

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 1994,)
1995, and 1996 by the Secretary of Revenue)
of North Carolina)
vs.)
[Applicant])

FINAL DECISION
Docket No. 2000-420

This matter was heard before the Acting Assistant Secretary of Administrative Hearings, Marilyn R. Mudge, in the city of Raleigh on May 10, 2001, upon an application for hearing by [Applicant], wherein he protested the proposed assessments of additional income tax for the taxable years 1994, 1995, and 1996. The hearing was held by the Acting Assistant Secretary of Administrative Hearings under the provisions of G.S. 105-260.1 and was attended by Applicant and Gregory B. Radford, Assistant Director of the Personal Taxes Division.

Pursuant to G.S. 105-159 and G.S. 105-241.1, assessments proposing additional tax, penalties, and accrued interest for the tax years 1994, 1995, and 1996 were mailed to Applicant on May 6, 2000. Applicant 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 Applicant for the taxable years 1994, 1995, and 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 E. Norris Tolson, Secretary of Revenue, to Marilyn R. Mudge, Acting Assistant Secretary of Administrative Hearings, dated March 13, 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 6, 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 6, 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 6, 2000, a copy of which is designated as Exhibit PT-4.
5. Letter from Kimberly Scott, Revenue Field Auditor, to Applicant dated April 4, 2000, with Field Auditor's Reports – Individual Income Tax for the tax years 1994, 1995, and 1996 attached, copies of which are collectively designated as Exhibit PT-5.
6. Internal Revenue Service Report of Income Tax Examination Changes dated October 28, 1997, a copy of which is designated as Exhibit PT-6.
7. Title 17, North Carolina Administrative Code, subchapter 6B, rule .0101, a copy of which is designated as Exhibit PT-7.
8. Letter from Applicant to D. Kimberly Scott dated April 27, 2000, with related attachments, copies of which are collectively designated as Exhibit PT-8.
9. Letter from Gregory B. Radford to Applicant dated May 16, 2000, a copy of which is designated as Exhibit PT-9.
10. Letter from Applicant to the Department of Revenue dated May 30, 2000, with related attachments, copies of which are collectively designated as Exhibit PT-10.
11. Letter from Gregory B. Radford to Applicant dated June 6, 2000, a copy of which is designated as Exhibit PT-11.
12. Letter from Applicant to Gregory B. Radford dated June 16, 2000, with related attachments, copies of which are collectively designated as Exhibit PT-12.
13. Letter from Michael A. Hannah, former Assistant Secretary of Revenue, to Applicant dated July 27, 2000, a copy of which is designated as Exhibit PT-13.
14. Letter from Michael A. Hannah to Applicant dated August 9, 2000, a copy of which is designated as Exhibit PT-14.
15. Letter from Michael A. Hannah to Applicant dated November 14, 2000, a copy of which is designated as Exhibit PT-15.
16. Letter from Applicant to Michael A. Hannah dated December 4, 2000, a copy of which is designated as Exhibit PT-16.
17. Letter from Michael A. Hannah to Applicant dated December 9, 2000, a copy of which is designated as Exhibit PT-17.
18. Letter from Applicant to Michael A. Hannah dated December 27, 2000, a copy of which is designated as Exhibit PT-18.

19. Letter from Muriel K. Offerman, former Secretary of Revenue, to Applicant dated January 19, 2001, a copy of which is designated as Exhibit PT-19.
20. Letter from Marilyn R. Mudge, Acting Assistant Secretary of Revenue, to Applicant dated April 24, 2001, a copy of which is designated as Exhibit PT-20.

At the hearing, Applicant presented the following evidence:

1. Special Preamble to Presentment dated May 10, 2001, a copy of which is designated as Exhibit TP-1.
2. G.S. 105-134.5, a copy of which is designated as Exhibit TP-2.
3. G.S. 105-228.90, a copy of which is designated as Exhibit TP-3.
4. G.S. 105-152, a copy of which is designated as Exhibit TP-4.
5. Administrative Interrogatories dated May 10, 2001, a copy of which is designated as Exhibit TP-5.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. Applicant is and at all material times was a natural person, sui juris, and a citizen and resident of North Carolina.
2. Applicant did not file North Carolina or federal individual income tax returns for the tax years 1994, 1995, and 1996.
3. The Department of Revenue received a report from the Internal Revenue Service indicating that the Internal Revenue Service had determined Applicant's federal taxable income to be \$3,725.00 for the tax year 1994; \$44,731.00 for the tax year 1995; and \$53,528.00 for the tax year 1996. The amounts were determined based on a filing status of married filing separate and allowing the standard deduction and one personal exemption.
4. Upon examination, the Department calculated Applicant's North Carolina taxable income for each year by increasing Applicant'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 \$4,850.00 for the tax year 1994; \$45,756.00 for the tax year 1995; and \$54,428.00 for the tax year 1996.
5. For the tax year 1994, Applicant understated taxable income by 52% of gross income. For the tax year 1995, Applicant understated taxable income by 96%. For the tax year 1996, Applicant understated taxable income by 99%.

