

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Additional)
Income Tax for the Taxable Year 1999 by)
the Secretary of Revenue of North Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 2001-20

This matter was heard before the Acting Assistant Secretary of Administrative Hearings, Marilyn R. Mudge, in the city of Raleigh on May 2, 2001, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessment of additional income tax for the taxable year 1999. The hearing was held under the provisions of G.S. 105-260.1 and was attended by Taxpayer and Gregory B. Radford, Assistant Director of the Personal Taxes Division.

Pursuant to G.S. 105-241.1, an assessment proposing additional tax, a twenty-five percent negligence penalty, and accrued interest totaling \$4,352.99 for the tax year 1999 was mailed to Taxpayer on August 23, 2000. Taxpayer filed a timely protest to the proposed assessment and 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 proposed against Taxpayer for the taxable year 1999 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. Taxpayer's North Carolina individual income tax return for the taxable year 1999 with related attachments, copies of which are collectively designated as Exhibit PT-2.

3. Notice of Individual Income Tax Assessment for the taxable year 1999 dated August 23, 2000, a copy of which is designated as Exhibit PT-3.
4. Federal income tax return detail information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1999, a copy of which is designated as Exhibit PT-4.
5. Title 17, North Carolina Administrative Code, subchapter 6B, rule .0101, a copy of which is designated as Exhibit PT-5.
6. Letter from L. E. Davis, Tax Auditor, to [a payroll service] dated August 7, 2000, a copy of which is designated as Exhibit PT-6.
7. Information provided by [a payroll service] in reply to Exhibit PT-6, copies of which are collectively designated as Exhibit PT-7.
8. Letter from Taxpayer to the Department of Revenue dated September 17, 2000, with related attachments, copies of which are collectively designated as Exhibit PT-8.
9. Letter from Gregory B. Radford to Taxpayer dated October 12, 2000, a copy of which is designated as Exhibit PT-9.
10. Letter from Michael A. Hannah, former Assistant Secretary of Revenue, to Taxpayer dated November 20, 2000, a copy of which is designated as Exhibit PT-10.
11. Letter from Michael A. Hannah to Taxpayer dated December 27, 2000, a copy of which is designated as Exhibit PT-11.
12. Letter from Marilyn R. Mudge to Taxpayer dated February 28, 2001, a copy of which is designated as Exhibit PT-12.

FINDINGS OF FACT

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

1. Taxpayer was, at all material times, a natural person, sui juris, and a citizen and resident of North Carolina.
2. Taxpayer timely filed his North Carolina income tax return for the tax year 1999. Taxpayer's 1999 return reflected federal taxable income of zero, North Carolina income tax of zero, and an overpayment of \$2,892.00, equal to the North Carolina tax withheld by his employer. Taxpayer requested that the overpayment be refunded to him.
3. Upon examination, the Department calculated Taxpayer's federal taxable income to be \$48,692.00 by subtracting the standard deduction for an unmarried individual and one personal exemption from total wages as reported by the Employment Security Commission. The Department calculated North Carolina taxable income to be \$50,242.00 by increasing federal taxable income for the difference in the State and federal standard deductions and personal exemptions.

4. 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 \$4,352.99 was mailed to Taxpayer on August 23, 2000.
5. Taxpayer objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.
6. The proposed assessment did not allow Taxpayer credit for the North Carolina income tax of \$2,892.00 withheld from his wages by his employer.
7. Subsequent to the proposed assessment, federal tax return detail for the tax year 1999 was received from the Internal Revenue Service. The report shows that federal taxable income was determined by the Internal Revenue Service to be \$50,960.00, \$2,268.00 more than calculated by the Department of Revenue in determining North Carolina taxable income in the proposed assessment.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Acting 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 gross income derived from business. 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 the taxpayer's filing status. Additions of \$1,550.00 were properly made for the tax year 1999.

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. 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.
9. 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.
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. 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.
13. 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 twenty-five percent negligence penalty was properly assessed for the tax year 1999 because Taxpayer understated taxable income by 91% of gross income. The amount of penalty must be corrected to equal \$164.25 to recognize the increase of \$2,268.00 in federal taxable income and the reduction in tax liability by allowing credit for North Carolina income tax withheld.
14. 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.
15. The proposed assessment for the tax year 1999 is lawful and proper based on the best information available except that North Carolina taxable income reflected in the proposed assessment must be increased by \$2,268.00 for the difference in federal

taxable income as determined by the Internal Revenue Service and federal taxable income as calculated by the Department of Revenue in the proposed assessment; credit must be allowed for the \$2,892.00 of North Carolina income tax withheld by Taxpayer's employer; and the twenty-five percent negligence penalty must be calculated on the corrected tax liability after making the other two adjustments.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Acting Assistant Secretary of Administrative Hearings finds the proposed assessment for the tax year 1999, to the extent hereinafter modified, to be lawful and proper and is hereby affirmed.

