "matching" assessment is a standard method of determining additional tax owed by taxpayers and is routinely issued in the normal course of business. I find no basis to void the assessment under Taxpayers' arguments.

Taxpayers contend that the Internal Revenue Service violated section 6103 of the Internal Revenue Code because (1) the tape program by which the Internal Revenue Service shared Taxpayers' 1996 federal income tax information with the State exists only in the Internal Revenue Manual, is not law, and was not authorized by the Secretary of the Treasury; (2) Code section 6103(d) has no regulation; therefore, it does not have the force and effect of law; (3) Code section 6103(d) was never published in the Federal Register; therefore, that Code section is void; and (4) any information that the State received from the Internal Revenue Service is void because the sharing of the information was procedurally defective.

The Internal Revenue Manual sets forth policy and procedures followed by the Internal Revenue Service's employees. Taxpayers are correct in that the Manual does not have the effect of law. However, the fact that the Federal/State Tax Exchange Program is described in the Manual does not cause the use of that method of sharing information to be invalid. Section 6103(d) of the Internal Revenue Code provides that federal income tax returns and return information are open to inspection by, or disclosure to, any State agency, body, or commission which is charged under the laws of that State with responsibility for the administration of the State's tax laws. Such inspection or disclosure is permitted only upon written request by the head of the agency or an individual designated by the head of the agency. In 1982, the Department of Revenue and the Internal Revenue Service executed an Agreement on Coordination of Tax Administration that allows for the continuous sharing of tax information between the two agencies. The courts have consistently held that such standing agreement satisfies the written request requirement of Code section 6103(d) (*T. J. Smith,* CA-7, 92-2 USTC ¶50,382; *A. T. McQueen,* DC Tex., 98-1 USTC ¶50,388; *F. J. Taylor,* CA-8, 97-1 USTC ¶50,203; *J. C. Stone,* 76 TCM 371, Dec. 52,855(M), TC Memo. 1998-314.) Taxpayers' contention that Code section 6103(d) is void because it has no regulation is without merit. As a general rule, a duly enacted law does not need a regulation to be valid. In *Langert v. United States*, 95-2 USTC ¶50,504, the court found the plaintiffs' "implementing regulation" argument to be without merit. The court stated that "[p]ursuant to Section 7805(a) of the Code, the Commissioner has broad authority to 'prescribe all NEEDFUL rules and regulations for the enforcement of [the Code]. Including all rules and regulations as may be NECESSARY by reason of any alteration of law in relation to internal revenue.'... Section 7805(a) is a general grant of authority by Congress to the Commissioner to promulgate – as necessary –'interpretive regulations' stating the agency's views of what the existing Code provisions already require. … Section 7805(a) does not require the promulgation of regulations as a prerequisite to the enforcement of each and every provision of the Code." The court cited *Russell v. United States,* 95-1 USTC ¶50,029, in which the court held that "if the Congressional mandate of a Code provision is sufficiently clear, an interpretative regulation is not necessary." Similarly, Code section 6103(d) was not required to be published in the Federal Register; it is a law, not a regulation. I find that the sharing of the information between the Internal Revenue Service and the State of North Carolina was not procedurally defective and the information is admissible.

Taxpayers contend that North Carolina is in violation of the North Carolina Constitution because a taxpayer's North Carolina taxable income means the taxpayer's taxable income as determined under the Code. Section 2(1) of Article V of the Constitution provides in pertinent part that the "power of taxation…shall never be surrendered, suspended, or contracted away." To adopt by reference future amendments to the Internal Revenue Code would likely be held to be an unconstitutional delegation of legislative power. Taxpayers' argument fails, however, because the State's reference to the Code does not automatically adopt future changes to the Code. G.S. 105-228.90 defines "Code" by referring to the Internal Revenue Code as of a specific date. The definition is revised as needed to reflect the General Assembly's decision to adopt amendments to the Code. The General Assembly always uses a reference date equal to or prior to the date the legislation is enacted to insure that it is not delegating its power to tax to the United States Congress.

Taxpayers contend that they do not have income because the Internal Revenue Code does not define "income" and the United States Supreme Court has defined "income" to include only corporate profits. As Taxpayers state by citing *Conner v. United States*, 69-2 USTC ¶9662, and *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 decisions in *Conner v. United States* and *U.S. v. Ballard* do not support Taxpayers' position that they have no North Carolina income tax liability. In *Conner,* the court found that, while there may be differences of opinion as to what is or is not income, "the courts have chosen to use the meaning given the term in everyday use in common speech. … And the meaning of income in its everyday sense is a 'gain or recurrent benefit usually measured in money that derives from capital or labor.'" In *Ballard*, the court continued by reciting the Code's definition of "gross income," which includes compensation for services, including fees, commissions, and similar items (26 U.S.C. 61). Neither case dealt with the issue of whether wages are income. The issue in *Conner* was whether insurance proceeds that compensated the policyholder for living expenses incurred while a damaged residence was being repaired was income to the recipient. *Ballard* was concerned primarily with income from a merchandising business and whether gross income was the gross receipts from the business or 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.

Taxpayers contend that income is limited to corporate profit and cite *Eisner v. Macomber,* 252 U.S. 189, and *Merchant's Loan and Trust Co. v. Smietanka,* 255 U.S. 509, in support of their position. Neither case supports their 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. 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) There are many other cases that could be cited. Taxpayers can cite none that rule otherwise.

I find all of Taxpayers' arguments to be without merit. The proposed assessment for the tax year 1996 is hereby sustained in its entirety and is determined to be final and collectible, together with interest as allowed by law.

Made and entered this __27th__ day of __November__, 2000.

Signature____

Michael A. Hannah
Assistant Secretary of Revenue