6. Notices of Individual Income Tax Assessment proposing assessments of additional income tax, a twenty-five percent late filing penalty, a ten percent late payment penalty, a twenty-five percent negligence penalty, and accrued interest for each tax year were mailed to Applicant on May 6, 2000. The proposed assessments for the tax years 1995 and 1996 also included the penalty for underpayment of estimated income tax.
7. Applicant objected to the proposed assessments and timely requested an administrative tax hearing before the Secretary of Revenue.
8. Applicant did not present any evidence at the hearing that shows that his income, deductions, exemptions, or credits are other than those reflected in the assessments.

CONCLUSIONS OF LAW

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

1. One of the duties of the North Carolina Department of Revenue is to collect taxes due to the State.
2. Division II of Article 4 in Chapter 105 of the North Carolina General Statutes 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 tax imposed by Division II of Article 4 in Chapter 105. "Individual" is defined as a human being.
4. A resident of North Carolina is an individual who is domiciled in this State at any time during the taxable year or who resides in this State during the taxable year for other than a temporary or transitory purpose. In the absence of convincing proof to the contrary, an individual who is present within the State for more than 183 days during the taxable year is presumed to be a resident.
5. 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 as statutorily provided for differences in State and federal law.
6. Federal taxable income is defined in 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 interest. 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. Gross income also includes amounts received as prizes and awards.
7. In arriving at adjusted gross income, a deduction is allowed for one-half of the self-employment tax imposed for the taxable year.

8. A taxpayer who does not claim itemized deductions may claim a standard deduction. For a married person filing separate, the basic standard deduction is \$2,500.00. The basic standard deduction is increased each year for inflation. As a result, the standard deduction for a married person filing separate for the tax years 1994, 1995, and 1996, is \$3,175.00, \$3,275.00, and \$3,350.00, respectively.
9. A taxpayer may claim an exemption for himself and for each qualified dependent. The basic exemption amount is \$2,000.00. The basic exemption amount is increased each year for inflation. As a result, the personal exemption for an individual entitled to only one exemption for the tax years 1994, 1995, and 1996 is \$2,450.00, \$2,500.00, and \$2,550.00, respectively.
10. Additions to federal taxable income are required for the amount by which the taxpayer's standard deduction has been increased for inflation and the amount by which each of the taxpayer's personal exemptions has been increased for inflation under the Code. Additions of \$1,125.00, \$1,025.00, and \$900.00 were properly made for the tax years 1994, 1995, and 1996, respectively.
11. 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.
12. 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. 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. 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.
13. 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.
14. 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.
15. 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 \$1,000 or more. There are four required installments for the taxable year: April 15, June 15, and September 15 of the taxable year and January 15 of the following taxable year. The amount of each required installment is twenty-five percent of the lesser of ninety percent of the tax due for the taxable year or one hundred percent of the tax due for the preceding year. A penalty is imposed for any underpayment of estimated income tax. The penalty is in the nature of interest and is determined by applying the applicable annual interest rate to the amount of the underpayment for the period of

underpayment. Penalties of \$17.27 and \$185.37 were properly assessed for the tax years 1995 and 1996, respectively.

16. A penalty is imposed for failure to file a return when due. The penalty is equal to five percent of the tax for each month, or fraction of a month, the return is late (minimum \$5.00, maximum twenty-five percent). Penalties of \$73.25, \$774.50, and \$934.25 were properly assessed for the tax years 1994, 1995, and 1996, respectively.
17. A penalty is imposed for failure to pay tax when due. The penalty is equal to ten percent of the tax (minimum \$5.00). Penalties of \$29.30, \$309.80, and \$373.70 were properly assessed for the tax years 1994, 1995, and 1996, respectively.
18. 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. Penalties of \$73.25, \$774.50, and \$934.25 were properly assessed for the tax years 1994, 1995, and 1996, respectively.
19. The proposed assessments are lawful and proper based on the best information available.
20. The Department of Revenue was created under the provisions of the Executive Organization Act of 1973. 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. (*Insurance Co. v. Gold*, 254 NC 168). The constitutionality of the income tax statutes is not within the Secretary's jurisdiction.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Acting Assistant Secretary of Revenue finds the proposed assessments for the tax years 1994, 1995, and 1996 to be lawful and proper, and they are hereby affirmed.

Applicant presents two main arguments. First, he argues that he is not subject to the income tax laws of the State of North Carolina or the Internal Revenue Service because he is a sovereign citizen of the North Carolina Republic. Second, he argues that he has not earned any income or participated in any revenue taxable activity.