Taxpayer presents many arguments in defense of his position that the assessment is in error. These arguments have been made on many occasions both before the courts and in previous administrative tax hearings by individuals who object to the payment of income tax. The arguments include (1) Taxpayer earned no income; (2) the Internal Revenue Code does not impose an income tax liability or require that income tax be paid on the basis of a return; (3) no statute authorizes the Internal Revenue Service or North Carolina Department of Revenue to change Taxpayer's return; and (4) income tax is voluntary and taxpayer is the only one who can "self-assess" the tax.

I concur with the Final Decisions rendered in previous administrative tax hearings (see Final Decisions for Docket Nos. 2000-340 and 2000-370) and find that the Department's Brief for Tax Hearing adequately addresses those arguments. Taxpayer also cites two cases in support of his claim that he earned no income that have not previously been addressed in Final Decisions. Those cases are *Millard F. Staples and Emily S. Staples v. United States of America*, 38-1 USTC ¶9023 and *Bowers v. Kerbaugh-Empire Company*, 271 U.S. 170. Neither of the cases supports Taxpayer's argument. In *Staples*, the issue was whether the value of a building erected by a lessee is income to the lessor. In *Kerbaugh*, the issue was whether the difference in the value of German marks measured by dollars at the time of payment of a loan and the value when the loan was made was income. Neither case dealt with whether wages

are income, as is the issue in this case. Both cases cite the same case law the Department cited in reaching the conclusion that income may be defined as gain derived from capital, from labor, or from both combined.

Taxpayer also presents three other arguments that I will more fully address. Those arguments are: (1) the enactment of the Internal Revenue Code of 1954 resulted in salaries, wages, and compensation for personal services no longer being gross income; (2) pursuant to Code sections 871 and 911, only nonresident aliens and citizens of the United States working outside of the United States are subject to income tax; and (3) 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.

Taxpayer is correct in his claim that the Internal Revenue Code of 1939 specifically provided that gross income includes "income derived from salaries, wages, or compensation for personal service" while section 61 of the Internal Revenue Code of 1954 no longer specifically includes salaries and wages in the listed items of income. Taxpayer asserts that the deletion of those terms indicates Congress' intent to no longer subject salaries and wages to the income tax. However, the regulations for Code section 61 and innumerable court cases completely overcome Taxpayer's assertions. Pursuant to Regulation §1.61-2(a)(1), 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. That regulation was proposed on November 2, 1956, and was adopted on November 25, 1957, subsequent to the enactment of the Internal Revenue Code of 1954. 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. Taxpayer can cite none that rule otherwise.

Taxpayer contends that, pursuant to Code sections 871 and 911, only nonresident aliens and citizens of the United States working outside of the United States are subject to income tax. Such is not the case. For a citizen of the United States, the source of income is irrelevant. In *Glenshaw Glass Co.*, 348 U.S. 426, 55-1 USTC ¶9308, the court concluded that income tax is imposed on “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion” with no restrictions as to “sources.” Regulation 1.1-1(b) provides that “in general, all citizens of the United States, wherever resident, and all resident alien individuals, are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.” Code section 861 provides that the income of most citizens is from sources within the United States. Section 861(a) lists items of gross income that are treated as income from sources within the United States. Item (3) is compensation for labor or personal services performed in the United States. Regulation 1.861-4(a)(1) states that “gross income from sources within the United States includes compensation for labor or personal services performed in the United States irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment...” In *Aiello v. Commissioner*, T.C. Memo 1995-40, the court stated “Apparently, petitioner believes that the only sources of income for purposes of section 61 are listed in section 861, that income from sources within the United States is taxed only to nonresident aliens and foreign corporations...Under section 61(a)(1) and (4), petitioner clearly is required to include his wages, tokens, and interest in gross income.” Code sections 871 and 911 only provide direction as to the effect of being a nonresident or of working overseas on the calculation of taxable income.

Taxpayer contends 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. Taxpayer's 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 the same as 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.

The federal tax return detail information received by the Department of Revenue from the Internal Revenue Service reflects federal taxable income that exceeds the amount used by the Department of Revenue in the proposed assessment by \$2,268.00. Taxpayer's employer withheld \$2,892.00 of North Carolina income tax from Taxpayer's wages that was not allowed as a credit in the proposed assessment. The proposed assessment of income tax, penalty, and interest for the tax year 1999, modified to increase North Carolina taxable income by \$2,268.00; to allow credit for North Carolina income tax withheld; and to make corresponding changes in the amount of penalty and interest due as a result of the revised tax; is found to be lawful and proper in every respect and is hereby determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this 22nd day of May, 2001.

Signature _____

Marilyn R. Mudge
Acting Assistant Secretary of Administrative Hearings