Applicant is certainly not the first to raise the issue of the authority of the government to tax a sovereign citizen of the "de jure" state. In *United States v. Cruikshank*, 92 U.S. 542

(1876), the Court held that “the people of the United States resident within any State are subject to two governments: one State, and the other National...” In *United States v. Collins*, 920 F.2d 619, 629 (10th Cir. 1990), the Court stated that “the tax code imposes a ‘direct nonapportioned [income] tax upon United States citizens throughout the nation, not just in federal enclaves, such as postal offices and Indian reservations.” In *Lonsdale v. United States*, 919 F.2d 1440, 1448 (10th Cir. 1990), the Court ruled that the argument that the United States’ authority is confined to the District of Columbia is “completely lacking in legal merit and patently frivolous.” In *Nieman v. Commissioner*, T. C. Memo 1993-533, the Court held that “we find no support in any of the authorities petitioner cites for his position that he is not subject to Federal income tax on income he earned in Illinois...Petitioner’s arguments are no more than stale tax protester contentions long dismissed summarily by this Court and all other courts which have heard such contentions.” In *L. T. Hanson*, CA-9, 94-1 USTC ¶50,075, the Court held that an individual’s claim that as a natural born citizen of Montana he was a nonresident alien exempt from the tax laws was without merit. The court held that an individual is a person under the Internal Revenue Code and thus subject to the provisions of the tax code. In *E. M. Lonsdale*, CA-10, 90-2 USTC ¶50,581, the Court determined that the following arguments alluded to by the taxpayers were completely lacking in legal merit and patently frivolous: (1) individuals (“free born, white, preamble, sovereign, natural, individual common law “de jure” citizens of a state, etc.”) are not “persons” subject to taxation under the Internal Revenue Code; and (2) the authority of the United States is confined to the District of Columbia. In *H.H. McKinley*, DC Ohio, 92-2 USTC ¶50,509, the taxpayers made the argument that Ohio is a sovereign state and, therefore, a separate country from the United States. As residents of Ohio, they are non-resident aliens and not subject to United States taxes. The Court rejected the argument.

Applicant contends that he does not have income because the Internal Revenue Code does not define “income” and the United States Supreme Court’s definition of “income” does not include wages and compensation for labor, except for selected groups of individuals, such as

government employees. Instead, income is limited to corporate profits and gains derived. As Applicant states 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 Applicant’s position that he has 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. The courts have consistently held that wages and other forms of compensation for services rendered are income. (See *E. M. Lonsdale*, *supra*; *H.H. McKinley*, *supra*; *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.); *United States v. Collins*, supra. There are many other cases that could be cited. Applicant's arguments are very similar to the ones raised in *Stelly*. In that case, the Court held that "[t]he frivolity of this argument is patently obvious. It is clear beyond peradventure that the income tax on wages is constitutional. Every court that has addressed the issue of the constitutionality of the income tax on wages, 28 U. S. C. §61(a), has held the statute valid." In *Ficalora*, the appellant was employed by the New York Telephone Company, not the government, and his wages were determined to be taxable. In *Collins*, the individual was employed by CDI Corporation and his wages were held to be taxable.

Applicant also contends that the United States (or a State) cannot impose a mandatory, graduated, non-apportioned income tax on property belonging to citizens of the United States. In *Ficalora*, the Court held that Congress had the constitutional authority to impose an income tax on individuals. The court cited the United States Supreme Court's decision in *Pollock* (157 U.S. 429), which explicitly stated that taxes on income from employment were not direct taxes and were not subject to the necessity of apportionment. Furthermore, the Sixteenth Amendment granted Congress the power to lay and collect taxes on incomes, from whatever source derived, without apportionment. In *United States v. Gerads*, 999 F.2d 1255 (8th Cir. 1993), the Court stated "we have rejected on numerous occasions, the tax-protester argument that the federal income tax is an unconstitutional direct tax that must be apportioned."

Finally, Applicant presented administrative interrogatories and requested answers to those questions. Many of the questions have been answered by the Department of Revenue in their various correspondence with Applicant, the Brief for Tax Hearing, and in this Final Decision. Other questions are either not within the purview of the Department or are not relevant to Applicant's arguments. The Department is under no obligation to utilize its time and resources to answer questions that are not germane to the issue of determining an individual's proper income tax liability.

I find all of Applicant's arguments to be without merit. Applicant has not availed himself of the numerous opportunities afforded to him by the Department of Revenue to provide evidence that his income, deductions, exemptions, or credits are different than the amounts used by the Department in calculating his North Carolina income tax liability. The proposed assessments for the tax years 1994, 1995, and 1996 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 9th day of July, 2001.

Signature _____

Marilyn R. Mudge

Acting Assistant Secretary of Administrative Hearings